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Super and bankruptcy: protecting your nest egg

Superannuation represents the largest asset for many Australians. However with tough economic times, bankruptcy and other insolvency activity is on the rise. In the September 2008 quarter there were 9,007 instances of total personal insolvency activity (including 6,693 new bankruptcies). This is an increase of 12.57% against the same period in 2007–08. An important question therefore becomes: how is superannuation treated upon bankruptcy? To properly answer this question, it is vital to understand what the former bankruptcy provisions were and how they have recently changed.

The bad old days: the former bankruptcy provisions

Not so long ago, all property that belonged to a bankrupt at the start of the bankruptcy was divisible amongst the creditors of the bankrupt. This raised the tricky question: was an interest in a superannuation fund 'property'? Bankruptcy legislation expressly answered this question with a no: the interest of a bankrupt in a regulated superannuation fund was not property divisible among creditors.

However, this protection of superannuation was not absolute. The excess of a bankruptcy's interest in a superannuation fund that exceeded the pension RBL did constitute property that was divisible among creditors. For example, in the 2007 financial year, this typically meant that only the first $1,356,291 of a bankrupt's superannuation interests was protected. Anything over that amount generally was available to creditors.

The law on undervalued transactions was also a sticking point. If a person transferred property within two years before bankruptcy for no consideration, or less than market value, the property could be 'clawed back' by creditors. This raised the question: is a contribution by a member to a superannuation fund for consideration? If so, what is the consideration that the member receives and is the consideration less than market value?

Recent changes

Simpler Super

The simpler super reforms in mid-2007 marked a large change for superannuation upon bankruptcy. The main change was the deletion of the provision in the bankruptcy legislation that effectively provided that the excess over the bankruptcy's pension RBL was available to creditors. This means that the protection of superannuation upon bankruptcy now is — subject to the discussion below — absolute. A bankrupt can now have an extraordinary large amount in a superannuation fund — even $1 billion theoretically — and this amount can be fully protected.

The government officially described the changes as follows:

> Currently, under the Bankruptcy Act 1966, a bankrupt's interest in a superannuation fund up to the bankrupt's pension RBL is protected from being divisible amongst creditors. A bankrupt's superannuation interest in excess of the pension RBL automatically vests in the bankruptcy trustee.
>
> The amendments remove references to RBLs from the Bankruptcy Act 1966 to ensure consistency with the new Simplified Superannuation rules which abolish RBLs with effect from 1 July 2007. *This means that, from 1 July 2007, a bankrupt's entire interest in a superannuation fund is protected from being divisible amongst creditors* [emphasis added]

Cook v Benson

The High Court decision of *Cook v Benson* considered the case of Peter Benson who became entitled to a lump sum from a superannuation fund. Shortly before becoming bankrupt, Benson rolled that money into other superannuation funds. Benson could have used that money to 'have purchased a sports car, a recreational boat, a block of land or some other asset which ... [and if he had done so] it would have been available to his creditors upon his subsequent bankruptcy.'

The High Court considered whether the trustees of the superannuation funds that received moneys had given 'valuable consideration' for the moneys they received. The majority held that the trustees had given valuable consideration. The consideration was the valuable covenants, duties and obligations assumed by the trustees of funds (eg, obligation to provide insurance, pay retirement and death benefits, be bound by terms of deed, etc).

The important implication of this case is that if a person transfers property to the trustee of a superannuation fund (even if it is only one day before bankruptcy) the property cannot be 'clawed back' by creditors pursuant to the 'undervalued transaction' provision. This is because it is not an undervalued transaction (ie, the member received valuable consideration for the transfer). There were other provisions of the bankruptcy legislation as it then was that could be used to try to claw back property.

However, these provisions are often difficult to use where a member receives valuable consideration.

In response to Cook v Benson, the bankruptcy legislation was amended. New provisions were inserted that effectively mean a contribution to a superannuation fund can be 'clawed back' if the transferor's main purpose was either to:

- prevent the transferred property being available to creditors; or
- hinder or delay the process of making property for division among creditors.

The new provisions outline a number of ways in which a main purpose is taken to be to prevent/hinder/delay.

One way it can be reasonably inferred that the member's main purpose was to prevent/hinder/delay is if he or she was insolvent. There is a rebuttable presumption of insolvency if the member fails to keep and preserve usual records, accounts etc to disclose their solvency. These new provisions apply to any contribution to a superannuation fund after 27 July 2006.) Consider an example where a member contributes to a superannuation fund on 28 July 2006 but then in 2026 no longer has records to disclose their solvency. If the member became a bankrupt in 2026, theoretically creditors can claw back the 2006 contribution from the superannuation fund. That is, there is a rebuttable presumption of insolvency. This means — unless the member can rebut the presumption — the member's main purpose is taken to be to prevent/hinder/delay creditors and thus the contribution can be clawed back ... even 20 years after the contribution! The point here is that it is vital to make records, accounts etc and to keep them!

Another way the main purpose can be reasonably inferred is where the contribution is 'out of character'. Consider a member who contributions $100 each every week for 20 years to a super fund and then becomes bankrupt. The $100 that he or she contributed in the week before bankruptcy is not out of character and therefore is unlikely to have the main purpose of preventing/hindering/delaying creditors. Alternatively, consider a member who has only made one contribution ever and shortly after becoming bankrupt. It is far more likely that this would be held to be out of character. That being said though there are still arguments as to why this could be in character. For example, perhaps the member can prove that he or she has always wanted to contribute to superannuation but lacked free cash flow until that point in time and the bankruptcy was a mere coincidence.

Creditors are also free to use any other way they feel is appropriate to establish the main purpose in making a transfer.

Self managed super funds and bankruptcy

Remember that a 'disqualified person' must not be a trustee of a superannuation entity. A disqualified person includes a person who is an insolvent under administration (which includes an undischarged bankrupt).

This means that if a person has an SMSF, they must resign/retire as a trustee (or director of the corporate trustee) before becoming bankrupt. Failure to do so can result in imprisonment for up to two years. After the person resigns/retires, the SMSF will probably fail to meet the basic conditions necessary to be an SMSF. Naturally, this is because there will be a member who is not a trustee (or a director of the corporate trustee). However, this is not necessarily fatal because the SMSF has a period of grace of up to six months in which to restructure. Restructuring can include rolling the bankrupt's superannuation interests to a non-SMSF superannuation fund. Alternatively, it can involve appointing an RSE licensee to act as trustee of the SMSF (at which point the fund would stop being an SMSF and would become another type of superannuation fund). Although RSE licensees can be expensive, this is preferable where the fund has 'lumpy' non-liquid assets that can not readily be rolled to another superannuation fund.

Typically, a person who holds an enduring power of attorney in respect of a member can act as trustee of the SMSF instead of the member. However, this does not apply in respect of a member who is bankrupt.

Benefits from superannuation funds

Subject to the discussion above, an interest in a superannuation fund is fully protected upon bankruptcy. So is any lump sum received from a superannuation fund after a person becomes bankrupt. This means that a bankrupt who receives, say, a lump sum of $10 million from a superannuation fund, could keep that money in their own name. Typically all of that money would be unavailable to their creditors. To put it colloquially, any money received from a superannuation fund by way of lump sum has a halo around it.

The same is not true of pension payments received from superannuation funds. They are expressly denied the protection that interests in — and lump sums from — superannuation funds receive.(xxvi) Pension payments are treated as income(xxvii) and income only receives minimal protection from creditors. The exact level of protection afforded to pension payments is adjusted for inflation twice a year, but as at 22 October 2008, the level is as follows:

Number of Dependants	Income Limit
0	$41 250.30
1	$48 675.35
2	$52 387.88
3	$54 450.40
4	$55 275.40
More than 4	$56 100.41

Income in excess of the above limits is typically available to creditors.

The difference in the treatment between lump sums and pensions has important practical implications now that account-based pensions have been introduced. Unlike other types of pensions, account-based pensions have no maximum periodic payment limit. With allocated pensions, there is a maximum amount of pension payment and any money drawn in excess of that amount would be treated as a partial commutation (ie, a lump sum).

Consider Bill who is bankrupt, has no dependants and receives an allocated pension that was worth $1 million on 1 July of this financial year. Bill was 60 years old on 1 July. Bill withdraws $400,000 from his allocated pension account. Only a maximum of $91,740 can be treated as a pension payment and — subject to his fund's specific governing rules — the rest must be treated as a partial commutation lump sum. This means of the $91,740 pension payment, only $50,489.70 is available to creditors and the $308,260 lump sum is fully protected.

However, if the trustee of Bill's superannuation fund converts his allocated pension to an account-based pension, $358,749.70 is available to creditors.

Superannuation v discretionary trusts

It is worth noting that the recent case of ASIC, Re *Richstar Enterprises Pty Ltd v Carey (No 6)* has called in question the effectiveness of family discretionary trusts upon bankruptcy. This is an interesting development in light of the changes in respect of superannuation and bankruptcy. The recent High Court case of *Kennon v Spry*, which involved a family law dispute, also demonstrates the ability of the courts to look through to the assets of discretionary trusts.

Conclusion

Now — unlike the not-so-distant past — a person can have a large amount of money in a superannuation fund and this is generally fully protected upon bankruptcy. The same is often true for contributions to superannuation funds, provided that the contribution is not out of character and that the member retains records to prove that they were solvent at the time of the contributions. SMSFs cease to be appropriate for those who are bankrupt. Provided benefits are structured properly, bankrupts can draw an unlimited amount as lump sums from superannuation funds and those amounts are not available to creditors.

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