

## Is super safe from bankruptcy?

Julie Fox, Senior Technical Manager, FirstTech | 22 February 2022

One of the advantages of investing in superannuation is that it may offer protection from creditors in the event of bankruptcy. This protection is particularly important for small business owners or clients in high risk professions.

### Overview

Generally superannuation held in a regulated superannuation fund at the date of bankruptcy is protected property. Lump sums paid from the fund to the bankrupt during bankruptcy are protected, and any property purchased with those amounts is also protected.

In some situations superannuation is not protected from bankruptcy. If your client is facing bankruptcy, it is important to consider:

- Super withdrawn prior to the date of bankruptcy is not protected.
- Where property was transferred to a super fund before the date of bankruptcy to defeat creditors, the property is not protected. This includes transfers made by the bankrupt and transfers made by third parties for the benefit of the bankrupt.
- For the period of bankruptcy, the client must make payments to the bankruptcy trustee of half of any income they earn over a certain threshold. Gross annual pension payments from a superannuation income stream are included in the definition of income for this purpose.

### Insolvency v bankruptcy

The focus of this article is bankruptcy and super, so it is important to understand the meaning of bankruptcy and how it differs from insolvency.

Insolvency is when a company or person can't pay debts when they are due. Bankruptcy, which is the focus of this article, is just one option for dealing with personal insolvency.

### Corporate insolvency reform

Corporate insolvency is beyond the scope of this article. The most common corporate insolvency procedures for an insolvent company are liquidation, voluntary administration and receivership.

Significant corporate insolvency reform came into effect at the beginning of 2021.<sup>1</sup>

A new formal debt restructuring process was established for eligible small companies to be supervised by Small Business Restructuring Practitioners (SBRP). This enables financially distressed but viable companies to restructure

---

<sup>1</sup> The [Corporations Amendment \(Corporate Insolvency Reforms\) Act 2020](#) commenced on 1 January 2021.

their existing debts so that they can continue to trade.

ASIC regulates insolvent companies. See the [ASIC website](#) for more information on corporate insolvency.

## Personal insolvency

Options for dealing with personal insolvency include:

- **bankruptcy** (detailed in the next section)
- **debt agreements** - also known as a Part IX (9) agreement, is a legally binding agreement between the client and their creditors. A percentage of the combined debt that the client can afford over a period of time is negotiated to be paid via a 'debt agreement administrator'.
- **personal insolvency agreements (PIA)** – also known as a Part X (10) agreement, is a legally binding agreement between the client and their creditors. A trustee is appointed to take control of the client's property and make an offer to their creditors. The offer may be to pay part or all of the client's debts by instalments or a lump sum.
- **temporary debt protection** - provides a 21 day protection period in which unsecured creditors (including sheriffs) can't take enforcement action to recover money owed.

While the focus of this article is bankruptcy, personal insolvency agreements can have similar consequences to bankruptcy, including the inability to be a company director, and the inability to be a director of a corporate trustee of an SMSF.<sup>2</sup>

The [Australian Financial Security Authority \(AFSA\)](#) provides information and resources regarding the personal insolvency options above.

## Bankruptcy

A client who is insolvent is 'bankrupt' if they have been declared bankrupt under the provisions of the *Bankruptcy Act 1966* and have not been discharged from the bankruptcy. The bankruptcy is registered with the Australian Financial Security Authority (AFSA).

Bankruptcy can be initiated on an involuntary or voluntary basis.

### Involuntary bankruptcy

Involuntary bankruptcy generally involves a creditor owed \$10,000<sup>3</sup> or more. A bankruptcy notice served on the client requires payment of the debt within the timeframe given in the notice (generally 21 days).<sup>4</sup> If the client does not make the required payment, the creditor can complete a creditor's petition for the client to be declared bankrupt. If the application is approved a sequestration order will be made by the court which makes the client bankrupt.

### Voluntary bankruptcy

Voluntarily bankruptcy involves the client lodging a debtor's petition to AFSA to become a bankrupt.

### Consequences of bankruptcy

Once a client is declared bankrupt, most unsecured creditors are unable to pursue further legal action (although in rare cases the courts have allowed creditors to continue with court action).

Once the period of bankruptcy ends the client is 'discharged' from bankruptcy and most of the client's debts are cleared through the sale of assets and compulsory payments.

However, some of the consequences of bankruptcy include:

- A trustee will manage the client's bankruptcy.
- Bankruptcy may affect income, employment and business.
- Bankruptcy does not release the client from all debts. If secured debts cannot be paid, the client will have to surrender the secured item back to the creditor.
- It affects the client's ability to travel overseas.
- The client's name will permanently appear on the National Personal Insolvency Index (NPII).
- Bankruptcy can affect the client's ability to obtain future credit. A client's credit report will continue to show their bankruptcy for either:
  - 2 years from when their bankruptcy ends or

<sup>2</sup> See ASIC, Information Sheet ([INFO 14](#)) for more information.

<sup>3</sup> Reg 10A *Bankruptcy Regulations 2021*. Note: the *Bankruptcy Regulations 2021*, remade the *Bankruptcy Regulations 1996* on 1 April 2021 in substantially the same form, with minor and technical amendments.

<sup>4</sup> If the bankruptcy notice was issued before 25 March 2020 or after 31 December 2020, the client has 21 days to pay the amount owed.

- 5 years from the date they became bankrupt (whichever is later).
- The trustee may sell the client’s assets.
- The client may lose the right to take or continue legal action.
- Bankruptcy normally lasts for 3 years and 1 day from the day AFSA accept the client’s bankruptcy form

AFSA provides further information on the [Consequences of bankruptcy](#) on their website.

### Consequences for directors

One particularly important consequence of bankruptcy is that a bankrupt client is automatically disqualified<sup>5</sup> from managing corporations and ceases to be a director, alternate director or secretary of a company under the Corporations Act, if they are an undischarged bankrupt, or if they have entered into a personal insolvency agreement which hasn’t been fully complied with. Bankruptcy will trigger certain reporting obligations to ASIC.

For more information please see *ASIC Information Sheet (INFO 14) for general information for directors, alternate directors and secretaries about bankruptcy and personal insolvency agreements*.

For the impact on SMSFs, see *SMSFs and bankruptcy* below.

### Which assets are divisible amongst creditors?

When bankruptcy is declared, a trustee registered with AFSA is appointed to administer the client’s estate. The bankruptcy trustee has powers under the Bankruptcy Act to sell the client’s divisible assets or recover income over the allowable income threshold, to repay debts.

Section 116(1) of the *Bankruptcy Act 1966* provides a broad description of property that is divisible amongst creditors, including all property that:

- belonged to, or was vested in, the client at the commencement of the bankruptcy

- is acquired by the client, or devolves on them, after the commencement of the bankruptcy and before discharge

Divisible assets do not extend to property held by the bankrupt in trust for another person.

Certain assets, including superannuation, are specifically excluded from the definition of assets that are divisible among creditors.

### Superannuation assets

An interest in a regulated superannuation fund, approved deposit fund or exempt public sector superannuation scheme is specifically protected in bankruptcy, subject to any contributions that were made to defeat creditors (see next section).<sup>6</sup>

Any payment to the bankrupt from superannuation, received on or after the date of the bankruptcy, is also protected if the payment is not a pension payment within the meaning of the SIS Act<sup>7</sup>.

This protection extends to any assets purchased with the superannuation proceeds on or after the date of bankruptcy.<sup>8</sup>

#### Example 1

June cannot pay her debts, which exceed the amount she has in her super fund. She is able to access her super fund due to being at retirement age. Her adviser suggests she does not obtain any amounts of money from her fund before her expected bankruptcy. The money withdrawn prior to bankruptcy could be absorbed by the bankruptcy trustee.

Once June has become bankrupt, she can legally access her super (due to meeting the retirement condition of release) and this lump sum payment is protected from the bankruptcy trustee. This includes any purchases made with those funds.

If June commenced an income stream during the bankruptcy period, 50% of any income over the

<sup>5</sup> Unless a client has been given leave by the court to manage corporations.

<sup>6</sup> Section 116(2)(d)(iii) *Bankruptcy Act 1966*

<sup>7</sup> Section 116(2)(d)(iv) *Bankruptcy Act 1966*

<sup>8</sup> Section 116(2D)(a)[exempt money and protected money], 116(3) and Section 58(6) *Bankruptcy Act 1966*. After-acquired property,

in relation to a bankrupt, means property that is acquired by, or devolves on, the bankrupt on or after the date of the bankruptcy, being property that is divisible amongst the creditors of the bankrupt. See also AFSA, [Treatment of property in bankruptcy](#).

bankruptcy income threshold could be absorbed by the bankruptcy trustee (see Income stream payments section below).

The protection of superannuation applies regardless of whether the interest is in accumulation or pension phase. The protection also applies regardless of the preservation status of the funds, that is, even if the funds are unrestricted non-preserved.

So when are a client's superannuation benefits recoverable by the bankruptcy trustee?

## Contributions made to defeat creditors

The Bankruptcy Act contains specific provisions which allow a Bankruptcy Trustee to recover superannuation contributions where the main purpose of the contributions was to defeat creditors.

These provisions were enacted to prevent people from moving money or property into superannuation and when they later became bankrupt, relying on the exclusion of superannuation from the definition of divisible property.

In order for the bankruptcy trustee to establish that the contribution was a void transaction:

- the transfer must occur before bankruptcy (and after 28 July 2006 when the legislation came into force)
- the property would otherwise have become part of the bankrupt estate and have been available to creditors
- the client's main purpose was to prevent the property from being available to creditors or to delay the process of making the property available to the Bankruptcy Trustee.<sup>9</sup>

Sections 128B and 128C of the *Bankruptcy Act 1966* deal specifically with superannuation contributions made to defeat creditors.

Section 128B allows contributions made by a client such as personal after tax contributions or personal concessional contributions to be remitted to the Bankruptcy Trustee.

Section 128C enables the Bankruptcy Trustee to claw back contributions made by third parties, for example employer contributions such as salary sacrifice.

Superannuation guarantee contributions are protected as they are compulsory and are not made with the intention of defeating creditors.

In determining whether a contribution was made to defeat creditors, the pattern of contributions needs to be considered, specifically whether any contributions leading up to bankruptcy can be considered "out of character". In determining whether a contribution is able to be recovered, it will be up to the contributor to explain the purpose of any contributions.

## Example 2

John has a regular salary sacrifice arrangement in place of \$10,000pa for five years before becoming bankrupt. In the year prior to becoming bankrupt, John increases his salary sacrifice contributions to \$40,000.

The bankruptcy trustee makes an application to the Official Receiver to recover the salary sacrifice contribution.

When determining whether this contribution can be recovered, the pattern of contributions is considered. John argues that he increased his superannuation contributions to provide for his retirement. The bankruptcy trustee argues that the contribution is out of character and was made with the intention of defeating creditors.

The Official Receiver reviews the evidence and makes a decision that the superannuation contribution is voidable. The Official Receiver then issues a notice to the superannuation fund requiring the funds to be remitted to the bankruptcy trustee.

## Payments from super funds

### Before bankruptcy

Super payments (income or lump sums) received before bankruptcy:

- are claimable by the bankruptcy trustee
- the bankruptcy trustee can claim assets purchased with those funds, e.g. a house.

<sup>9</sup> Official Receiver Practice Statement 7

## During bankruptcy

Super lump sum payments received during the bankruptcy period:

- are not claimable by the bankruptcy trustee if it is a lump sum payment
- the bankruptcy trustee cannot claim assets purchased with those funds, e.g. car.

Super income stream payments received during the bankruptcy period form part of assessable income. If income is over a set amount, compulsory payments may be required.<sup>10</sup>

## Superannuation income stream payments

For the period of bankruptcy, the client must make payments to the bankruptcy trustee of half of any income they earn over a certain threshold. The threshold<sup>11</sup> is set at 3.5 times the maximum basic rate of age pension for a member of a couple. As at 20 September 2021 this is **\$60,515.00** (higher if the client has dependants).

Importantly, gross annual pension payments from a superannuation income stream are included in the definition of income for this purpose.<sup>12</sup>

When determining whether a bankrupt client should draw pension payments from their superannuation fund, consideration should be given to limiting the amount of pension payments to ensure their total income is below the relevant threshold.

## Case study

John is age 59 and having financial difficulties. He is considering declaring voluntary bankruptcy.

John is working part-time earning \$50,000pa. In addition, he has a transition to retirement pension that he commenced at age 58 and is drawing pension payments of \$15,000pa.

If John continues to receive this level of pension payments, his income for bankruptcy purposes is:

\$65,000 pa (\$50,000 + \$15,000)

As this exceeds the income threshold of \$60,515.00, he would have to pay 50% of the excess to the bankruptcy trustee.

This equates to:

$(\$65,000 - \$60,515.00) \times 50\% = \$2,242.50\text{pa}$

Alternatively, John could reduce the pension payments from his TTR pension to \$10,515 (assuming this satisfies the minimum TTR payment requirement) which ensures that his income is below the threshold.

## SMSFs and bankruptcy

A client who is an undischarged bankrupt, or has executed a personal insolvency agreement, will be a disqualified person under superannuation legislation.<sup>13</sup>

The appointment of a restructuring practitioner under the insolvency reforms is also an insolvency event that triggers the disqualification of a corporate trustee, custodian or investment manager of a superannuation entity from managing a superannuation entity.<sup>14</sup>

This means the client:

- must not act as trustee of an SMSF or act as a director of a corporate trustee of an SMSF.<sup>15</sup>

<sup>10</sup> AFSA, *Is my superannuation affected?*

<sup>11</sup> The 'base income threshold amount' is defined in s 139K *Bankruptcy Act 1966*. This base amount is increased by up to 36%, depending on the number of dependants.

<sup>12</sup> s 139L(1)(a)(i) *Bankruptcy Act 1966*

<sup>13</sup> s 120 *Superannuation Industry Supervision Act 1994* and s10 definition of insolvent under administration.

<sup>14</sup> **Explanatory Memorandum**, Treasury Laws Amendment (2021 Measures No. 5) Bill 2021, para 2.27

<sup>15</sup> Where a responsible officer (eg, director) of a fund's corporate trustee is a disqualified person, the corporate trustee is also a disqualified person and must immediately cease to be the fund's trustee.



- must immediately inform the ATO that they have become a disqualified person.

Since each member of an SMSF must be either a trustee of the SMSF or a director of the fund's corporate trustee, once a member becomes bankrupt they cannot have an SMSF.

The SMSF definition in section 17A of SIS confirms that a legal personal representative is not permitted to act as a trustee in the disqualified person's place. For example, a trustee who has become disqualified due to becoming bankrupt could not appoint someone else to act as trustee in their place.

While a person who becomes bankrupt must immediately cease to be a trustee or director of a corporate trustee of an SMSF, the SMSF definition provides a six-month grace period during which the person can remain a member of the fund, allowing the SMSF to deal with this issue and make alternate arrangements.

Potential solutions may include:

- rolling over to a retail superannuation fund. However, this could force the sale of fund assets, triggering transaction costs and tax liabilities.
- Converting the SMSF to a small APRA fund.

### FirstTech comment: Protection of SMSF assets

Where a client has an SMSF, it is important for the trustee to ensure the asset is properly identified as being held in trust for the SMSF.

As well as satisfying the requirement under both the SIS Covenants and the SIS Regulations to keep money and other assets of the fund separate from the money and personal assets of the trustee and any related parties, correctly identifying assets as being held in trust for the SMSF will assist to protect the assets from being available to creditors in the event of a trustee's personal bankruptcy.

Where it is not possible to identify or record that the asset is being held in trust, such as in the case of real property in most states, trustees

should ensure they maintain sufficient records to demonstrate the fund's ownership of the asset. For example, this could include trustee minutes documenting the trustee's decision to acquire the asset and financial statements and records demonstrating that the fund's resources were used to acquire the asset and that all income generated from the asset has been paid back to the fund.

Alternatively, or in addition, the ATO has outlined that trustees could also consider registering a caveat over the asset or putting in place a declaration of trust over it. However, before putting in place any such arrangements over dutiable property, such as real property, trustees may wish to seek specialist legal advice to ensure it would not trigger any stamp duty or other liabilities.

\* For example, in the case of *Frigger v Trenfield (No 10)* [2021] FCA 1500 (1 December 2021), the Court ruled that certain assets of two bankrupts were not held in their SMSF (and were divisible among their creditors) where a number of bank accounts, a share portfolio and two investment properties purportedly owned by their SMSF were not determined to be correctly held on the terms of the SMSF for beneficiaries of that fund.

### Practicalities of clawing back contributions

#### Freezing superannuation accounts

The Official Receiver<sup>16</sup> may issue the superannuation fund with an 'account-freezing notice' (s 128E notice) where the bankruptcy trustee demonstrates that contributions were made to defeat creditors. This notice may also be issued to another superannuation fund where the bankruptcy trustee has identified that the contributions made to defeat creditors have been rolled over to another fund.

The notice prohibits the trustee of the super fund from cashing, debiting, rolling over, transferring or forfeiting of the whole or any part of the superannuation interest except as permitted under s 128E of the Bankruptcy Act.

<sup>16</sup> The Official Receiver retains copies of those documents that are required to be filed or lodged under *the Bankruptcy Act 1966* and *Bankruptcy Regulations*.

2021.

The effect of the notice is to prevent the bankrupt dissipating a superannuation interest while investigations are ongoing.

The bankruptcy trustee then has the following options to obtain the frozen superannuation funds.

### **Clawing back contributions made to defeat creditors**

Bankruptcy trustees may apply to the Official Receiver for a '139ZQ' notice, to recover contributions to super funds made to defeat creditors.

If the Official Receiver is satisfied that the trustee has provided enough information to suggest that some or all of the funds in the superannuation fund can be clawed back, the Official Receiver can issue the notice to the superannuation fund that requires remittance of the superannuation balance to the bankrupt estate.

The amount in the notice will be the lesser of the void transaction or the member's account balance.

Other options include:

- obtaining the co-operation of the client and superannuation fund trustee to facilitate transfer of the superannuation moneys to the bankrupt estate.
- making an application to the court requesting a court order that requires the superannuation fund trustee pay the funds to the bankrupt estate.

### **Condition of release**

There is no condition of release related to bankruptcy. Instead, section 349A of the SIS Act provides that if a member of a regulated super fund becomes a bankrupt, nothing in the SIS Act, regulations or prudential standards prevents a trustee of the fund from paying to the trustee in bankruptcy an amount out of the fund that is property divisible amongst the member's creditors.

A person who refuses or fails to comply with a notice under section 139ZQ commits an offence punishable by up to 6 months imprisonment.

### **Transfer balance account reporting**

Any contributions that are clawed back by the bankruptcy trustee from a superannuation income stream will need to be reported by the client in an ATO *Transfer balance event notification form*.

### **In summary:**

- Superannuation balances are protected from creditors both in pension and accumulation phase.
- Contributions to superannuation made to defeat creditors can be clawed back to repay debts.
- Gross annual pension payments from superannuation pensions are assessed as income when determining whether the bankrupt person needs to contribute a portion of their income to the bankruptcy trustee. Consideration should be given to reducing pension payments.
- Where a trustee of a SMSF becomes bankrupt, they must immediately cease to be a trustee of the SMSF. If a director of an SMSF's corporate trustee becomes bankrupt, they must immediately cease to be a director of the corporate trustee.

## How to contact us

Adviser Services 13 18 36

[firsttech@cfs.com.au](mailto:firsttech@cfs.com.au)

The information contained in this article is based on the understanding Colonial First State Investments Limited, ABN 98 002 348 352, AFS Licence 232468 (CFSIL), has of the current regulatory requirements and laws as at 22 February 2022. While all care has been taken in the preparation of this article (using sources believed to be reliable and accurate), no person, including CFSIL, accepts responsibility for any loss suffered by any person arising from reliance on this information. This article is for adviser use only and is not to be handed on to any investor. This article does not constitute advice (including taxation or superannuation) and does not take into account any individual's objectives, financial situation or needs. Any examples are for illustrative purposes only and actual risks and benefits will vary depending on each investor's individual circumstances. You should read the relevant Product Disclosure Statement (PDS) and Financial Services Guide (FSG) before making any recommendations to a client. Clients should read the PDS and FSG before making an investment decision and consider talking to a financial adviser. The PDS and FSG can be obtained from [www.cfs.com.au](http://www.cfs.com.au) or by calling us on 13 18 36. Taxation considerations are general and based on present taxation laws and may be subject to change. You should seek independent, professional tax advice before making any decision based on this information.

Colonial First State Investments Limited is also not a registered tax (financial) adviser under the Tax Agent Services Act 2009, and you should seek tax advice from a registered tax agent or a registered tax (financial) adviser if you intend to rely on this information to satisfy the liabilities or obligations or claim entitlements that arise, or could arise, under a taxation law.

© Colonial First State Investments Limited 2022. All Rights Reserved. The copyright of this material is owned by Colonial First State Investments Limited and any reproduction, copying or unauthorised use of this material without written consent of Colonial First State Investments Limited is strictly prohibited.