MLC TechConnect

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Is super safe from bankruptcy?

Whilst superannuation is generally protected, there are circumstances where amounts may be subject to claw back provisions by the trustee in bankruptcy.

Background

Clients with unmanageable debts have various options under the Bankruptcy Act:

- temporary debt protection
- debt agreements
- personal insolvency agreements, and
- bankruptcy.

The **Australian Financial Security Authority** provides details on these options.

Clients should seek specific legal advice to understand the implications of the options for their situation. For example, options may impact the client's ability to obtain credit, prohibit travel or limit employment options.

Ordinarily, assets are accessible under bankruptcy to repay creditors unless the assets are considered 'exempt property'. Superannuation is exempt property but may be accessed by the trustee in bankruptcy in certain circumstances. This article focuses on the treatment of superannuation for bankruptcy purposes.

While this article provides general guidance about super and bankruptcy, clients should seek advice from a legal specialist to understand the application of the Bankruptcy Act to their personal circumstances.

Contents

What's protected? 1
What's not protected? 1
Recoverable contributions 2
Contributions made on or after 28 July 2006 2
Mechanics of recovery.................................4
Super death benefit paid to bankrupt beneficiary 4
Death benefits paid from the super fund 4
Death benefits paid via the estate 4
Bankruptcy and SMSFs 4
Strategy tips...5
Resources 5

What's protected?

A bankrupt's entire interest in a regulated superannuation fund is potentially protected from creditors regardless of age. This includes any lump sum paid to the bankrupt from a regulated superannuation scheme on or after the bankruptcy date, even where that lump sum is subsequently invested by the bankrupt in their own name.

What's not protected?

Protection only applies to amounts held in a regulated superannuation fund, approved deposit fund or public sector superannuation scheme. If a bankrupt is a member of a superannuation fund which becomes non-complying, that super interest is not protected.

Amounts withdrawn from superannuation prior to becoming bankrupt are not protected. These amounts simply form part of the estate claimed by the trustee in bankruptcy.

Superannuation benefits paid in the form of a pension or annuity do not receive the same level of protection as lump sums. This is because the pension and annuity payments are not considered to be 'exempt divisible property' but are instead classified as 'income'[1], which receives limited protection.

The income limit that is protected from creditors each year is based on the number of dependants of the bankrupt. The current (net of tax) limits are shown in the table below, which are indexed twice[2] yearly.

Number of dependants	Income limit[3]
0	$71,826.30
1	$84,755.03
2	$91,219.40
3	$94,810.72
4	$96,247.24
More than 4	$97,683.77

The trustee in bankruptcy can generally claim 50% of the income which exceeds these levels. For this reason, there may be an advantage in keeping the bankrupt's benefits in the accumulation phase of super and making only lump sum withdrawals (assuming a condition of release is met).

As pension and annuity payments are included in income, these are available to creditors to the extent the payments are part of income above the protected income limit.

While these are the general principles, certain amounts contributed to super (either by, or on behalf of the bankrupt) in the lead up to bankruptcy can be 'clawed back' by the trustee in bankruptcy. This is generally the case where the contributions have been made with the intention of defeating creditors. Whether the contributions are potentially recoverable depend on when the contributions were made, and the purpose of the bankrupt person, as explained more below.

Recoverable contributions

Contributions made on or after 28 July 2006

Specific rules apply to contributions made on or after 28 July 2006 that are contained in sections 128A to 128N of the Bankruptcy Act. These rules apply to personal contributions made by the bankrupt, as well as contributions made by a third party (eg an employer) for the benefit of the bankrupt. The contributions are potentially recoverable by the trustee in bankruptcy where the:

- transferred property would have been available to creditors had the contributions not been made
- main purpose in making the contributions was to prevent (or hinder/delay) these amounts being available to creditors, and
- contributions were made on or after 28 July 2006.

The 'main purpose' of defeating creditors is taken to arise if it can reasonably be inferred that at the time of the contribution, the person was, or was about to become, insolvent[4]. Furthermore, it is necessary to examine whether there was an established pattern of making contributions in the past, and whether the transfer, in light of this pattern, is out of character.

1 Bankruptcy Act 1966 s139L

2 Figures updated on 20 March and 20 September each year

3 *Bankruptcy Act 1966* S139K. Figures are current at 20 September 2024. Refer to **Australian Financial Security Authority** for current and additional rates.

4 A rebuttable presumption of insolvency arises if the bankrupt did not keep and preserve proper business and financial records at the time of the transfer to prove that they were solvent at the time of transfer or contribution - *Bankruptcy Act 1966* S128C (7).

However, a contribution that is 'out of character' is not automatically assumed to have been made with the purpose of defeating creditors. Instead, it is up to the bankrupt to explain the purpose of the contribution to the Court's satisfaction.

In relation to contributions made by a third party for the benefit of the bankrupt, it is also necessary to establish that a 'scheme' existed between the third party and the bankrupt person. This is defined quite broadly and covers any type of arrangement (implied or expressed) that the bankrupt person was a party to.

This basically includes any arrangement whereby the third party (such as an employer) agrees that money that would otherwise be paid directly to the future bankrupt be instead paid into their super fund (eg as salary sacrifice or voluntary employer contributions).

Example: Recoverable contributions

Brett (age 64) was an employee of his private company. He was declared bankrupt on 1 August 2024. Over the last five years he made the following salary sacrifice and personal after-tax contributions.

Year	Salary sacrifice	Personal after-tax
2019/20	$15,000	$10,000
2020/21	$15,000	$10,000
2021/22	$17,500	$12,000
2022/23	$17,500	$200,000
2023/24	Nil	Nil

It could be argued by the trustee in bankruptcy that the 2022/23 contributions were out of character and were made with the intention of defeating creditors, given the:

- size of the personal after-tax contributions made in 2022/23 (relative to the size and pattern of his previous contributions)
- the fact that they were made after 28 July 2006, and
- the proximity of the contributions to the bankruptcy of Brett.

Brett would need to argue that the contributions were not made to defeat creditors, such as because he had always wanted to contribute more but lacked sufficient cash flow to do so until that year.

Regardless of whether these contributions can be clawed back by the trustee in bankruptcy, the remaining balance of Brett's superannuation interest would be protected from creditors, provided he kept this amount in an accumulation account and made only lump sum withdrawals (where eligible).

Advice tip

Holding life and TPD insurance in super may be advantageous due to the protection afforded to superannuation interests and lump sums paid from these interests. If the insurance was instead held outside super, benefits would be protected from creditors if received on or after the date of bankruptcy, but this would not be the case if the policy proceeds were paid prior to bankruptcy[5].

5 *Bankruptcy Act 1966* S116(2)(d)(ii)

Mechanics of recovery

Trustees of bankrupt estates investigate pre-bankruptcy transfers or transactions when they believe the transaction improperly dissipated or removed assets that would otherwise have come under the trustee's control and are available to creditors.

The Bankruptcy Act can void some transactions and require the other party to return an asset or make payment to the trustee. As discussed earlier, contributions made by or on behalf of the bankrupt (pre-bankruptcy) to superannuation funds may fall into this category.

To void such a transaction, the trustee in bankruptcy must show that:

1. a transaction was entered into
2. they can identify the other party to the transaction
3. the transaction occurred within a specific time period, or while the debtor was insolvent
4. the transaction was either undervalued or had the required purpose, and
5. it does not involve protected property.

To the extent the trustee in bankruptcy can recover void contributions from the bankrupt's super fund, the super fund trustee must comply with a notice issued by the Official Receiver to pay the trustee in bankruptcy an amount equal to the void contribution or the withdrawal benefit (whichever is less).

Super death benefit paid to bankrupt beneficiary

As outlined above, the bankruptcy legislation provides protection to superannuation that is the bankrupt's own superannuation. However, let's consider whether this general protection extends to situations where the bankrupt is a beneficiary and receives the super death benefit. The treatment depends on whether the benefit is paid directly from the super fund or via the deceased's estate6.

Death benefits paid from the super fund

Where the super death benefit is paid directly from the super fund to the bankrupt beneficiary, this amount is treated as an interest paid from a super fund. This is because the individual has a beneficial interest in that super fund. This may arise under a binding nomination or trustee discretion where the trustee has determined a payment will be made directly to that beneficiary. As the amount is an interest in a super fund, the protections under the Bankruptcy Act relating to super lump sums apply to this payment.

Death benefits paid via the estate

Payments made to the estate are treated differently. The Federal Court of Australia considered this situation and whether the super benefit retains its character once it is paid to the estate. In this case, the beneficiary is considered to have an interest in the estate regardless of the source of the funds. The payment from the estate is not an interest in a super fund. This means the payment from the estate has no bankruptcy protection and can be accessed to pay creditors.

Bankruptcy and SMSFs

An insolvent person under administration (which includes an undischarged bankrupt) is disqualified from acting or becoming a trustee (or a trustee director) of an SMSF. The person must <u>immediately</u> resign as trustee of the super fund[7].

The trustee of the super fund has up to six months to rollover the disqualified member's interest. Options to consider are:

- to appoint an independent corporate trustee and become a small APRA fund, or
- the bankrupt member rolls over their benefits into a non-SMSF super fund.

6 *Bankruptcy Act 1966 S116*; *Cunningham (Trustee) v Gapes, in the matter of Gapes (Bankrupt)* [2017] FCA 787 (13 July 2017); *Trustees of the Property of Morris (Bankrupt) v Morris (Bankrupt)* [2016] FCA 846 (22 July 2016).
7 Penalty of up to two years imprisonment can be imposed if fail to resign SIS s126K.

If other members remain in the superannuation fund after the bankrupt member has exited, those members need to ensure the fund's trustee structure is compliant. This would need to be done within the six-month grace period for restructuring the SMSF.

It is not possible[8] to appoint a Power of Attorney to replace the bankrupt member as trustee. In summary, the bankrupt person cannot remain as a member of an SMSF.

Strategy tips

- Clients looking to use super as an asset protection strategy should make consistent and ongoing super contributions to reduce the possibility of the 'claw back' provisions.
- Clients should retain suitable records every time a contribution is made to prove the client wasn't insolvent at the time of transfer or contribution.
- Given the protection afforded to lump sum withdrawals from a super fund, it can often be beneficial to keep super balances in the accumulation phase during the bankruptcy period and only make lump sum withdrawals.
- Pension clients can consider commuting back (in part or full) into accumulation phase to ensure they do not receive income payments above the protected income limit. When doing this, consider any social security implications and tax implications.
- Clients should seek legal advice to understand the implications of the different options for their circumstances.

Resources

The Australian Financial Security Authority (**www.afsa.gov.au**) provides general information and resources on bankruptcy and other debt management options.

Important information and disclaimer

8 *SIS Act 1993* S17A(10)