# Bankruptcy hits home

**Recent legislation and court decisions mean it's time to rethink approaches to protecting wealth by placing it in superannuation, trusts or the family home, PETER BOBBIN writes.**

> If the trust is simply a device, and it is really the bankrupt person in another financial guise, then it will be treated as such.

**FINANCIAL PROSPERITY** is at a new high in Australia. Money in managed investment funds made up of Australian savings exceeds one thousand billion dollars. At the close of 2006 the Australian Stock Exchange soared to record highs. Inflation remains at a record low, as does unemployment. And we are living longer – among the longest in the world.

It is during times like these that the financial holy trinity – wealth creation, wealth preservation and wealth distribution – is forgotten or ignored. But people do so at their peril.

Most have engaged in wealth creation to finance a secure retirement, the timing of which is directly linked to the size of the wealth created and the gap between it and the targeted nest egg. But without wealth preservation there can be no guarantee of becoming a retiree with money instead of an impoverished senior citizen.

Now is a particularly good time to review wealth preservation strategies, especially after legal developments in 2006 which has turned much traditional asset protection thinking upside down. New ways of thinking are needed if holding wealth to and beyond retirement is to be achieved.

Changes to the Bankruptcy Act, adopted or proposed during 2006, underpin the need to ensure that wealth preservation is practised with the first investment dollar – not years later when a fear of creditors may begin to emerge. A doubling of the two-year clawback provisions to four years means that the most common form of asset protection, which often involves family members, will be unsuccessful longer than previously. The time to secure wealth preservation is now, and some actions that begin today will not be effective for four years; only then will protection exist.

Perhaps the most significant of the changes to the Bankruptcy Act are those that involve how family money is spent. Assets held by a spouse but financially supported or developed by the financially troubled partner who enjoys their use will remain exposed. This is where rethinking of old ways needs to be applied. The solution may be as simple as managing family spending to ensure that life's consumables are paid for by the at-risk partner and the income or investment earnings of the not-at-risk partner is applied to the house renovations.

Superannuation will become a fertile ground for review by a bankruptcy trustee. Once lauded as the only true protected personal investment that can be relied upon to survive a bankruptcy, the new principles open up past contributions to review. A bankruptcy trustee can seek to claw back for creditors the bankrupt's contributions to superannuation based on the individual's history of superannuation contributions and whether the relevant contributions are out of character.

This has significant implications for the first half of 2007 and the new tax-free superannuation environment. The last hurrah for getting up to $1 million in savings into superannuation will end on July 1, 2007, and this will encourage many Australians to make superannuation contributions that are out of character compared to past contributions.

Many Australians may be affected by the out-of-character super contribution bankruptcy rules. They could be called on to explain why these extraordinary contributions were made.

This is where the financial planner statement of advice can be a powerful tool in clearly expressing the reasoning behind what would otherwise be seen as an out-of-character contribution to super. The reasoning needs to bring the contribution well within the character of retirement planning.

Not all changes were to the black-letter law of the Bankruptcy Act. In 2006, traditional asset protection thinking was turned upside down by two court decisions: the Cummins case and Richstar Enterprises decision. Both are important for what they say about family wealth preservation objectives.

## Family home ruling

The Cummins case involved the High Court in deciding whether half the Hunters Hill, Sydney, waterfront home wholly in the name of Mrs Cummins, wife of Queen's Counsel barrister Mr Cummins, was accessible to his bankruptcy trustee. The largest creditor by far in his bankruptcy was the Australian Taxation Office. Before lodging in 2000, Mr Cummins had not lodged any income tax returns since about 1955.

The conclusion of the High Court? The family home is no longer safe when held by the not-at-risk partner. The most important implication of the court's decision is that, unless there is good evidence to the contrary, the family home is held for both parties to the marriage. It does not matter whose name the home is held in. On the financial failure of one of them, if the home is in the name of the not-at-risk partner, their bankruptcy trustee has access to half of it.

The family home is for many the most valuable asset they will ever hold. What is important for wealth preservation is whether there is good evidence to the contrary that the home is for both marriage partners, even if it is only held in the name of one partner.

Again this is where the financial planner's financial plan can be instrumental in identifying the reason that the family home is only in the name of one partner. But a word of warning: the nature of the evidence must have been in existence at the time of acquiring the home, not later. The traditional view of putting the home into the name of one marriage partner is no longer enough; new thinking is required, especially at the time of purchase.

How the family discretionary trust can fail as a wealth preservation strategy is illustrated by Richstar Enterprises, a single judge decision of the Federal Court of Western Australia. Justice French, in a decision involving Norm Carey and Richard Beck of the Westpoint Group, resolved that because the trustee of the particular family discretionary trust was effectively the alter ego of the relevant beneficiary, or otherwise subject to his or its effective control, that beneficiary had at least a contingent interest within the meaning of that term as used in the definition of property in section nine of the Corporations Act.

This is important for those whose main wealth preservation strategy relies on a family discretionary trust. This decision should not surprise, as in many ways it is common sense and is quite respectful of the centuries old laws of trust. In effect, Justice French said that if the trust is simply a device, and if the truth is that it is really the bankrupt person in another financial guise, then it will be treated as such.

## Treat trusts separately

The remedy to this view is relatively simple to achieve but many do not use it. Treat the trust and its assets or investments as has always been intended – as an arrangement for the benefit of the family members, not one individual.

Again, the financial planner's plan can assist. How does the plan describe the wealth held within the family discretionary trust? Is it simply part of the wealth of an individual, and is it simply listed as an asset holding vehicle of that person? If the answer is yes, then the plan is describing the family trust as the alter ego of that person.

Trusts over the centuries have worked because they have clearly been for the persons for whom the trust was established. Treating a trust separately will go a long way towards it being treated separately in the event of bankruptcy or other challenge from a family member.

In the present climate of unprecedented financial prosperity, wealth preservation has never been more important. Wealth of any size leads towards a secure retirement. In view of the challenges presented in 2006, preserving wealth should be the challenge for planning in 2007. ✪

## BEVY OF BUST-UPS

**In the last quarter of 2006, an eye-popping 6016 new bankruptcies were declared, according to statistics from Insolvency and Trustee Service Australia, the agency that runs the nation's personal insolvency system. This is nearly 20 per cent more than 5027 in the December 2005 quarter. ITSA's annual report lists unemployment as the most common cause of bankruptcy, playing a part in more one-third of all cases, followed by excessive use of credit in a quarter of cases. Domestic discord and ill health each resulted in just over 10 per cent. As an alternative to bankruptcy, debtors may enter into a Part IX debt agreement or a Part X agreement which allow debtors and creditors to negotiate a binding compromise. They represent a low-cost alternative to bankruptcy.**