



WHAT HAPPENS IF AN SMSF MEMBER BECOMES BANKRUPT?

With over 23,000 individual bankruptcies in Australia last financial year it is not unlikely that an SMSF may find itself in the position of having a bankrupt member.

In this article we look at two consequences of a member's bankruptcy that will directly impact on an SMSF and provide a number of strategies on how to respond to them.

Trustee/member eligibility

An "insolvent under administration" (which term extends to any form of undischarged bankruptcy, whether in Australia or overseas) is automatically deemed to be a "disqualified person" under the superannuation legislation.

A disqualified person must not act as trustee of an SMSF or act as a responsible officer of the corporate trustee of an SMSF. Further, where such a person is a trustee of the SMSF they must "immediately" inform the ATO that they have become a disqualified person. These requirements carry heavy penalties, including imprisonment, for their contravention.

Strategy 1 – ensure that the governing documents of your SMSF provide for a trustee/director to be removed from that office automatically upon becoming a disqualified person.

In order to qualify as an SMSF, each member of the fund must be either a trustee of the SMSF or a director of the SMSF's corporate trustee. Accordingly, a member who becomes bankrupt can no longer be a trustee of the SMSF or a director of the SMSF's corporate trustee. The corollary being that the bankrupt member cannot remain a member of the SMSF.

However, there is no immediate need to remove a bankrupt member as a member of the SMSF. This is because the superannuation legislation provides a 6 month grace period for the SMSF to meet the trustee/director/member requirements. This will usually give the SMSF some time to make arrangements in relation to the superannuation interests of the bankrupt member and will avoid disadvantaging any other members of the SMSF. However, as a bankruptcy normally lasts for at least 3 years, action to remove the bankrupt member from the fund will need to be taken within the grace period.

Strategy 2 – Consider whether to transfer the interests of a bankrupt member to a non-SMSF or to pay non-preserved amounts to the member as a lump sum benefit.

Special care is needed with a single member SMSF in which the bankrupt member is the sole director of the corporate trustee. In that case, a new director would need to be appointed straight after the bankruptcy of the member. If the bankrupt member was also sole shareholder then the trustee in bankruptcy has power under the corporations legislation to appoint the new director.

Strategy 3 – Consider whether the corporate trustee of a single member SMSF should have someone other than the member as shareholder so that the shareholder rather than the trustee in bankruptcy will be able to appoint a replacement director.

Protection against creditors

In relation to the treatment of the bankrupt member's superannuation interests in the SMSF the bankruptcy legislation provides considerable protection for the bankrupt member. Generally, the account balance of a bankrupt member is protected from the bankrupt's creditors while it is in the SMSF and even after it is paid out as a lump sum benefit.

However, there are two instances where the trustee in bankruptcy may be able to claim some or all of a bankrupt member's superannuation interest:

Pension payments – Such payments will be treated as income in the hands of the bankrupt member and hence available to creditors if the bankrupt's income exceeds the prevailing income thresholds under the bankruptcy legislation.

Strategy 4 - Having regard to the bankrupt member's income and the rules of the pension, consider whether the SMSF should reduce or cease paying a pension to that member.

Contribution claw backs – Certain contributions made to the SMSF by or in respect of the bankrupt member may be repayable to the trustee in bankruptcy where the main purpose of making the contribution was to defeat the bankrupt's creditors. In determining the main purpose it must be considered whether the contributions were "out of character" having regard to any pattern of making contributions that had been established in the period up to the applicable contribution being made.

Strategy 5 – Members should try and establish a regular pattern of contributions to their SMSF rather than making irregular, one-off type payments.

The trustee in bankruptcy is able to serve a "freezing" notice on the SMSF to stop payment out of the fund and may also trace the contributions to any other superannuation fund which they have been rolled over to. The trustee of the SMSF receives legal protection against anything done or not done in compliance with these requirements.

Strategy 6 – Remember that the trustee of an SMSF has a statutory duty to act in the best interests of the bankrupt member. Normally, this will mean taking action (of the types suggested above) that will keep the member's superannuation interests out of the reach of his or her creditors. However, the trustee should be wary that it does not become complicit in action to defeat the interests of creditors in a manner that contravenes the bankruptcy legislation. For this reason, trustees should seek professional advice when dealing with the bankruptcy of a member.