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Bankruptcy, Self Managed Superannuation Funds and the Loss of Control

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The use of self managed superannuation funds (“SMSF”) has been steadily growing over the years with more people, particularly business owners, choosing to control the destiny of their superannuation rather than relying on third party fund managers. The ATO indicates that in 1999 there were around 187,000 SMSFs in existence with assets of around \$61 billion, in ten years this has grown to more than 400,000 SMSFs with assets of around \$326 billion.

For a superannuation fund to be classed as a SMSF, all the individual members of the fund must either act as a trustee of the fund or be a director of the corporate trustee of the fund. In a typical mum and dad SMSF established by a small business owner, mum and dad would be the members of the SMSF and also the directors of the corporate trustee of the SMSF.

Disqualified persons

Many advisors and clients do not know that when an insolvent person becomes bankrupt or enters into a personal insolvency agreement¹ with their creditors so as to avoid becoming bankrupt, these insolvent persons may lose control of their SMSF in which they are a member because they become a “disqualified person” under the Superannuation Industry (Supervision) Act (the SIS Act). When control is lost because an insolvent person becomes a disqualified person, then all members of the fund (even those who are not insolvent) may lose control of their members entitlements in that SMSF.

A disqualified person cannot act as trustee of a SMSF or as a director of the SMSF’s corporate trustee. The rationale behind this disqualified person rule is to protect superannuation assets from being used to resolve a disqualified person’s financial difficulties – such use would be contrary to the SMSF’s intended purpose which is to fund its members’ retirement.

¹ under Part X of the Bankruptcy Act 1966



A “disqualified person” is defined to include an “insolvent under administration”. An “insolvent under administration” includes not only bankrupt individuals but also persons who have entered into personal insolvency agreements under Part X of the Bankruptcy Act 1966 so as to avoid bankruptcy, where such persons have not yet received a section 232 certificate from their trustee indicating that all their obligations under the personal insolvency agreement have been discharged.

Where a member of a SMSF becomes a disqualified person, and they remain in the role of trustee or director of the corporate trustee of the SMSF, the trustee is required by law to notify the ATO immediately in writing of this occurrence. Failure to do so is an offence punishable by a fine. If a member of a SMSF is not a trustee or a director of a SMSF trustee company for a period exceeding 6 months, **then control of the Fund will have to be yielded to an external registered superannuation entity (“RSE”) licensee (i.e. a government approved trustee)**. When a RSE is appointed the fund converts from being a SMSF into what is known as a small APRA fund.

Consequences of a SMSF having a disqualified person

May lose concessional super fund tax status

If a disqualified person continues to act as a SMSF trustee or as a director of a SMSF trustee company, then this is a contravention of the SIS Act and can lead to the SMSF losing its complying super fund status. If this was to happen then there would be disastrous financial consequences for the fund and its members. If a SMSF becomes non-complying it loses the benefit of tax concessions available to complying superannuation funds (e.g. the concessional 15% tax rate). Additionally, loss of complying status triggers a significant tax liability for the SMSF – this tax liability claws back all the tax concessions which the SMSF received whilst it was a complying superannuation fund. Loss of complying status is by far the biggest penalty of all.

A punishable personal offence is also committed

It is an offence punishable by a fine or gaol for a person to become a trustee of a SMSF or a director of a SMSF’s corporate trustee, or to continue in these roles, where they know that they are a disqualified person. Additionally, it is also an offence for a corporate trustee to knowingly allow a disqualified person to become a director of the corporate trustee or to remain in that role.

Most SMSF trust deeds automatically remove a member as trustee (or as a director of the corporate trustee) where that member becomes a disqualified person. This prevents the member committing an offence.

Automatic removal does not solve the issue that to remain a complying SMSF, all members of the fund must either be trustees of the fund or a director of its corporate trustee. The disqualified person is still a member of the SMSF after their removal from their trustee role.

Possible solutions to protect innocent and solvent fund members

The disqualified persons rule means that every time a small business owner runs into financial difficulties they need to consider whether their SMSF needs to be restructured if they become bankrupt (and hence a disqualified person). For a typical mum and dad



SMSF, the disqualified persons rule means that if dad becomes bankrupt the SMSF will either have to be split with dad having to roll his superannuation benefits out of the SMSF or control of the SMSF will have to be yielded to an external RSE licensee.

Members of a SMSF have **6 months** from the time when a member becomes a disqualified person to take the necessary steps before their superannuation investment becomes controlled by a RSE licensee.

Many fund members who are being innocently affected by the presence of a disqualified person may choose to exit their membership of the SMSF by rolling their individual member superannuation benefits out of the SMSF that has the disqualified person into either a new, sole member SMSF or alternatively, into an externally managed independent retail superannuation fund.

Alternatively it may be better for the disqualified person to exit their membership from the SMSF fund by rolling over their membership benefits into an externally managed independent retail fund – but not into a new sole member SMSF because the disqualified member cannot be a trustee or director of that sole member SMSF.

Both of these alternatives will allow the innocent member to maintain control of their superannuation if they so choose but the disqualified person will effectively lose the day to day control of their superannuation.

Whether a particular solution is appropriate for a SMSF depends on the fund's particular circumstances. If a SMSF has more than one member there may be some leeway in dealing with this disqualified person problem. For instance, continuing on with our mum and dad example, if dad can sort out his bankruptcy issues within 6 months, then all that may be required is that dad be removed from his role as a director of the corporate trustee during the period of his bankruptcy and be quickly re-appointed within the 6 month period, once he ceases to be bankrupt. Where the SMSF contains only one member, then appointment of a RSE licensee or a rollover of benefits will be required because there will be no one else who can act as a director of the SMSF's corporate trustee during the member's bankruptcy. In the mum and dad example, mum still remains a director of the corporate trustee.

Further complications will arise if the SMSF has illiquid assets, complex binding death benefit nominations or has entered into an instalment warrant borrowing arrangement since rolling over a disqualified person's superannuation benefits may not be practically feasible. Additionally, there may be resistance from an external RSE licensee in taking over the role of trustee because of these complex arrangements.

The harsh penalties that can be imposed and the potential loss of complying SMSF status means that a person who has a SMSF and finds themselves facing bankruptcy should seek expert superannuation advice to deal with this disqualified person problem.

Please contact Peter McCrohon of MBP Legal if you require insolvency or bankruptcy advice or on how tax and superannuation impacts on insolvent companies and personal bankruptcy.

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