

Asset protection planning and discretionary trusts



RECENT LEGISLATIVE CHANGES AND JUDICIAL DEVELOPMENTS HAVE CAST DOUBT ON THE PERCEIVED EFFECTIVENESS OF THE USE OF DISCRETIONARY TRUSTS IN THE AREA OF ASSET PROTECTION. IS THE REAL IMPACT OF THESE CHANGES AS SIGNIFICANT AS MAY HAVE BEEN ASSUMED?

Over the last few years much interest has arisen regarding the effectiveness of discretionary trusts in providing asset protection for accumulated wealth.

The interest arises from relatively recent legislative and judicial developments in the area of insolvency and family law.

This article will focus on an analysis of these recent developments in insolvency law as they apply to discretionary trusts and will provide the writer's assessment of the true impact of the developments and the viability of discretionary trusts for continued asset protection planning.

RISKS REQUIRING PROTECTION

Before embarking on this analysis of recent developments, it is important to firstly identify exactly from whom or what we are trying to protect assets. The common risks from which protection is desired includes potential future liability of:

- the ultimate business owner for business and trade creditors if the business fails;
- the ultimate business owner for successful court actions against the business;
- the ultimate business owner for taxation liabilities from the Australian Taxation Office ("ATO") and the State Revenue Office;
- the ultimate business owner for statutory contravention proceedings and reparation orders of regulatory entities such as the Australian Securities and Investments Commission ("ASIC") or the Australian Competition and Consumer Commission ("ACCC");

- the business for division under any family law or domestic partner property claims by the spouses of the ultimate business owners and their children; and
- the business from potential testator family maintenance claims by spouses and domestic partners and children of the ultimate business owners.

There are a wide variety of risks against which a discretionary trust may be used to provide increased protection. This article does not suggest that discretionary trusts constitute a means to avoid the payment of existing or future tax obligations or existing or future liabilities or debts incurred in the ordinary course of business. Instead the intent of this article is to focus on the sturdiness of a properly drawn discretionary trust which is established and accumulates wealth and assets at a time when a business is thriving but which is then faced with attack as a result of some unforeseen adverse event.

LEGISLATIVE CHANGES

On 13 May 2006 the *Bankruptcy Legislation Amendment (Anti-Avoidance) Act 2006* (Cth) ("BLAA 2006") came into effect. The BLAA 2006 made several important changes to the Bankruptcy Act 1966 (Cth) ("BA 1966").

Extension of claw-back periods

Section 120 BA 1966 was amended by the BLAA 2006 to extend the period in which certain undervalued transactions can be reversed.

Subject to certain exemptions, a transfer of property by a transferor who later becomes a bankrupt is void against the trustee in the transferor's bankruptcy if the

transfer took place in the period beginning 5 years before the commencement of the bankruptcy and ending on the date of the bankruptcy and the transferee gave no consideration for the transfer or gave consideration of less value than the market value of the property. However, a transfer is not void against the trustee if:

- (a) in the case of a transfer to a related entity of the transferor:
 - (i) the transfer took place more than 4 years before the commencement of the bankruptcy; and
 - (ii) the transferee proves that, at the time of the transfer, the transferor was solvent; or
- (b) in any other case:
 - (i) the transfer took place more than 2 years before the commencement of the bankruptcy; and
 - (ii) the transferee proves that, at the time of the transfer, the transferor was solvent.

The change is that, for gifts or undervalue transfers from individuals to associated discretionary trusts, the period for which the gift or transfer of property could be subject to claw-back in the bankruptcy of the individual where the individual can prove they were solvent at the time of the transfer has now increased from 2 years to 4 years. There is no change to the position for gifts or undervalue transfers from unrelated parties where the individual can prove they were solvent at the time of gift or transfer (which remains at 2 years) or in relation to gifts or undervalue transfers where the individual cannot prove they were solvent at the time of gift or transfer (which remains at 5 years).

The policy objective behind these changes is summarised in para 7 of the Revised Explanatory Memorandum to the BLAA 2006 (“BLAA 2006 EM”) as follows:

This approach is based on the premise that gifts designed to dissipate assets rendering them unavailable to creditors are in practice more likely to be made to relatives and associates rather than to strangers. Further, it is common for people to be aware they are likely to become bankrupt more than 2 years before they become bankrupt or even become technically insolvent. If transfers in this early period can't be declared void, it is open to a person to dispose of their assets in a way that will leave little for creditors (e.g. gifts to relatives). It is appropriate to extend the bar to doing this to 4 years, not 2, because in the period between 2 and 4 years there is too much scope for a person to deliberately divest themselves of assets.

For a discretionary trust that has been established for some time and which may have had gifts or undervalue transfers made to it over the years before 13 May 2006, the change is of no effect. Such gifts or undervalue transfers could not be clawed back, unless this could be done under s 121 BA 1966 (discussed below).

For proposed gifts or undervalue transfers made after 13 May 2006, the change reduces the extent of the desired asset protection because of the longer period which must pass before the relevant asset is protected from claw-back. This does not mean that the use of discretionary trusts as the recipient of surplus cash or as the holder of security under a gift, loan and mortgage arrangement should be reconsidered.

“ For proposed gifts or undervalue transfers made after 13 May 2006, the change reduces the extent of the desired asset protection. ”

If a gift or undervalue transfer is made at a time when there are current liability risks then the extended claw-back period is certainly more likely to be applicable. However, gifts or transfers made at such times are much more likely to be caught

under s 121 BA 1966 in any event, so the change is likely to have little practical effect.

If a gift or undervalue transfer is made at a time when there are no current liability risks, the extended claw-back period only results in an increased period before any asset protection planning will become protected from claw-back. This is unlikely to have any real effect. The exception to this would be a sudden down turn to the business or some sudden unexpected court action which cannot be foreseen. Despite the extended claw-back period, it is better to proceed with an asset protection strategy and adopt a wait and see approach. Any potential protection is better than no protection at all and the sooner any action is taken, the sooner time will start running.

Transfers to defeat creditors

Section 121(1)-(4) BA 1966 was amended by the BLAA 2006. The amended section provides that a transfer of property by a transferor, who later becomes a bankrupt, is void against the trustee in the transferor's bankruptcy if:

- (a) the property would probably have become part of the transferor's estate or would probably have been available to creditors if the property had not been transferred; and
- (b) the transferor's main purpose in making the transfer was:
 - (i) to prevent the transferred property from becoming divisible among the transferor's creditors; or

- (ii) to hinder or delay the process of making property available for division among the transferor's creditors.

A transfer of property is not void against the trustee if:

- (a) the consideration that the transferee gave for the transfer was at least as valuable as the market value of the property; and
- (b) the transferee did not know, or could not reasonably have inferred, that the transferor's main purpose in making the transfer was the purpose described in para (1)(b); and
- (c) the transferee could not reasonably have inferred that, at the time of the transfer, the transferor was, or was about to become, insolvent.

The change is the addition of the words “and could not reasonably have inferred” in s 121(4) BA 1966. The BLAA 2006 EM explains the policy objective behind this change as follows:

Additional element of “reasonableness” in section 121

It is proposed to amend subsection 121(4) to place an additional limit on the circumstances in which a transfer is protected by that provision. At present, a transferee can be wilfully blind as to whether a transferor's purpose is to defeat creditors. For example, if a person is heading towards bankruptcy and transfers all their assets to their spouse, that transfer is protected by subsection 121(4) if the non-bankrupt spouse claims they did not think about why the transfer was occurring. This “wilful blindness” can be used to take advantage of subsection 121(4) and protect actions divesting the bankrupt (and later, their creditors) of assets.”

The proposed amendment will introduce standards of reasonableness in relation to the transferee's knowledge of the transferor's intention in conveying the property.

This change is unlikely to have much effect in relation to the use of discretionary trusts as in most cases the trustee of the discretionary trust would not be seeking to take advantage of the exception in subs (4) as the individual involved in the transfer would usually be a trustee or a director of a corporate trustee and so the trustee would be fixed with knowledge of the individual's main purpose in any event.

What has not changed is the proviso that, for s 121 BA 1966 to be invoked, it must be proved or inferred that the individual making the transfer has the main purpose to prevent the property becoming divisible among creditors or hinder or delay the making of that property available in

a division among creditors. The question of whether a transfer made at a time when there are no existing creditors but where the purpose of the transfer may include protecting an asset from claims from future creditors (such as under future court actions) has been discussed judicially but not ultimately decided.¹

Even if the scope of s 121 BA 1966 is sufficient to attack such transfers (which in the writer's opinion, is not the best view), one needs to keep in mind that in the context of most businesses, the business will be owned and operated by a company of which the relevant individual may be a director. In this situation, it is very unlikely that the individual concerned will have any personal creditors or even potential future creditors in mind at the time of transfer. Those personal creditors would only emerge if insolvency risk concerns arose, taxation or statutory convention proceedings by the ATO were taken or ASIC or ACCC or a liquidator sought to take action against directors of a failed company. Based on this, the use of discretionary trusts and asset protection strategies remain as strong as they ever were under s 121 BA 1966.

Transactions with third party payments

New s 121A BA 1966 was inserted by BLAA 2006 extending the operation of ss 120 and 121 BA 1966 to situations of third party payments that arguably escaped the operation of the provisions.

121A Transactions where consideration given to a third party

- (1) This section applies if:
 - (a) a person who later becomes a bankrupt (the **transferor**) transfers property to another person (the **transferee**); and
 - (b) the transferee gives some or all of the consideration for the transfer to a person (a **third party**) other than the transferor.
- (2) Sections 120 and 121 apply as if the giving of the consideration to the third party were a transfer by the transferor of the property constituting the consideration.
- (3) if the giving of the consideration to the third party is void against the trustee in the transferor's bankruptcy under section 120 and 121, the trustee has the same rights to recover the property constituting the consideration as the trustee would have if the giving of the consideration had actually been a transfer by the transferor of the property constituting the consideration."

Accordingly, the operation of ss 120 and 121 BA 1966 is likely to be more robust, but without affecting its substantive operation discussed above.

Rebuttable presumption of insolvency

The BLAA 2006 introduced a new "rebuttable presumption of insolvency" for the purposes of ss 120 and 121 BA 1966. The wording is the same for each section and the presumption in s 120 (3A) is set out below:

- (3A) For the purposes of subsection (3), a rebuttable presumption arises that the transferor was insolvent at the time of the transfer if it is established that the transferor:
 - (a) had not, in respect of that time, kept such books, accounts and records as are usual and proper in relation to the business carried on by the transferor and as sufficiently disclose the transferor's business transactions and financial position; or

or 121 BA 1966. It is not the case that the failure to keep proper books and records or the destruction of books and records is in itself an act of bankruptcy which could be relied upon to make an individual bankrupt. The possibility of making a failure to keep records an act of bankruptcy was raised in the context of previous draft legislation and discussion papers but was not adopted.

- (2) The more obvious point (although often overlooked) is that the rebuttable presumption is in fact rebuttable. In other words, even if circumstances are proved which give rise to the rebuttable presumption, it is still open to the bankrupt to prove that they were in fact solvent at the time of the relevant transfer. Although this may be difficult in the absence of proper books and records, it is by no means impossible.

“...the case is useful to focus one's mind on the need to ensure that trusts are not operated as “mere puppets” or “creatures” of the ultimate business owners.”

- (b) having kept such books, accounts and records, has not preserved them.

The policy objective for the introduction of this concept is set out in para 9 of the BLAA 2006 EM as follows:

These amendments are proposed on the basis that it is usual commercial practice to keep these books and records. This removes the incentive to avoid making, hiding or destroying, records that would demonstrate insolvency. This amendment will overcome some of the difficulties faced by trustees when, for example, endeavouring to establish an intention on the bankrupt's behalf to defeat the interests of creditors under section 121. The bankrupt will of course have the opportunity to rebut the presumption.

The two important things to note about the extent of these changes are:

- (1) The rebuttable presumptions of insolvency can only apply if there has been a gift or undervalue transfer made which a trustee in bankruptcy is seeking to claw-back under either s 120

The effect of this change in relation to the use of discretionary trusts is again minimal. Provided the trustee keeps proper books and records, then it should be relatively easy to prove solvency for the purposes of ss 120 and 121 BA 1966.

Exposing assets held by third parties

Division 4A BA 1966 provides for an entity (which could include a discretionary trust) to be required to pay the trustee in bankruptcy an amount representing the increase in the trust's asset value during the period where the bankrupt provided services to the trust at undervalue remuneration.

In particular, the new definition of the “examinable period” extends the period which the trustee in bankruptcy may review retrospectively.

The claw-back period for related transactions has increased from 2 to 4 years to align it with the changes made

to s 120 BA 1966 (discussed above). The rebuttable presumption of insolvency is also introduced. Together, these changes increase the extent of assets captured by the BA 1966 because of the extended period. However, the changes do not render discretionary trusts for asset protection strategies as unviable. As discussed earlier in the context of s 120 BA 1966, in most cases the acquisition of assets will continue and they will eventually become protected in the ordinary course of events. In addition, other strategies may be able to be employed to ensure that the provisions of Div 4A BA 1966 do not apply to particular discretionary trusts which are used to accumulate wealth and assets.

JUDICIAL CHANGES – RICHSTAR CASE

*ASIC in the matter of Richstar Enterprises Pty Ltd v Carey (No 6)*² (“Richstar”) has been the subject of much commentary.³

Although the case is useful to focus one’s mind on the need to ensure that trusts are not operated as “mere puppets” or “creatures” of the ultimate business owners who may be sued, there are a number of important points about the case which are often overlooked.

First, the case is not one which involves bankruptcy, but the operation of the provisions relating to action under the *Corporations Act 2001* (Cth) (“CA 2001”). Although there are some analogies between the CA 2001 and the BA 1966, it is by no means clear that, even if the reasoning in the *Richstar* is accepted, it could be applied to the BA 1966 with the effect that any person becoming bankrupt could have assets in discretionary trusts which they effectively control put at risk.

Secondly the decision involves orders of an interim nature only, required to preserve assets pending further investigation and court action. There has not been any final decision made in relation to the fate of assets held in the discretionary trusts which could be affected by the orders in the case. It certainly cannot be said that the decision means that assets in a discretionary trust could be accessed simply because an individual effectively controls the trust.

Thirdly, there has been subsequent judicial comment on the interests of beneficiaries in discretionary trusts which

are at odds with the conclusions in *Richstar* and which seem to support the traditional view of the nature of those interests as understood prior to *Richstar*⁴.

Whilst the decision appears to be groundbreaking, its reverberation will only be potentially felt when the Courts consider another similar case and even then it will be dependent on its particular facts and circumstances, the structure of the trusts under consideration and their constituting documentation, as well as the powers conferred by the relevant statutory provisions.

In the writer’s opinion, a properly structured discretionary trust including at least one truly independent appointor should remain unaffected by the *Richstar* reasoning. Even if the reasoning of *Richstar* is adopted by later judgments or embraced by later legislative changes, it is still clear that discretionary trusts continue to afford better asset protection than any of the alternatives.

CONCLUSION

In summary, therefore, it seems that the most recent legislative amendments and court decisions have made little impression on the asset protection effectiveness of well written and structured discretionary trusts. Care is required to ensure that a discretionary trust is an appropriate entity for a particular asset protection structure or strategy. Although the period for which assets are exposed to insolvency risk has been extended the discretionary trust remains the most effective means of providing asset protection for the ultimate owners of a business.

*Philip Lambourne, Special Counsel,
Accredited Specialist in Business Law
Harwood Andrews Lawyers.*

With thanks to Ron Jorgensen, Principal, Accredited Specialist in Tax Law, Harwood Andrews Lawyers

Reference notes:

- 1 Refer *Trustees of the property of John Daniel Cummins, a Bankrupt v Cummins* [2006] HCA 6 at para 41.
- 2 [2006] FCA 814
- 3 Refer “Discretionary trusts post Westpoint liquidation – is it now just a matter of effective control?” *Taxation in Australia Issue 41 No 2 August 2006 pp111-114*
- 4 Refer *Lygon Nominees Pty Ltd v Commissioner of State Revenue* [2007] VSCA 140