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Asset Protection
Safeguarding Your Future

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ASSET PROTECTION: SAFEGUARDING YOUR FUTURE

HUMAN RESOURCES CORNER

Using KPIs for Salary Determination

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Asset Protection:

Safeguarding Your Future

Emerging Issues in 2022 for asset protection structures

- A significant change to the directors' penalty notices (DPN) regime
- Navigating the post-pandemic world for directors
- Update on one-year bankruptcy
- Personal guarantees. Beware of ghosts from the past
- Other issues emerging in 2022 that will test asset protection structures are
  - Climate change
  - Supply chain issues
  - Inflation and higher interest rates
  - Housing market
  - ATO debt recovery action
  - Political and global environment

Climate change

The bottom line is to do your due diligence when purchasing property or taking out leases when relocating businesses. Due to repeated floods, some properties are now uninsurable. Just because a property has not flooded in the past, it is no guarantee it will not be susceptible in the future. It is suggested you take expert advice on this issue.

Supply chain issues

If at all possible, avoid being beholden to one major supplier. Be nimble and alert for alternative sources. Cultivate good relationships with suppliers and, on rare occasions, even consider paying a slight premium for essential supplies if delays result in significant cost overruns. Factor escalation clauses into contracts if at all possible.

Inflation and higher interest rates

Take expert advice and consider locking in rates for a portion of your debt. Talk to brokers about the best deals in the market and consider changing banks to get a better deal. Re-structure debt if rate increases will be too harsh on your cash flow.

Housing market

Many people have already started pulling in their belts because their major asset, the family home, is now likely to decrease in value. Be mindful that it may be more challenging to re-finance the family home and, if possible, get ahead in your debt reduction.

ATO debt recovery action

This is covered in detail in this edition under director penalty notices. The most important thing is to be open and transparent in your dealings with the ATO. If you don't respond to them and your debt exceeds $100k, they may report you to a credit agency, seriously affecting your ability to get finance.

The takeout

Be mindful that given issues well beyond your control, stringent budgeting and detailed cash flows are now more critical than ever. Face up to the problems and deal with them, taking expert advice. This applies to families and business budgets alike.

Principles of asset protection

The reasons for asset protection are -

- Society has become more litigious, meaning more people see legal action as a remedy or opportunity.
- Over time we have seen an increase in the incidence of marital breakdown.
- Individuals have a greater consumer awareness of matters concerning investment and wealth accumulation.

- Failures of insurance companies have cast some doubt on the availability and extent of insurance coverage.
- Amendments to bankruptcy laws threaten the effectiveness of existing arrangements and structures.
- The increasing complexity of our taxation system means minor structural deficiencies can have significant tax impacts, threatening the effectiveness of existing arrangements and structures.
- The Covid-19 crisis has shattered business and consumer confidence leaving many in a marginal position.
- Many investors and business clients have made decisions based on the availability of cheap credit.
- The commencement on 30th January 2012 of the Personal Property Securities Act 2009 has had a major effect on asset protection structures.

Broad Principles of asset protection:

Looking at a typical mum and dad family situation, the following fundamentals apply:

- There should be one 'at risk' person and one 'low risk' person.
- The 'at risk' person is involved in the operation of the business and should be the only director exposed to liabilities associated with being a company officeholder.
- This 'at risk' person should not own or control any assets or wealth. Note sound Estate Planning means this person should not directly inherit wealth either.
- Control and ownership of all assets and wealth is the domain of the 'low risk' spouse. As such, they should not be exposed to any liabilities with directorships of the trading companies, and this should be distinguished from investment situations. The 'low risk' spouse may be an investment company's sole director or controller, or trustee of an investment trust with no trading operations.

The described outcomes are to:

- Contain risks in limited liability entities or as affecting 'at risk' entities only and
- To keep, accumulate or move assets away from 'at risk' entities and into the hands of 'low risk' entities (including superannuation funds).

In achieving these desired outcomes, the following must not be overlooked.

- The moving of assets must consider bankruptcy and other 'clawback' rules.
- Anticipate the future receipt of assets under wills and superannuation to keep assets away from 'at risk' entities and individuals.
- Continual changes in legislation (see above) and legal precedents.

Asset protection checklist

1. Property Transfers between Spouses

- Consider Bankruptcy Act 'clawback' provisions that may defeat pre-bankruptcy transfers.

2. Are assets held in Company or Trust entities or Personal Names?

- Business is conducted in an entity separate from where assets accumulate.

3. If an individual is a Company Director, are their assets owned personally?

- Note personal liability of Company Directors.

4. Have any personal guarantees for business debts or liabilities been granted in favour of creditors?

- Note: Seek releases when you leave the business.

5. Ensure discretionary trust provides for appropriate provisions in the event of bankruptcy of the Appointor.
6. Ensure the loans from stakeholders to the business operating entity are appropriately secured with mortgage debenture, mortgage registered charge or other securities.
7. Consider implementing asset protection strategies concerning a spouse or de facto partner in appropriate circumstances.
8. Consider implementing appropriate business structuring strategies for asset protection purposes:

- Separate ownership of intellectual property assets from the business.
- Use of small business CGT provisions to move business away from property assets.
- Consider the more complex strategies that may be available.

9. Consider whether appropriate to transfer assets to a superannuation fund but note the proposed changes to apply from 3.05.2016, announced in the May 2016 Federal Budget.
10. Once problems arise, seek professional advice to implement an appropriate strategy that may be utilised in particular circumstances.

Binding financial agreements

The Family Law Act 1975 (Cth)(FLA) allows parties in a relationship to enter into a binding financial agreement (BFA) to provide for how matrimonial assets (including those assets brought to the association by the parties) are to be divided in the event of separation. A BFA can be drafted to take account of specific assets in existence at the time the agreement is made and/or those acquired after the agreement.

Of course, the subject of entering into a BFA can be challenging to broach – however, it does give both parties certainty as to how assets are to be divided in the event of a relationship breakdown.

Although a BFA may not always be completely 'watertight', it can provide the parties with certainty concerning the distribution of assets during a marital breakdown.

When financial agreements are binding

A BFA is binding on the parties to the agreement if:

- Both parties have signed the agreement.

Before signing the agreements, each party was given independent legal advice as to:

- The effect of the agreement on their rights, and
- The advantages and disadvantages of entering into the BFA.
- Each spouse was provided with a signed statement stating that the advice was provided.
- After the agreement is signed, the original agreement is given to one of the parties and a copy given to the other (or their legal representatives), and
- The agreement has not been terminated and has not been set aside by a court.
- Parties entering into a compliant BFA enjoy the enduring benefit that the Family Court cannot make an order inconsistent with the terms of the agreement.

A binding financial agreement can be set aside by Family Court

A binding financial agreement can be set aside by the Family Court if it is satisfied that:

- The agreement was obtained by fraud, including non-disclosure of material matters.
- The agreement is void, voidable our unenforceable.
- The circumstances have arisen since the agreement made it impracticable for the agreement or a part of the agreement to be carried out.
- Since the making of the agreement, a material change in circumstances has occurred (being circumstances relating to the care, welfare and development of a child of the marriage) and, as a result of the change, a party to the agreement will suffer hardship if the court does not set the agreement aside, or
- In respect of the making of a BFA – a party to the agreement engaged in conduct unconscionable in all the circumstances.

The role of an accountant as a Trusted Adviser

Case study 1: Special events company

In this case, a successful 'special events' company in a regional city suffered a severe blow to their turnover. At the same time, their two most prominent clients, both large hotels, decided to take these functions in-house. Two-thirds of their turnover was gone.

This was a time to slash overheads immediately, revise their business plan (if one existed) and seriously consider whether they should remain in business. Within a short length of time, a tax debt of 250k existed. With the ATO pressing, the owners went to their lawyers, who worked out a payment plan. This involved 50% down and the balance over 12 months. Even with the sale of the family home, the couple struggled to achieve this. At the end of the 12 months, the ATO accepted a further $30k and waited six months before liquidating the company. This avoided any suggestion of preferential payments under the corporation's law. This couple lost everything.

It would be fair to ask, what should have happened? As indicated above, closing or liquidating the business is a real option if the business is unviable. It is illegal to continue to trade when insolvent, and a reputable accountant could have advised on this matter.

Case study 2: A trading company with real property becomes unprofitable

In this case, an operating company with a $3 million commercial property on its balance sheet became unprofitable. There had been a lack of planning and asset protection structuring here. Fortunately, in this case, the business owners were advised that their business was no longer viable due to technological obsolescence and unlikely to return to profitability. The business was closed orderly, and the commercial property was retained. Again, this couple is in their sixties, but here they are, able to contemplate a comfortable and secure retirement.

Unwelcome advice

This is undoubtedly the case when business owners are told to exit their industry. The accountant may be described as hopeless, pessimistic and lacking in understanding. Emotion can take over. But seriously, are the same comments made if a Doctor of Medicine tells someone they have an illness? In these cases, a second opinion may be sought, and there may be a referral to a specialist. All professional advisers have a duty of care to their clients. If a client is one-quarter behind in their BAS payments for PAYG/ Super and GST, a severe problem must be addressed immediately. Realistic budgets need to be prepared for the business to establish ongoing viability.

In many cases, there may be seasonal lull or timing issues regarding trade debtors. A family budget needs to be done in conjunction with the business budget. Is the overall position sustainable? The business may be viable, but prompt remedial action needs to be taken regarding the family's living expenses. It could well be that excessive director's drawings eventually bring the business to its knees. Quite often, one owner shields their spouse from the actual situation. Sadly, in the absence of firm and objective advice, the problem gets worse.

The Trusted Adviser's role is to be honest and forthright with the client. Accountants may lose fees but must always act in the client's best interest.

Case Study 3: Timely advice

John is in his mid-fifties and has operated a successful business for seventeen years. However, recent changes in the market have made his business marginally profitable. Under the weight of this pressure, John feels that he is constantly putting out bushfires; no longer can he maintain an overview of his business. The business owes the wife's family $125,000. John's adviser makes some valuable suggestions, but John dismisses them as impractical or too expensive. John expresses concerns about his business future, and the subject of asset protection is raised. The conventional asset protection techniques are suggested but again, John baulks.

Two and a half years later, John's business is liquidated, and he was found personally liable for insolvent trading; when credit card debt is taken into account, there is the real prospect of losing the family home.

What should have happened?

To the least, John could have implemented:

- Only one at-risk individual, i.e., only one director.
- The wife's family could have taken a secured charge over the business.
- To isolate risk, a new company with no fixed assets should have been formed to operate the business under licence.
- Normal contributions to super should still have been made for the directors.
- The adviser should have given objective advice telling John that unless he was willing to implement changes to ensure his business's survival, he should sell or close business. In the case of business closure, John could then have earnt a comfortable living as a consultant without all the pressure and without losing everything
- SWOT analysis (Strengths, Weaknesses, Opportunities, Threats) is usually done on a business, but often in a family business, this should squarely focus on the principal(s).
- A break-even analysis is crucial, with John aware of the monthly turnover and gross profit figures required for his business survival.
- Furthermore, John should have been apprised of the insolvent trading provisions under the Corporation Law and the risk to family assets.
- Both the adviser and John should have monitored the figures monthly.

We expect many asset-protection structures to be tested in the financial crisis post-Covid-19. The trouble is some asset protection structures have been implemented without:

- The business owners have a clear understanding of the rationale behind the re-structure
- A proper follow-up or overview by the adviser
- A lack of ongoing review.

The main issues are a lack of rigour and discipline around asset securitisation and inter-entity loan accounts.

The role of the adviser in the recovery period

In short, the first point of contact for business owners has to get more involved – this usually is the accountant. Examine debt with the ATO and state revenue authorities and get involved in negotiating terms. In the event of rent deferrals, negotiations with landlords are crucial.

You may need to ask some difficult questions. Consider asking some of the following questions:

- Does a business need to retain more significant cash amounts for future challenges?
- Has the client's market changed, and do they now need to adapt to new circumstances to meet customer expectations?
- Do they need to restructure their employee numbers or retrain their employees to deal with the permanent changes that the business has seen occur in the last 12 months?
- How much has revenue grown or decreased?
- Are cost trends a concern, and what are the solutions/ alternatives?

Compromised mental health and asset protection – the role of trusted advisers

In the second week of September each year RU OK? day aims to reach out to any of us with mental health issues ensuring mutual support and help.

It is hard enough for anyone to survive in business – many of us face stress, exhaustion, and mental health issues. Consider the myriad of legal and statutory obligations an SME has. These include but are not limited to:

- Income tax and GST
- Contractual obligations
- Duties of care
- Trade practices concerns
- Superannuation requirements
- Employment laws
- Obligations of fidelity and good faith
- Occupational health and safety requirements
- Privacy obligations
- Disclosure requirements
- State revenue obligations, including payroll tax and stamp duty

There must be documented procedures and practices in each of these areas. This gives an overview of the regulatory environment a business operates in and allows key support staff and family members to keep a company operating correctly in the event of the founder/owner's illness. The above statutory obligations are onerous at the best of times, let alone for someone suffering from illness.

This leads us to a business's lifeblood– cash flow.

- An accounting software company, intuit, surveyed 500 accountants and bookkeepers, asking what their biggest problems were in their SME business. The top three responses were:
    - Lack of proper record-keeping, including the mixing of personal and business expenses.
    - Not using accounting software.
    - Not understanding the importance of cash flow; not keeping track of bills and debts.
- Cash flow is key to any business, and while cash pays the bills, many business owners are unable to produce a cash-flow statement, which records incoming and outgoing cash amounts to assist them in managing the budget of those bills

You can have the systems in place for all the above, but they need to be maintained, reviewed, and used as the basis for informed decision making, then timely action.

So, what is the takeout here?

Whether you be a consultant, adviser, friend, or family member, if you know a business owner struggling with life generally, there is a distinct possibility that their business welfare is being neglected. Simply ask R U OK? You may be able to help them.

This becomes even more important in the Covid-19 pandemic crisis.

Above all, business owners operating in these trying times need clarity – they need to clearly understand their options and be aware of the consequences of inaction. They do not need platitudes and throw-away lines!

It's business advisers who should themselves be -

- Aware of director penalty notices?
- Aware of the perils of inter-entity and personal loan accounts?
- Aware of all personal guarantees and the consequences?

- Thinking clearly and showing a willingness to tackle the real issues?

This leads the adviser to ask their clients whether they -

- Taking the time to deal with the issues?
- Genuinely care about your client(s) and their outcomes?
- Have you shown the fortitude to tell the client some unpleasant truths regarding their business?

Restructuring business

Of course, the time to identify risks is at the very beginning and certainly before we encounter financial difficulties.

This is because the cost of implementing a restructure for an established business may be substantial, and the restructure may be ineffective if the clawback provisions in the Bankruptcy Act or Corporations Act apply.

It is also important to properly assess the actual risk. Most clients require external finance to fund their business assets and operations. Never overlook that external financiers generally require collateral securities and guarantees to hold all assets connected with the business (and usually the director's private assets) as security.

In this context, the decisions concerning business structures may not greatly impact the extent to which the clients' assets are exposed to claims by their financiers. However, an appropriate structure can reduce the risk of the client's business and private assets from being exposed to claims of a contingent nature – for example, large damages claims arising from contractual disputes or negligence actions.

You must avoid holding personal or passive investment assets in the same entity that carries on its business activities. This should not involve complex structures or high costs – mainly if the asset protection issues are considered at the outset.

A married couple who operates a business with some risk potential might choose to:

- Acquire their home in the name of the wife or husband – but not jointly.
- Hold investment assets in a discretionary trust.
- Operate the business through a trading company and have a single director who is not the spouse who owns the family home.

Valuable business assets should also be separated from the risks associated with trading operations. It is increasingly common for intellectual property assets that contribute to the value of the business to be held in one entity and for that entity to grant a licence to the operating entity to use the intellectual property.

While using separate structures and splitting the ownership of assets does not completely quarantine clients' assets from the business risk, it will provide a reasonable level of protection. Using separate business structures becomes very important for developers. A common strategy for developers is to establish a holding company in which shares are held by individual participants (usually a family trust) and then to use a separate wholly-owned subsidiary company to carry out each project.

After each project, the subsidiary is wound up, and surplus profits are distributed as dividends to the holding company.

Offshore Structures

On the leap of faith issue – if you go to a consultant specialising in these offshore issues, invariably, the recommendations will be to set up some offshore structures. This will sometimes occur in cases where there is no good reason to do this. It just means expensive and unnecessary structures.

Quite often, the decision of Justice Robert French in ASIC in the matter of Richstar Enterprises Pty Ltd v Carey (No 6) (2206) FCA 814 and the possible far-reaching implications of that decision on the security and protection of assets held in a trust, is given as the reason an offshore structure is necessary.

We discuss this case and the protective measures to overcome this elsewhere in this Bonus Edition.

There may be a place for offshore structures, but you should be genuinely conducting commerce overseas, and any management fees or charges must reflect commercial reality. Professionals often line their pockets by providing unnecessary and expensive structures.

In March 2014, the Commissioner of Taxation announced an initiative to allow eligible taxpayers to come forward and voluntarily disclose unreported foreign income and assets. He urged taxpayers with offshore assets to declare their interests ahead of a global crackdown on people using international tax havens.

The initiative covered amounts not reported or incorrectly reported in tax returns, including:

- Foreign income or a transaction with an offshore structure
- Deductions relating to foreign income that have been claimed incorrectly
- Capital gains in respect of foreign assets or Australian assets transferred offshore
- Income from an offshore entity that is taxable in your hands.

These benefits were available only to eligible taxpayers who came forward before 19 December 2014. Under the initiative, taxpayers had the opportunity to avoid steep penalties and the risk of criminal prosecution for tax avoidance.

We have seen several recent cases of whistle-blowers with explosive Wiki Leak-style revelations. The last one was 11.5 million documents known as the Panama Papers leaked from leading offshore law firm Mossack Fonseca in April 2016.

This trend will continue with information sharing between large numbers (90+) of the world's revenue authorities. Those going offshore can no longer count on confidentiality.

Offshore asset protection and tax evasion

When one mentions Asset Protection, it has some gravitas to require it denotes awareness and sophistication; this can be a problem.

We all want to feel important, coupled with self-important and fee-generating advisers can lead to overstated problems with resultant overly expensive and inappropriate structures. With time some of these are not even properly utilised or implemented.

A balance is required – you need to clearly understand your situation and why the structures are being implemented. Beware the leap of faith when dealing with the suave, articulate adviser in the expensive suit. If you don't have a clear understanding or feel uncomfortable, seek a second opinion.

In recent years offshore asset protection has also been a cloak for tax evasion, and some of these inappropriate structures are causing real strife in the wake of the ATO-initiated Operation Wickenby. If something sounds too good to be true, it generally is. Similarly, since the Banking Royal Commission, it has become clear to this tax practitioner that a number of clients did not understand the advice they received from some Financial Planners.

Once again, a leap of faith was involved with risky and inappropriate investments, the result being many people, particularly older persons, are never going to recover their position as a result of this. Many legitimate financial planners could justifiably take umbrage with these comments due to the meticulous care they exercise with their clients. Nonetheless, significant Australians have received inappropriate recommendations from accountants, consultants, and advisers.

What is the lesson here? Do not be afraid to ask questions. Always seek to gain an understanding. Advisers must earn your trust over time, and once again, if you have any doubts, always seek a second and, if necessary, a third opinion.

Exposures to contractors, employees and Workcover

Recently a company went into liquidation. The company's major creditor was Workcover, and the debt arose because of an injury to a 'worker'.

The word worker is important because whether or not the person injured was a worker as defined in the Act and whether the company was an 'employer' at the time was the subject of some debate.

The company employed labourers under contract and did not consider them as 'employees' in common sense. But the employees were hired under a contract of service for the provision of labour only and therefore were 'workers' under Section 11, Schedule 2, Part 1, (1) of the QLD Workers Compensation and Rehabilitation Act 2003. Section 48 of the Act says that every employee must be insured.

Other Exposures

Other states have similar provisions in the relevant legislation. These include but are not limited to Payroll Tax and the Superannuation Guarantee Charge.

Here we see the consequences of one company choosing the path of least resistance. Indeed, this is an extreme example, but it is common for employers to encounter large superannuation and payroll tax liabilities because they have not bothered to check their exposures for subcontractors under the relevant statutes.

From experience, Employers who want to get some or all of their workforce on ABNs when these people are, in essence, employees have little prospect of long-term success:

- Commonly a business plan has not been prepared, and there are no long-term business strategies in place
- Little attention is given to financial management

- Having to properly budget for PAYG tax and other cash outflows forces a level of discipline in a business
- Employers who don't want the admin headaches on relatively simple matters usually cannot be bothered with business strategies in a challenging business environment.

The contractor versus employers' issue is an area of audit focus for the ATO in 2020-21. From practical experience, these matters typically come to the attention of the ATO when they do a superannuation guarantee charge audit.

Trusts, what are they, and how do they work?

What is a Trust?

The general law still wallows to some extent in the feudal age, and society puts up with technicalities that can have no possible purpose except to confuse where trusts and the law of trusts are concerned. Trusts stem from the feudal system under which the Crown did not part with land ownership but instead allowed land to be used and occupied in return for feudal or knight service.

There must be a difference between the legal ownership of an asset and beneficial ownership. That is, there must be some person (either a natural person or corporation) that is the actual owner of the property and some other person (a natural person or corporation) that receives the benefit of the property and is referred to as the beneficial owner. The beneficial owner is the real owner of the property, the person who gets the benefit of ownership. Where there is no separation between legal and beneficial ownership, then no trust can exist. Hence, a Trustee cannot be the sole Trustee and, at the same time, the trust's sole beneficiary.

There must be an asset in respect of which the trust exists, i.e., money, some object, a business etc. Without some object in respect of which the trust exists, there is nothing to be held in trust. Therefore, no trust. There must be a certainty.

Both the Trustee and the beneficiary must know what is involved in the trust, how the obligations of the Trustee are to be discharged, and what the entitlement of the beneficial owner is. Hence, in the case of a discretionary Trust, there is a settled sum that establishes the trust. There are also a series of rules that enable the Trustee to discharge the duties of the Trustee and to determine (albeit by way of application of some formula) who the beneficiaries are or are to be. In a Unit Trust, there are defined units with a specific and defined value and, similarly, a set of rules that enable the Trustee to carry out the Trustees' obligations as Trustees.

Family (Discretionary) Trusts

The concern with Family Trusts continues, but what better vehicle currently exists to protect assets? Notwithstanding, the status of family trusts and hybrid trusts as an effective investment structure from both tax planning and asset protection perspectives has been under pressure.

In 1998, Treasury wanted trusts taxed as separate entities (the 'entity taxation regime'), and draft legislation to implement the change was prepared. Due to pressure from the National Party and the business community, the entity taxation regime was eventually rejected by the government. Since then, the effectiveness of the trust structure has been challenged by amendments to the bankruptcy legislation to:

- Continuing attempts (to date unsuccessful) by trustees in bankruptcy argue that the power of appointment over trust assets is an asset of a bankrupt capable of being exercised by the trustee in bankruptcy.
- Amendments to the bankruptcy legislation widen the situations in which trust assets might be exposed if an individual associated with the trust becomes bankrupt.
- The Richstar decision calls into question the level of asset protection a discretionary trust can provide if one of the core people involved in the trust individually becomes bankrupt. The Richstar decision took on further significance when the judge who issued the decision, Justice French, subsequently became Chief Justice of the High Court.
- Various family law cases have continued to significantly undermine the trust structure where there is a personal relationship breakdown – perhaps the highest-profile of these cases was the High Court decision at the end of 2009 in Kennon v Spry.
- The Bamford High Court decision and recent Decision Impact Statement released by the Tax Office in relation to the issues associated with making effective trust distributions.
- The Government's decision to abolish the capital gains tax exemption for trust cloning in late 2008 stripped the owners of many family trusts of the ability to restructure their trusts to achieve asset protection or succession planning objectives; and
- Numerous changes to the application of the Division 7A regime to capture and tax many arrangements where present unpaid entitlements had arisen following distribution from a discretionary trust.

Discretionary Trusts

A Discretionary Trust is a legal entity where there is a Trustee who holds assets legally in their name on behalf of others (beneficiaries). The trustee manages the Trust Fund for the benefit of the beneficiaries, who are the recipients of the income and capital of the trust.

In a Discretionary Trust (also called a non-fixed trust), the Trustee has discretion as to which of the beneficiaries receives the Trust Fund's income or capital and to what extent. The beneficiaries do not have a fixed entitlement or interest in the Trust Fund as they do in a unit or fixed trust. The rights of beneficiaries in a Discretionary Trust are limited to a right to be considered for nomination by the Trustee and to compel proper administration of the trust only.

A Discretionary Trust is established through a Trust Deed between the Settler and the Trustee. The Trust Deed regulates how the Trustee can exercise its discretion. The Trust Deed provided by this service is drafted by lawyers who practice extensively in this field. It gives the trustee broad discretion regarding the classification of income and capital into different classes and a broad definition of beneficiaries to allow greater flexibility in tax planning and asset protection.

Benefits of a Discretionary Trust Deed

There are a variety of reasons why people establish Discretionary Trusts. The principal reasons are:

- Tax benefits which in turn, lead to wealth creation
- Asset protection
- Providing financial security for family members during their lifetime
- Retaining control of the assets while having flexibility in how the income is distributed
- Estate privacy

Unit Trust

A unit trust is a common investment vehicle that allows the pooling of investment funds and the investment of those funds through a trustee, whose powers are clearly defined in a trust deed. The trustee may be assisted by a separate entity known as a manager, whose job is to select and manage the investments, while the trustee acts as a guardian of the interests of the unit holders.

Trust beneficiaries, known as unit holders, have set interests in the income and capital of the trust. These interests can often be on-sold by the unit holders.

Many unit trusts invite the subscription of public funds, which are then pooled and invested in specified items for income or capital gain.

In certain circumstances, there may be advantages in selecting a trust as a business organisation, particularly from a taxation viewpoint. However, care must be taken to determine that it is appropriate for the type of business, the desired taxation status, the required return, the degree of control required, and the flexibility needed.

A Superannuation Fund is a trust, in the same way as a family discretionary trust. However, it simply has a limited and special purpose. There are over 570,000 surging more towards 600,000 Self-Managed Superannuation Funds in Australia, controlling $650B+ in assets. Given recent incentives offered by the Government, they are increasingly popular as wealth accumulation vehicles with asset protection benefits.

Hybrid Trusts

The hybrid trust has the feature of both a discretionary trust and a unit trust. The hybrid trust is based on the standard discretionary trust with the added feature that it also offers a fixed (by unit) system of interest in the trust.

Hybrid trusts have become popular vehicles for negatively gearing investment property with asset protection benefits. If a hybrid discretionary trust purchases a property, the taxpayer can gear the units, thereby claiming a tax deduction.

A negatively geared investment will not work in a family trust with no other income to offset the loss. In trusts and companies' losses are quarantined and carried forward to the next year.

The beneficiaries or shareholders cannot get the benefits of those losses to reduce their income. However, the hybrid discretionary trust can be administered as a normal discretionary trust for a couple of years until the investment funds are required, and the trustee can then issue units. There is no need to issue units when the trust is set up. The flexibility is with the trustee, and generally, there are no stamp duties or capital gains tax implications.

Recent case law and Taxpayer Alert 2008/3 now make it clear that the ATO will challenge the deductibility of interest on loans used to purchase units in some circumstances.

The ATO has expressed concern about taxpayers claiming deductions for interest and other borrowing costs when the borrowing produces (or may produce) income for other people. This limits the use of hybrid trusts, and we urge caution. Notwithstanding, hybrid trusts still should be considered as an asset protection option.

Lifting the veil of a discretionary trust

Despite the duties imposed on trustees in bankruptcy, they are in many respects ill-equipped to penetrate the protective veil of a properly planned discretionary trust.

Genuine estate planning, which employs the discretionary trust well in advance of insolvency (rather than as a response to it), remains an effective mechanism for the protection of wealth.

An attempt to overturn a trust as being a sham arrangement presents a trustee in bankruptcy with a very difficult challenge.

Where the trust arrangement cannot be challenged, then the bankruptcy trustee is limited to a passive role as in circumstances where there is a judicial sanction for the exclusion of creditor interests and the preservation of the bankrupt's power to control the affairs of the trust.

It is probably no surprise that only the Bankruptcy Act's remedies give the trustee clearly defined powers and rights of recovery. Even these powers are restricted.

The avoidance of transactions under Sections 120 and 121 is limited to arrangements made in the face of bankruptcy. Properly structured, long-standing trust arrangements are unlikely to be successfully challenged.

The remuneration skimming provisions of Division 4A of the Bankruptcy Act alone can target the bankrupt's conduct regardless of the purpose or time the trust was established. These provisions, however, are complex and unwieldy, and they have been used successfully on only a handful of occasions.

Introduction

As a matter of policy, individuals are entitled to structure their financial affairs in any way they see fit. However, the increasing sophistication of financial services makes it more difficult to distinguish between legitimate estate planning and the efforts of insolvents (or potential insolvents) to deprive creditors of their legitimate rights of recourse.

The common view is that the discretionary trust is the shelter of choice for the corporate cheat. More and more, this perception is colouring the reputation of the trust as an instrument of estate planning.

When the protective elements of the discretionary trust are called to action, it is often the trustee in bankruptcy who must weigh these competing considerations and decide when recovery action is warranted. The trustee in bankruptcy is charged with the collection, administration, and distribution of the assets of the bankrupt.

The term discretionary trust can conveniently be defined as a trust created by a settler who settles property upon a trustee to hold on trust for identified potential beneficiaries.

The acquisition by a beneficiary of an interest in trust property, or the devolution of trust property to any purpose pursuant to the trust, depends on the trustee's discretion.

The nature of a beneficiary's interest is limited to a right to be considered as the potential recipient of benefit by the trustees and a right to have his interests protected by a court of equity.

Exposing Sham Trust Arrangements

Perhaps the most straightforward way for a trustee in bankruptcy to pursue trust property is to overturn the trust in its entirety. To this end, such a trustee may attempt to reveal the trust as a sham and pursue underlying property interests.

To be a sham, the creation of a trust must be a disguise for a different and independent arrangement to which all parties are in agreement (the parties being the trustee and the settlor).

Once the trustee in bankruptcy can establish a sham transaction, he must remove the disguise and identify the real nature of the transaction.

The trustee in bankruptcy faces a formidable task when considering an attempt to identify a discretionary trust as a sham:

- By law, the trustee in bankruptcy must establish an intention, common to at least the trustee and settlor, to treat the discretionary trust as a mere disguise for an underlying arrangement or relationship. The trustee in bankruptcy is likely to allege a bare trust in favour of the settlor/debtor.
- Forensically, the trustee will require evidence beyond the exercise of mere influence or even control by the debtor. The trustee must breach the divide between control and beneficial ownership to establish entitlements to the underlying asset.

Trustee as Beneficiary

If a beneficiary becomes bankrupt, the trustee pays money or transfers property to the bankrupt, and that money or property will automatically vest in the trustee in bankruptcy.

The trustee in bankruptcy occupies the beneficiary position under the discretionary trust and may exercise rights or powers conferred by the trust instrument.

Where the beneficiary's interest in the trust is a mere discretionary interest, the right to be considered for the distribution falls short of an entitlement to trust property or distributions. In the right of the beneficiary, the trustee in bankruptcy can sue if the trustee fails to exercise discretion.

Trustee's Discretion

The trustee's obligations are fiduciary. If the trustee has exercised discretion conscientiously and with integrity, it is unlikely that its decisions can be impugned.

The trustee may consider when exercising its discretions:

- Information is given to them personally or in a confidential memorandum, prepared by or on behalf of the settlor.
- The impact of taxation law on their decisions (where tax planning appears to be one objective of the trust).

Although not bound to follow the directions of the beneficiary, the trustee must take into account the wishes of the beneficiaries.

The trustee's duties are to carry out the directions contained in terms of the trust rather than directions later given by the settler. A trustee is not a delegate of the trust's creator or the beneficiary, and neither of them can direct the trustee in respect of carrying out duties unless the trust instrument (deed) empowers them to do so.

The exercise of discretion

A discretion given to trustees is not entirely unfettered, and that would be inconsistent with the trustee's fiduciary duties to exercise an act of informed discretion and jeopardise the courts' supervisory jurisdiction.

Various cases have provided that trustees are to:

- Give effect to the settlor's intention in making a settlement and will derive that intention not from the terms of the powers necessarily or exclusively but from all of the terms of the settlement, the surrounding circumstances, and their personal knowledge acquired or inherited.
- Inform themselves before deciding matters which are relevant to the decision. These matters may not be linked to simple matters of fact but will, on occasion, often include taking advice from appropriate experts. However, it is for advisers to advise and trustees to decide.
- Consider the trusts prevailing when they exercised their powers, which may differ from those at the date of the trust creation.

Where a trustee exercises discretion, it may be impugned where exercised in bad faith, arbitrarily, capriciously, wantonly, irresponsibly, mischievously, or irrelevantly or without giving genuine consideration to the exercise of discretion. Where discretion is expressed to be absolute, it may be that bad faith needs to be shown.

Trust Powers

Discretionary trust instruments will often provide powers exercisable by the bankrupt. In some circumstances, that power will control the distribution of trust property. Exercise of the power in a manner favourable to the bankruptcy could result in the acquisition of the property divisible among creditors. Is a trust power exercisable by the trustee in bankruptcy, or is it fiduciary and, therefore, personal?

The courts have considered that the powers conveyed by the trust ought to be used for the benefit of its beneficiaries rather than their creditors. Equity would not permit a trust power to use for an object extraneous to and in conflict with the objects of the trust.

The courts consider the power a trust or fiduciary power, being a power conferred by the Deed of Trust, to be exercised accordingly in the interest of the beneficiaries. Thus, the power is not the property that vests in the trustee in bankruptcy or power that might have been exercised by the bankrupt for their own benefit.

Using Asset Protection Trusts

You can, in effect, create another exemption by placing your assets in a sophisticated form of trust. Properly formed asset protection trusts will make your property unavailable to creditors even when no other exemptions apply.

After reading these sections, take an inventory of your assets and how you own them. In doing this, you will be able to gauge the degree of risk you face and make adjustments (conversions of assets) accordingly.

When dealing with asset transfers, timing is critical in asset exemption planning. Ideally, you will do this planning before your business is formed. Nevertheless, a thriving business owner is also ideal for effective exemption planning. Significant wealth can be protected before any serious problems develop. The poorest candidate for exemption planning is the small business owner who is already amid a financial crisis. Even here, however, steps can be taken cautiously to protect assets.

The protection offered by discretionary trusts - Richstarr

This raised a significant question regarding the protection offered by discretionary trusts. In the decision of ASIC v Carey (No 6) (2006) FCA 814 **(Richstar)**, Justice French in the Federal Court was prepared to look through trust and see the discretionary objects of the trust having an interest in justifying the appointment of receivers to the trusts.

Comments arising from Richstar

The message is clear for asset protection purposes. Only by removing control of the appointer, trustee and ensuring the trust is non-exhaustive can any discretionary trust be seen to avoid the risk of being the subject of a particular beneficiary's control.

Be warned; insolvency practitioners will also look more closely at how discretionary trusts operate to see whether there is a degree of control over the trust equivalent to a proprietary interest. If this is the case, they may attack assets held in Trusts. For this reason, Richstar is a landmark decision.

In past editions, we have covered the Richstar case in detail, but developments in the law have not progressed in the way first contemplated by many first analysing the Richstar judgement. While it would be fair to suggest the same level of concern does not exist, there is no place for complacency.

Appointor of Trust Trumps Deregistration and Bankruptcy – Thorne Developments Pty Ltd (CAN 109 570 194) V Thorne (2015) 106 ACSR 481

We draw your attention to this case because it demonstrates how a suitably drafted Trust Deed may assist in protecting a Trust from deregistration of the Company Trustee due to the bankruptcy of its director. This is not an uncommon situation.

Bloodline trusts

Having covered discretionary trusts, we mention in passing the key features of a bloodline trust.

- It is a fully discretionary trust.
- The rules of the bloodline trust categorically provide that the capital (assets) of the trust can never go outside the bloodline during the life of the trust.
- Income may be allocated to in-laws, but the deed stipulates that capital must stay within the bloodline.

These trusts are sometimes used in succession planning in the rural sector to ensure land and assets are passed on to the next generations.

However, we stress there can be a lack of flexibility and real issues (stamp duty and capital gains tax) if you want to add a beneficiary later.

Trusts and family law

In recent times there has been much talk about the trust-busting powers of the Family Law Court. This occurs when the court treats the trust property as the property of the parties or one of them makes orders in the financial settlement that takes the trust property into account.

This takes the net asset (as well as the income derived from these assets) of the trust into account.

The key here is to take specialist advice when dealing with assets held in discretionary trusts to protect these assets from your own or your child's divorce or another cohabitation breakdown. The clear objective here is to avoid the trust assets being treated as the property of the parties and to avoid the trust being treated as a financial resource if the outcome is that most, if not all, of the non-trust assets are given to the other spouse.

The time for planning is at the start of the relationship – defensive moves such as removing a party's control when the relationship sours are likely to fail. Here the court will be asked to consider the actual history of the trust, including any changes when the marriage started to go wrong.

When entering a marriage or cohabitation, it would be helpful if a party's parents-controlled trust with assets. The trust assets may still be a financial resource if the party can benefit. The reality is that the Family Law Courts' attack on trust assets will continue for the simple reason that it is contrary to public policy to allow the matrimonial property to be shielded from a fair division.

Given this, binding financial agreements are becoming more popular – these can be made before, during and after marriage, dealing with property and financial resources, including superannuation entitlements. It is stressed that you should seek specialist advice.

Key cases include:

- Milankov and Milankov (2002) 28 FamLR 514
- Coventry v Coventry & Smith (2004) FamCA 249
- Kennon v Spry (2008) HCA 56
- Simmons v Simmons (2008) FamCA 1088
- Woley and Humbolt (2008) FamCA 1094
- Essex & Essex (2009) FamCAFC 236
- Stephens and Stephens (2009) FamCAFC 240

Family Law Changes

We point these out because Trustees in Bankruptcy continue to struggle with the Family Law Court's relatively newfound jurisdiction in bankruptcy.

- In 2005 the Family Law Act (1975) (FLA) was amended to grant the Family Law Court power to make orders concerning the vested bankruptcy property concerning the bankrupt party to the marriage.
- This means the Family Law Court (FLC) is empowered to divest a trustee in bankruptcy of the vested bankruptcy property in favour of the non-bankrupt spouse.
- The FLC considers sections 79 and of the FLA – see Hickey v Hickey 2003 FLC 93-143.
- We would also draw your attention to Witt and Witt (2007), where there was a genuine separation of the parties.
- This opens up some exciting possibilities if a high-risk spouse is about to go bankrupt.
- If ill winds are blowing, get specialist advice, as this could greatly benefit your advantage.

We refer you to the following cases Kennon and Spry (2008) HCA56

Other cases include:

- Edgehill & Edgehill (2007) FamCA 1102 at (82)
- Beeson & Spence (2007) FamCA 200 at (28)
- Stephens & Stephens (Enforcement) (2009)
- Leader & Martin-Leader (2009) FamCA 979 at (24)
- Pittman v Pittman (2010) FamCAFC 30 at (63)-(65)
- Harris & Harris (2011) FamCAFC 245
- Morton & Morton (2012) FamCA 30 at (35)

While the outcome of Kennon v Spry appears to undermine the fundamental principle of trust law that a mere discretionary beneficiary of a trust does not have a property interest in the assets of the trust, this decision was an example of the Court's utilisation of the broad powers under the Family Law Act in unique circumstances.

This is an evolving area of law and needs careful monitoring. The above decisions indicate that a well-structured trust will continue to be an effective asset protection and estate planning vehicle.

Superannuation and asset protection during bankruptcy

A key feature of the bankruptcy law that has acted as an appropriate safeguard to protect the interests of creditors was Sections 120 and 121 of the Bankruptcy Act 1966. Sections 120 and 121 of the Act allowed a trustee to recover property transferred prior to bankruptcy in certain circumstances.

In the case of superannuation contributions, it was argued that for these transactions to be valid, the Superannuation Trustee should consider the contributions made by a debtor. If, as in many superannuation deeds, the trustee's only obligation under the Deed is to recover additional contributions, such obligations would probably not constitute valuable consideration under Sections 120 and 121. However, the High Court disagreed with this proposition in Cook v Benson (June 2003).

The amendments will:

a. Allow a trustee in bankruptcy to recover the value of contributions made by the bankrupt to defeat creditors, where the contributions were made to the bankrupt's superannuation plan and that of a third party.

b. Allow the trustee to recover contributions made by a person other than the bankrupt for the benefit of the bankrupt, where the bankrupt's primary purpose in participating in the arrangement was to defeat creditors.

c. Provide that consideration given by the superannuation trustee for the contribution will be ignored in determining whether the contribution is recoverable by the trustee, thus overcoming the effect of the High Court decision of Cook v Benson.

d. Allow the court to consider the bankrupt's historical contributions pattern and whether any contributions were 'out of character' in determining whether they were made to defeat creditors.

e. Provide that the superannuation fund will not have to repay any fees associated with the contributions or any taxes it has paid concerning the contributions; and

f. Give the official receiver the power to issue a notice to the superannuation fund or funds that are holding the contributions that will put a freeze on the funds to prevent the bankrupt from rolling them over into another fund or otherwise dealing with them in circumstances where the trustee is entitled to recover them.

These changes will not be retrospective and apply to any 'out of character' contributions made after 27 July 2006. If approaching bankruptcy, note that keeping the funds in Superannuation is crucial. Superannuation remains an effective asset protection technique if you prove that you were solvent when making payments.

Self-Managed Super Funds and Bankruptcy

A corporate trustee manages most SMSF, and the SIS Act requires all members of the SMSF to be a director of that corporate trustee. But a difficulty arises when a member becomes bankrupt as the Corporations Act prohibits a bankrupt from acting as a company director. Further, under the superannuation legislation, a bankrupt is a disqualified person who cannot participate in the management of a super fund.

If a bankrupt cannot be a director of the trustee of an SMSF, he also cannot be a member of that fund, and his entitlements will need to be otherwise dealt with. But the good news is that there is a six-month period of grace during which this issue can be addressed.

The period of grace applies only to dealing with the bankrupt's entitlement. That is, there is no period of grace to acting as a director. This means that if the bankrupt is the sole member of the SMSF and the sole director of the trustee company, he will need to arrange for a new director to be appointed quickly.

The easiest way to deal with a bankrupt's interest in an SMSF is simply to have that interest transferred to a larger fund within six months of grace. This is not a transaction that the trustee in bankruptcy can frustrate unless they believe that that interest includes contributions that should not have been made and which are recoverable under section 128B of the Bankruptcy Act.

Another option is for the members' entitlements to be paid out, assuming this is permissible under the relevant deed and legislation. A superannuation payout made after bankruptcy is exempt from realisation in the bankruptcy. If the entitlement is taken as a pension, it will be included as the bankrupt's income when the trustee assesses whether or not income contributions are payable. Again, the provisions of section 128B may apply in some circumstances.

Are Superannuation Monies within the Taxman's Reach?

As we can see above, as long as contributions are made into superannuation when the contributor is solvent and does not intend to defeat creditors, superannuation funds have asset protection benefits.

Recently Denlay v Commissioner of Taxation (2013) FCA 307 saw a long-speculated question put to the test.

The ATO holds many powers to recoup what is owed to them, including the power to 'garnishee' the tax debtor's bank accounts, some trust funds, property sale proceeds, company shares and trade debtors. An unresolved issue was whether superannuation funds were also part of the list.

A garnishee notice is a process where an entity receives a notice demanding monies held on behalf of a tax debtor, which is to be taken as being authorised by the debtor and/or any other persons also entitled to all or part of the funds. This third party is compelled to make the payment directly to the ATO and is indemnified for doing so.

Superannuation funds, by nature, are supposed to be a protected source of money, and so it has been said that a garnishee order would not be effective until the tax debtor's (member's) benefits are payable under the rules of the fund – which is usually when the member retires or dies. In the event of bankruptcy, superannuation monies are excluded from the definition of divisible property and, therefore, cannot be realised by a bankruptcy trustee to benefit creditors.

In the case of Denlay v Commissioner of Taxation, a garnishee was issued over the taxpayers' superannuation fund. At this time, the parties were part way through the hearing of appeals filed by the Denlays to amended income tax assessments made by the ATO, and at a time when the ATO had consented to an order for a stay of the enforcement of a judgment to the tax debt.

Mr and Mrs Denlay were declared bankrupt in 2012 upon lodging debtor's petitions, and Mr Denlay was not in a position to pay the tax debt or further fund the appeal of the assessment.

Early in 2013, the Denlays filed an application in the Federal Court seeking a judicial review of the Commissioner's decision to issue the garnishee notice, particularly given the stay on the enforcement of the judgment. The court accepted Denlay's argument and quashed the garnishee notice ordering that the monies be refunded to the superannuation fund, awarding costs in favour of the Denlays on an indemnity basis.

However, this garnishee was quashed because it was considered inappropriate to issue such a notice at the time of a court ordered stay on enforcement proceedings, not because superannuation monies are generally believed to have some sort of protection.

We also refer you to the below case:

Australasian Annuities Pty Ltd (In Liquidation) V Rowley Super Fund Pty Ltd (2013) VSC 543 (Supreme Court of Victoria, Almond J, 17 October 2013)

Recent developments

So, it is clear the Commissioner has the power to issue a garnishee notice meaning the amount of money sitting in the super account can be swept up in the garnishee notice and taken immediately. The ATO has special powers to self-issue the garnishee notice. A creditor can also seek to obtain superannuation money with a Court ordered garnishee.

Debt can be claimed under a garnishee notice. This notice requires anyone who holds money for the debtor/taxpayer to pay the money to the creditor/ATO.

The garnishee will not be effective until the debtor's (member's) benefits are payable under the rules of the (superannuation) fund. The super fund will be required to pay the garnisheed amount to the Commissioner or relevant creditor.

The key concept is: what is due and payable from the superannuation fund. The person claiming the garnishee (including the ATO) can only garnishee what is accessible by the superannuation member. And this will depend on the rules of the fund. The rules of the fund concept are the key to a potential solution.

People need to get clear advice, be aware of their exposures and act promptly if bankruptcy is inevitable before a garnishee can be issued. Once a garnishee issues (whether ATO or creditor), it may be very difficult to protect the super. Declaring bankruptcy after the fact is too late; once issued on the superannuation, it will already have been garnisheed. Assess the probability and, if inevitable, protect the superannuation by embracing bankruptcy. All of the protections of the Bankruptcy Act will then apply.

But what about the pre-bankruptcy phase? The key to enhancing super's pre-bankruptcy protection lies in the phrase due and payable. It is only an amount due and payable from the super fund to the member that may be subject to a garnishee notice.

Of course, superannuation is still the subject of a condition of release that is not due and payable. Because we know that today all superannuation complies with the minimum standards of the Superannuation Industry (Supervision) Act and Regulations, we can recognise that no superannuation is due and payable until a condition of release is satisfied. Progressively the most common such condition is terminating employment after the age of 60 or reaching the age of 65.

If the superannuation is not due and payable before terminating employment after the age of 60 or before reaching the age of 65, the garnishee notice will not be effective. Otherwise, it can be and will. It is Australians over 60 who have the exposure here. This is a complex issue so in the event of financial hardship, take specialist advice to protect your super.

The clawback provisions

A lack of planning may prove fatal due largely to the clawback provisions of the Bankruptcy Act rendering manoeuvres to defeat creditors ineffective.

Section 120: Undervalued transactions

(1) A transfer of property by a person who later becomes a bankrupt (the transferor) to another person (the transferee) is void against the trustee in the transferor's bankruptcy if:

  (a) The transfer took place in the period beginning five years before the commencement of the bankruptcy and ending on the date of the bankruptcy; and

  (b) The transferee gave no consideration for the transfer or gave consideration of less value than the property's market value.

(2) Subsection (1) does not apply to:

  (a) a payment of tax payable under a law of the Commonwealth or a State or Territory; or

  (b) a transfer to meet all or part of a liability under a maintenance agreement or a maintenance order; or

  (c) a transfer of property under a debt agreement; or

  (d) a transfer of property if the transfer is of the kind described in the regulations.

(3) Despite subsection (1), 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 four 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 two years before the commencement of the bankruptcy; and

    (ii) the transferee proves that, at the time of the transfer, the transferor was solvent.

Section 121: Transfers to defeat creditors

(1) A transfer of property that later becomes a bankrupt (the transferor) to another person (the transferee) 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 making the property available for division among the transferor's creditors.

(2) The transferor's primary purpose in making the transfer is the purpose described in paragraph (1)(b) if it can reasonably be inferred from all the circumstances that, at the transfer time, the transferor was, or was about to become, insolvent.

(3) Despite subsection (1), a transfer of property is not void against the trustee if:

(c) the consideration that the transferee gave for the transfer was at least as valuable as the market value of the property; and

(d) 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 paragraph (1)(b); and

(e) the transferee could not reasonably have inferred that, at the time of the transfer, the transferor was or was about to become insolvent.

Section 123(6) provides that:

"Subject to section 121 nothing in this Act invalidates, in any case where a debtor becomes a bankrupt, a conveyance, transfer, charge, disposition, assignment, payment or obligation executed, made or incurred by the debtor, before the day on which the debtor became bankrupt, under or in pursuance of a maintenance agreement or maintenance order."

Which assets can be taken or sold in bankruptcy?

Divisible and non-divisible property

Asset protection extends into bankruptcy, and you need to understand the tricks, traps, and pitfalls fully. All too often, bankrupts lose family assets due to a lack of understanding or by way of oversight or a lack of care.

Understanding which assets in a bankruptcy a trustee can realise is necessary. The Bankruptcy Act 1966 defines assets into two categories:

1. Divisible assets are available to a trustee.
2. Non-divisible assets are not available to a trustee.

This issue is frequently disputed.

Section 58 of the Bankruptcy Act merely states all divisible property vests in the bankruptcy trustee. The starting point for the bankruptcy trustee is that divisible property is all the bankrupt's property, and non-divisible assets are then eliminated from the list.

The Bankruptcy Act broadly defines divisible property as covering the following:

- All property owned at the time of bankruptcy or acquired during the bankruptcy.
- Any rights or powers over property that existed at or during the bankruptcy date.
- Any rights to exercise powers over the property.
- Any property that vests because an associated entity received the property resulting from personal services supplied by the bankrupt (section 139D of the Bankruptcy Act).
- Monies recovered from an associated entity due to an increase in the entity's net worth resulting from personal services supplied by the bankrupt (section 139E of the Bankruptcy Act).

Section 116 of the Bankruptcy Act lists what classes of assets are also divisible among creditors.

Bankruptcy act 1966 – section 116

Property divisible among creditors

Subject to this Act:

a. all property that belonged to, or was vested in, a bankrupt at the commencement of the bankruptcy, or has been acquired or is acquired by him or her, or has devolved or devolves on him or her after the commencement of the bankruptcy and before his or her discharge; and

b. the capacity to exercise and to take proceedings for exercising all such powers in, over or in respect of property as might have been exercised by the bankrupt for their own benefit at the commencement of the bankruptcy or at any time after the commencement of the bankruptcy and before their Discharge; and

c. property that is vested in the trustee of the bankrupt's estate by or under an order under section 139D or 139DA; and

d. money that is paid to the trustee of the bankrupt's estate under an order under section 139E or 139EA; and

e. money that is paid to the trustee of the bankrupt's estate under an order under paragraph 128K(1) (b); and

f. money that is paid to the trustee of the bankrupt's estate under a section 139ZQ notice that relates to a transaction that is void against the trustee under section 128C; and

g. money that is paid to the trustee of the bankrupt's estate under an order under section 139ZU; is property divisible amongst the creditors of the bankrupt.

What is non-divisible property?

Determining what is not a divisible property can be a difficult area.

The Bankruptcy Act provides that some property types will not be divisible among creditors under Section 116(2).

The list of non-divisible assets is extensive, but these assets rarely appear in most cases. Some are quite common and are non-divisible because they are necessary for the bankrupt's ability to maintain a standard of living.

These can be grouped into the following areas:

- Property held by the bankrupt in trust for another person (i.e., not owned by the bankrupt).
- The bankrupt's household property.
- Personal property that has sentimental value for the bankrupt and is identified by a special resolution passed by the creditors before the trustee realises the property.
- The tools of the trade that the bankrupt uses in earning income by personal exertion—are subject to the value threshold.
- A vehicle used by the bankrupt as a means of transport—subject to the value threshold.
- Policies of life assurance or endowment assurance cover the life of the bankrupt or their spouse, whether the proceeds are received on or after the date of the bankruptcy.
- The bankrupt's interest in a regulated superannuation fund.
- Payment to the bankrupt under a payment split under Part VIIIB of the Family Law Act 1975, where the eligible superannuation plan is a fund or scheme covered by the Act, and the payment is not a pension within the meaning of the Superannuation Industry (Supervision) Act 1993.
- Money held in the bankrupt's retirement savings account (RSA)-or a payment to a bankrupt from an RSA received on or after the date of the bankruptcy—if the payment is not a pension or annuity within the meaning of the Retirement Savings Accounts Act 1997.
- Payment to the bankrupt under a payment split under Part VIIIB of the Family Law Act where the eligible superannuation plan involved is an RSA, and the payment involved is not a pension or annuity within the meaning of the Retirement Savings Accounts Act.
- Any right to recover damages or compensation (or amounts received before or after bankruptcy) for personal injury or wrongdoing or regarding the death of the bankrupt's spouse, de factor partner, or family member.
- Amounts paid to the bankrupt under a rural support scheme as prescribed by the Act.
- Amounts paid to the bankrupt by the Commonwealth as compensation in relation to loss as prescribed by the Act relating to the rural support scheme.
- Property that was purchased or acquired with protected money.
- Any property under an order—under either Part VIII or Part VIIIAB of the Family Law Act 1975—the trustee is required to transfer to the bankrupt's spouse, a former spouse, or a former de facto partner.
- The bankrupt's property is a support for the bankrupt funded under the National Disability Insurance Scheme (NDIS), or NDIS amount defined in that Act.
- Some divisible properties, including cars and tools of the trade (see above), are subject to statutory value thresholds, which are indexed by the Australian Financial Security Authority (AFSA).

The thresholds are designed to allow bankrupts to maintain a standard of living (the household property limitations) and maintain some employment (the tools of the trade and motor vehicle limitations).

Time limits for the realisation

Section 129AA of the Bankruptcy Act sets the periods that apply to divisible assets for the bankruptcy trustee to deal with these assets. Any divisible assets a bankrupt discloses must be realised within six years after the bankrupt is discharged. A bankruptcy trustee can extend this period up to three years at a time by giving written notice to the bankrupt before the six-year expiry. There is no limit on how many extensions a bankruptcy trustee can seek.

For after-acquired property disclosed during bankruptcy, the trustee has to deal with the property six years after the bankruptcy's discharge date. For any after-acquired property a bankrupt discloses after discharge, the bankruptcy trustee has six years from the disclosure date to realise the property. Again, a bankruptcy trustee can extend these periods.

If these assets are not dealt with during the required period, they can revert to bankruptcy.

Section 127 of the Bankruptcy Act outlines that a trustee has 20 years from the date of bankruptcy to deal with a bankrupt's property. After the 20 years expiry, the property reverts to bankruptcy.

Undischarged bankrupts and income tax refunds

Many people enter bankruptcy with large tax debts owed to the ATO. A common question is what will happen to the debtor's tax refunds after bankruptcy.

During bankruptcy, the debtor has to lodge their income tax returns each year as normal. Usually, any ongoing personal income tax refunds are retained by the ATO and set off against the ATO's pre-bankruptcy debt until the debtor is discharged from bankruptcy.

After being discharged from bankruptcy, the debtor will resume receiving their personal tax refunds if applicable.

This is because, upon release from bankruptcy, the individual is released from all debts provable in the bankruptcy (i.e., during the pre-bankruptcy period). Prior to discharge, tax debts remain owing, and the ATO has the power to retain tax refunds and apply them against the debt it is owed. Refer to Taylor v DCT [1987]

Upon discharge from bankruptcy (usually three years from lodgement of the debtor's Statement of Affairs, unless there is an objection to discharge), the pre-bankruptcy debt is considered irrecoverable at law, and the ATO 'writes off' these debts.

There is an exception where a tax refund relates to a pre-bankruptcy period; the ATO will retain the refund and set it off against the pre-bankruptcy debt, even after discharge.

Safe harbour protection for company directors against insolvent trading claims

In September 2017, new legislation was passed providing "safe harbour" protection for company directors against insolvent trading claims while they develop and implement plans to restructure the company.

Background

The Corporations Act 2001 (Cth) prohibits company directors from engaging in insolvent trading.

A director can be liable for debts incurred by the company while it is insolvent or if incurring the debt makes the company insolvent. The action is brought against the director by the liquidator when a company enters liquidation.

This new "safe harbour" legislation allows directors to attempt a restructure of the company without the threat of personal liability for insolvent trading.

This now encourages directors, when they believe that the company is insolvent, to take action reasonably likely to lead to a better outcome than formal insolvency.

Many consider the insolvent trading laws have led to companies being placed into voluntary administration or liquidation to avoid personal liability in circumstances where the company may have been viable in the longer term.

The new laws aim to give directors space to consider other strategies and to take reasonable risks without the threat of personal liability.

A director will enter safe harbour if they:

- suspect the company could be insolvent
- starts developing, and within a reasonable time, puts into effect a course of action that is reasonably likely to lead to a better outcome for the company.

It is crucial to develop a course of action. Optimism is not a course of action.

Safe Harbour is not allowed if the company has not:

- paid its employee entitlements, including superannuation, by the time they fell due
- provided its returns, notices, statements, applications, or other documents to the ATO more than once during the 12 months before a debt is incurred from which the director seeks the protection of the safe harbour.

Record keeping

When faced with an insolvent trading claim by a liquidator, directors must demonstrate they have met the legislative requirements for entry into the safe harbour. That means showing:

- employee entitlements were paid when due
- tax reporting obligations have been met
- they have developed a course of action has been framed which is reasonably likely to lead to a better outcome for the company

These must be documentation showing:

- the company's financial position at the time of the insolvency was suspected
- the likely outcome if the company was placed into formal insolvency (to show that the course of action undertaken was reasonably likely to result in a better outcome)
- advice on the restructure plan from a qualified adviser such as an accountant or lawyer and their opinion as to the prospects of the restructure achieving a better outcome; and
- strategies implemented to measure the turnaround (including creating turnaround committees and alternative plans).

Clearly, those who have not kept proper records and/or are seeking not to pay employee entitlements as well as not pay money they are holding in trust for the ATO (PAYG and GST) cannot enter the safe harbour. Quite properly, those seeking safe harbour need to be up to date in their lodgements with the ATO.

Safe harbour is there for those company directors who have dealt with adverse trading conditions but genuinely tried to do the right thing. Documentation is the key, and you must seek expert advice.

Ipso Facto Clauses

The new law puts a 'stay' on ipso facto clauses in contracts by preventing the enforcement of those clauses in certain circumstances, including when a company enters into administration or when the company is undertaking steps to avoid being wound up in insolvency. The period of the stay varies depending on the circumstances. For a company in administration, the period of the stay commences when a company comes under administration and ends when the administration ends.

By making ipso facto clauses unenforceable during a company's restructure, financially distressed companies will have some 'breathing space' to continue to operate while they restructure and take steps to avoid becoming insolvent.

The stay on enforcement of the ipso facto clauses came into force on 1.7.2018 and only applied to contracts entered into after 1.7. 2018.

One-year bankruptcy an update

The Bankruptcy Amendment (Enterprise Incentives) Bill 2017 ("the Bill") was referred by the Senate on 30 November 2017 to the Legal and Constitutional Affairs Legislation Committee for inquiry and report. The Committee was due to report by 19.3.2018. After submissions closed on 31.1. 2018.

The March deadline was not met, and there were no further developments at the time of going to print.

The Bill reduces the period a bankrupt individual must wait for an automatic discharge from bankruptcy from 3 years to 1 year after filing a statement of affairs by the bankrupt.

However, bankruptcy remains subject to the income contribution regime until the later three years from when they became bankrupt or when they are discharged.

This amendment may result in higher income contributions being paid to the bankrupt estate by a discharged bankrupt than may have been paid if the period of bankruptcy remained three years. The reasoning here is that after one year of bankruptcy, a discharged may return to business activities or gainful employment without the social stigma and legal disabilities of bankruptcy.

On the other hand, what incentives will the former bankrupt have to comply with their continuing obligations without the possibility of the Trustee objecting to a bankrupt's discharge?

If the legislation is passed, this would not be the first time Australia's bankruptcy discharge period has fallen to one year; the Bankruptcy Act 1966 previously allowed an "early discharge" after 12 months at the bankruptcy trustee's discretion. However, the law reverted to a three-year period in 2003 because it was believed the shorter period discouraged debtors from trying to enter debt arrangements with their creditors.

The intention was that this legislation would be passed late in 2018 and receive royal assent early in 2019. This had not occurred at the time of publication, and there remains some doubt as to whether this legislation will now be passed.

The Senate Legal and Constitutional Affairs Legislation Committee recommended that the Corporations Act be amended to ensure that the one-year default period does not allow bankrupts discharged immediately to become the sole director of a propriety company. Subject to that recommendation, the Committee recommended that the Bill be passed. We will keep you informed on developments.

Last year this segment was titled "One-year bankruptcy a step closer". The Morrison Government did not introduce the legislation, and it now seems doubtful the Albanese Labour Government will entertain it.

Strengthening company and directors' obligations

So, you've been asked to sit on the board

Typically, this is an unlisted public company, and the expectations are that this could lead to a public listing in one to two years.

You have been sought out because you are a Lawyer, accountant or leading academic. In short, you and others are needed to give the board credibility to attract future investors. Typically, we have an entrepreneur who is aiming high, is hands-on and has an unshakeable self-belief.

We never want to dampen the entrepreneurial spirit in any way – these people achieve great things, and we commend initiatives such as the 'National Innovation and Science Agenda' announced on 7.12.2015.

The cold hard facts are that less than 5% of these start-ups successfully achieve their objectives – some are wound up in an orderly fashion while others fail spectacularly, owing creditors and staff substantial amounts of money.

Sometimes when this happens, the non-executive directors express genuine surprise. The board meetings often had a hiatus after initial positive meetings that spoke of limitless opportunities.

Telephone discussions with the charismatic entrepreneur revealed that despite tight conditions, future funding was assured, and there was no real cause for concern.

What should have happened? Before accepting the appointment, you could have:

- Requested access to the company's corporate governance policy.
- Insisted on core inclusions on the agenda for the monthly board meetings.
- At the very least, these would have included monthly management accounts and summaries of cash balances, aged debtors (what is owed) and aged creditors (what the company owes).
- Copies of ATO portal balance establishing the position with company lodgements and debtors GST, PAYG, company tax and other liabilities.
- Sighting legal opinions/advice, etc., gives assurance regarding ownership of patents, intellectual property mining concessions and licences.
- Take steps to understand who you are dealing with – beware the entrepreneur well into middle age who is yet to achieve anything of note or, worse still, has a chequered past.
- It is very easy to make discreet inquiries and do internet and /or ASIC searches on the relevant individuals. Finally, how well do you understand the company's technology and market?
- Do the research yourself while seeking out independent parties in the industry for a second opinion. Do not take anything at face value.

Never forget- cash flow in a start-up is everything, and beware the charismatic chairman who does not make full disclosure on these issues at board meetings.

Survival checklist for company directors

1. Do 'Quick Analysis' on at least a Quarterly Basis. This is the ratio of current assets divided by current liabilities in the company's balance sheet, and a quick ratio of less than one is a cause for concern. Further, is the ratio improving or declining?
2. Periodically review related party loan accounts and fully understand the implications of these.
3. Ensure all compliance obligations with the ATO are up to date. This allows an overview of debt and avoids penalties and personal liability.
4. Leading on from this, always consider solvency issues – meaning can the company pay its debts as and when they fall due.
5. Consider the marketplace and the sometimes-rapid changes and challenges. Always question the ongoing viability of the business.
6. Often in SMEs, each director may have specific responsibilities - for instance, someone may be heavily involved in marketing. Such a person should insist on receiving key financial data monthly.

7. Be particularly careful with a start-up – an experienced and competent accountant must review and test the business model.

The above involves defensive steps that may be required, but we acknowledge where there are threats, there are also opportunities and that we like to see SMEs flourish and prosper.

The level of personal responsibilities for directors

For those becoming a director for the first time, it is essential that the following is clearly understood. You can be held personally liable.

In the event of insolvent trading:

- Not lodging BAS in a timely fashion, i.e., more than three months late, leaving the company owing GST, PAYG and superannuation in the event of liquidation.
- Giving personal guarantees.
- There are debit loan accounts in the company (you owe the company money) that a liquidator can pursue as an individual.
- There are other exposures, but the above are the most common.
- Anyone can understand these exposures, and the professional adviser should not just mention these at company inception but remind clients regularly. Any company director's key message is that you may be held personally responsible.

Director's Penalty Notices –Legislation

The Government passed this legislation in July 2012.

- In addition to PAYG withholding amounts, directors are personally liable for their company's unpaid superannuation guarantee charge. Further legislation, effective from 1.4.2020, extends this to GST.
- A new director is not liable to a director penalty for company debts that existed when they became a director until 30 days after they became a director.
- In addition to estimating unpaid PAYG withholding liabilities, the Commissioner can estimate unpaid superannuation guarantee charges.
- The Commissioner may also serve a copy of a director penalty notice on the director at their tax agent's address.
- Where three months have lapsed after the due day, the director penalty is not remitted by placing the company into administration or beginning to wind it up.
- New directors are not subject to these restricted remission options until three months after they become a company director, rather than three months after a debt arises.
- In addition to these defences, a director that becomes liable to a director penalty for not causing its company to comply with its superannuation obligations is not liable to a director penalty if the company treated the SGA Act 1992 as applying to a matter in a reasonably arguable way. The company took reasonable care in applying the SGA Act 1992 to the matter.
- Where a company has failed to pay PAYG withholding amounts to the Commissioner, the Commissioner has the discretion to reduce a director's entitlement to PAYG withholding credits relating to withholding payments made by the Company.
- Company directors and their associates entitled to a credit attributable to a payment by a company that has failed to pay amounts withheld under PAYG withholding to the Commissioner can be liable to pay PAYG withholding non-compliance tax.

Tips for Company Directors

If you are about to accept a position as a company director:

- As part of your due diligence, ensure that you cover the company's GST, PAYG, and superannuation guarantee obligations. A new director will become liable to a director penalty if, after 30 days of joining the company, the company still has not discharged its obligations.
- Companies should review their GST, PAYG and superannuation compliance procedures to ensure there are no risks identified, such as incorrectly classifying employees as contractors or incorrectly calculating their superannuation obligations.

Director penalty notice regime affected by significant change

Following the concessions offered due to the COVID-19 pandemic, in the first half of 2022, the ATO became more stringent in its debt collection, issuing thousands of Director Penalty Notices.

The ATO can issue one of two types of DPN to make a director personally liable for a penalty equal to the value of a company's overdue SGC, PAYG, and GST. These are a non-lockdown DPN, issued when statements are lodged (within three months of the due date) but debts aren't paid; and a lockdown DPN, issued where statements

have not been lodged (within three months of the due date) and debts are unpaid.

However, as outlined below by leading Insolvency firm Worrells, a major change has resulted from the recent Federal Circuit and Family Court of Australia decision in Clifton (Liquidator) v Kerry J Investment Pty Ltd trading as Clenergy [2020] FCAFC 5. It found that entering into a payment arrangement does not cause a tax debt due and payable to cease to be due and payable. This negatively impacts the non-lockdown DPN options to remit personal liability.

Directors must consider the other options to avoid personal liability, which includes:

- To place the company into liquidation.
- To place the company into administration.
- To appoint a small business restructuring practitioner and commence the small business restructuring process.
- For the company to pay its debt obligations to the ATO in full.

To comply, directors must action one of the above options within 21 days of the date on the non-lockdown DPN. With the low likelihood of companies in financial difficulty being able to fund their debt within this period fully, we fully expect this change to increase the number of formal appointments we see this year as directors are forced to decide to restructure or end their company's operations.

Is this change a good thing?

This change makes a payment arrangement with the ATO a far less palatable option and effectively provides clients with fewer options when receiving a non-lockdown DPN from the ATO. It also creates a greater risk of directors becoming personally liable for ATO debts without being aware that they have taken on that financial exposure.

Illegal phoenixing

The Treasury Laws Amendment (Combating Illegal Phoenixing) Bill 2019 passed through Parliament and received royal assent on 17 February 2020.

The latest laws come under a suite of legislative initiatives introduced to Parliament to combat this illegal activity, estimated to cost taxpayers billions of dollars annually.

The reforms are significant, including:

- restricting director resignations from being backdated
- preventing directors from resigning if it leaves the company without a director
- extending the director penalty regime (DPN) to cover a company's GST liabilities in certain circumstances
- prohibiting "creditor-defeating dispositions" of company property.

Additional exposures for directors, two cases – creditors and financiers

Do not think you can hide behind the corporate veil...

Personal liability for misleading contractual promises

It should be noted Australian Consumer Law (ACL) can render directors personally liable for misleading or deceptive conduct engaged on behalf of a company in commercial transactions.

A contractual promise will imply representations about the present intent and ability of the company to perform the promise. It is critical that reasonable grounds can be demonstrated for making these representations because the potential personal exposure of the director who transacted the deal can be devastating.

We direct you to the decision of the Western Australian Supreme Court in Grande Enterprises Ltd v Pramoko (2014) WASC 294, 22.08.2014. Here the director in question was effectively ordered to personally acquire an asset sold by him on behalf of the company for $2,250,000.

Unreasonable Director Related Transactions (UDRTs)

Liquidators have several weapons at their disposal for recovering money or assets removed from a company before it goes into external administration.

One powerful addition to the liquidator's arsenal is the Unreasonable Director Related Transaction (UDRT).

Following the collapse in 2001 of HIA due to large director bonuses, the Federal Parliament 2003 passed the Corporations Amendment (Repayment of Director's Bonuses) Act 2003, explicitly aimed at providing a way to recover bonuses paid to the directors of failed companies. Since then, the new powers have had a much wider practical implementation.

The 2003 Act introduced section 588FDA to the Corporations Act. The new section applies to transactions between a company and a director of the company or a "close associate" of the director and also

applies to transactions involving the company and third parties acting on behalf of a director or close associate.

Liquidators can establish that a transaction is a UDRT if it can show that a reasonable person in the company's position would not have entered into it after consideration of the benefits and detriments to the company, the benefits gained by others, and "any other relevant factor." Once this unreasonableness is established, the liquidator has a range of options under section 588FF to recover the money or property transferred or to otherwise relieve the company of the burden of the UDRT.

- *We can expect to hear more of URDT given recent corporate collapses. All of these point to the need for detailed asset protection before getting into financial difficulties.*

A decision of the Victorian Court of Appeal in Vasudevan v Becon Constructions (Australia) Pty Ltd (2014) VSCA 14 has the potential to significantly broaden the power of a liquidator to attack a company transaction under section 588FDA of the Corporations Act 2001 (Act) where there are 'indirect benefits' to a director or close associate of a director of the company.

Although liquidators will welcome the decision, it has worrying implications for financiers or creditors. Even a third-party arm's-length creditor could be caught.

For creditors, the type of transaction most at risk will be where a company has provided a guarantee or security for a third party's debt.

If a transaction is an unreasonable director-related transaction, there is a four-year relation back period, and the liquidator does not have to prove insolvency at the time of the transaction or that the company became insolvent as a result of the transaction.

No doubt an advantage to the liquidator, but very worrying for financiers and creditors.

Some relevant recent case law includes:

- Weave v Harburn (2014) WASCA 227
- Lyngray Developments Pty Ltd (In Liquidation) v Dushas & Anor (2013) QCA55
- Great Wall Resources Pty Ltd (in liq) (2013) NSWSC 354
- I & K Frost Pty Ltd (in liq) v Frost (2014) NSWDC 193

Fraud dangers for mature business owners

For mature business owners, read "older"; this is a generational issue.

In the last 30 years, there has been a major shift as most small businesses have completely moved to computerise their records.

This could be dangerous for business owners (typically those in middle age or older) who do not know their way about the ledgers of, say, Xero or MYOB.

Formerly such business owners would carefully scrutinise their manual cash books every month.

If your business is profitable and it is known you are "hands-off", this could be a problem. You should have the basic skills to navigate your accounting system – if not, get tuition and bear in mind you don't need accounting expertise to identify false transactions as you will generally know what is and isn't going on in your business.

If you cannot do this, at the very least, request hard copies of monthly ledgers, scrutinise these and ask questions. This puts your staff on notice that you are checking things.

Finally, you cannot count on your Public Accountants to pick up a fraud as they usually have a tax agents' focus - not an audit focus.

Fraud – Recent Development

The Association of Certified Fraud Examiners' 2018 annual report1 on "occupational fraud" (defined as fraud committed against an organisation by its own officers/directors/employees) shows that 2,690 cases of occupational fraud from 125 countries in 23 different industries:

- Asset misappropriation schemes are the most common but least costly, at a median loss of US$114,000.
- Small businesses lost almost twice as much per instance of fraud.
- Nearly half of frauds were attributed to internal control weaknesses.
- Offenders who were employed for over five years stole twice as much as those whose tenure was under five years.
- Most victims recovered nil.

At least one behavioural red flag of fraud was shown in 85 per cent of cases, for example:

- Living beyond their means.
- Financial difficulties.
- Unusually close association with a supplier or customer.
- Unwillingness to share duties.

- Family problems.
- "Wheeler-dealer" attitude.
- Refusal to take vacations.
- Data monitoring/analysis and surprise audits were correlated with the largest reductions in fraud loss and duration.

The association also found that a lack of management review is the most common reason for asset misappropriation.

- Conduct measures to be taken in regular and meaningful conversations with employees to uncover the above red flags.
- Implement random and frequent spot checks of business transactions.
- Ensure two-party authorisation on EFTs.
- Director or owner authority on payments made above a certain amount.
- Use the accounting software's reporting to identify anomalies and reconciliation issues.

Business owners should be vigilant about the real risk of employee fraud and work with their professional advisers to design and implement appropriate measures to manage that risk. Those measures need regular review. Changes in the business environment mean these measures need updating.

Bookkeeper Fraud

A national study into fraud by bookkeepers employed at small and medium-sized businesses has uncovered 65 instances of theft in more than five years, with more than $31 million stolen.

Fifty-six involved women, with nine involving men. However, male bookkeepers who defrauded their employer stole three times, on average, the amount that women stole.

The study looked at criminal convictions recorded across Australia over six years. $31,379,761 was stolen at an average of $482,766 in each instance.

Nothing excuses a breach of trust, but from personal experience, women and bookkeepers, in particular, steal due to pressing financial needs. Let us be clear the overwhelming majority of bookkeepers are decent, honest people who exercise their duty of care to their employers or clients. However, as fraud is becoming increasingly prevalent, we suggest the following steps:

- Establish a procedure policy for the receipt of payments, ensuring an employee, in addition to the bookkeeper, reconciles amounts owing with the customer ledger.
- Limit the scope of financial transactions the bookkeeper can undertake solely (electronic bank transfers, BPay, sole cheque signatory).
- Routinely, randomly examine financial transactions.
- Beware the bookkeeper who insists on not delegating financial account-keeping functions and rarely takes leave.
- Keep a careful eye out for any unusual general ledger accounts to which your accounts payable system is posting.

The majority of fraud can be prevented with the right controls in place. It is prudent risk management to take the risk of fraud seriously. The cost of prevention is usually a fraction of the loss that is possible if the fraud was not prevented.

Other ideas to minimise the likelihood of fraud:

- The real danger involves the small business that has owners that take a weekly draw or wage and are very hands-on and heavy involvement in the business,
- Such people tend to develop faith in the bookkeeper relying on them because they cannot stand paperwork,
- Whilst the bookkeeper may keep the office organised and tidy, they may also rob the owner blind!
- This is because the owner's content with their weekly draw (for now) and often do not conduct any checks,
- At the very least, request monthly Profit and Loss statements and balance sheets for review,
- You may have a limited understanding of accounting but do not be afraid to ask questions. At the very least, this puts the bookkeeper on notice that you have an active interest in the firm's finances,

Focus on sighting:

- Bank balances (Reconciliations)
- Aged Accounts Receivable lists (Debtors)
- Aged Accounts Payable lists (Creditors)
- Stock Levels (if applicable)
- Reconcile these back to the balance sheets.
- You may wish to involve your public accountant/tax agent if there are irregularities. They will then have an audit focus.

Internal Controls and the Safety of Money

Fraud control should always be an important consideration when designing any business system. Many small business insolvencies continue to attribute their insolvency, at least in part, to employee fraud. We would all prefer to believe that all our employees are sincere, but that is rarely the case.

Employees steal for various reasons, but three factors must be present in an environment for fraud to be committed.

- a need – the internal reason for the person to steal
- the opportunity to do so
- is the belief that you will not be caught

Internal controls are meant to limit (I doubt that you will ever eliminate) the opportunity, and to portray the position that a fraudster will be caught and prosecuted should be carefully considered. Internal controls are both meant to limit (I doubt that you will ever eliminate) the opportunity, and to portray the position that a fraudster will be caught and prosecuted should be carefully considered.

Electronic Funds Transfer (EFT) payment processes should be carefully considered in this age. What controls, particularly fraud controls, should be embedded in the process?

Focus on separation of duties, one flow of information, authorisations, and contemporaneous recording of the transaction. In a small business, this may not be practicable, but you should be aware of "best practice" because the cost of complacency could be your business's survival.

At least three people are involved in the preparation, authorisation and processing of any payment; each person will only handle the transaction once; the detail cannot be changed after authorisation; the system automatically records the transaction as it is done. At least three people are involved in the preparation, authorisation and processing of any payment; each person will only handle the transaction once; the detail cannot be changed after authorisation; the system automatically records the transaction as it is being done. Then the system automatically notifies all parties involved that the transaction has been done as soon as it is done. In the end, the system records the transaction and saves a PDF version on the computer file and in the audit trail.

The sole director and shareholder become bankrupt

The sole director and shareholder companies have been allowed since the mid-'90s. This may well be an ideal structure for many small businesses, but what happens when the sole director becomes bankrupt?

Section 206B of the Corporations Act provides that a person is automatically disqualified from "managing a corporation" upon becoming bankrupt. Further, section 201F (3) strongly suggests that "disqualified" automatically means removal from the director position. Thus, there appears to be no need for the bankrupt to take any overt action to resign as director.

The bankrupt's shareholding in the company will vest in the trustee of the bankrupt estate. However, the trustee does not become a shareholder in the company until the director causes the share register to be updated. This results in a company without a director and no registered shareholder who can rectify the position. It is a rudderless ship.

Often the bankrupt's company will be liquidated or struck off by ASIC. However, occasionally, there may be a financial advantage in keeping the company alive. Fortunately, the Corporations Act has a machinery section that overcomes the no director or registered shareholder impasse.

Section 201F (3) explicitly states that a trustee of the bankrupt estate may appoint a person as the company's director where the bankrupt was the sole director and shareholder. Further, subsection (4) allows the trustee to appoint themselves.

Whether the trustee should take up the appointment would depend on the circumstances, and many trustees would hesitate to take on that role if any risk were perceived.

Directors' duties – asset protection

Company Directors must ensure that the company does not incur a debt whilst it is insolvent or does not become insolvent by incurring that debt.

Accordingly, Company Directors are increasingly exposed to personal liability for business debts.

Further executions of personal guarantees by directors have become commonplace and essential today if one wants to continue in business. This means that directors of small to medium-sized businesses have exposed themselves to personal liability by guaranteeing the debts of their companies. Demands on the directors will normally proceed when there is a default according to a personal guarantee.

Since 1993 the Australian Taxation Office also has had its recovery powers for company debts extensively increased as the ATO can now place a penalty on directors equal to the tax debt outstanding for the company according to Section 588 FGA of the Corporations Act. This provision allows the ATO to be indemnified by the directors for certain company tax liabilities.

Common-Law and Contractual duties are also owed by directors governed by Case Law and their individual employment contracts.

The Common Law duty of care, skill, and diligence stems from the law of negligence and the relationship of proximity between the director and the corporation.

Rules of equity also impose several duties on directors by virtue of the fiduciary relationship between directors and the company. A liquidator is able to bring proceedings for breach by a director of a duty owed to the company that, but for the insolvency of the company, would otherwise be exercisable by the company.

So effectively, corporate structures are not the protective instruments they once were to secure against commercial risk. It is more evident that directors are personally exposed in the case of insolvency. A more litigious society has made unforeseen claims more of a reality, and consequently, directors need to protect themselves and their assets from adverse situations.

Directors and Officers (D & O) Insurance

There may be little benefit to an insolvency practitioner or creditors in pursuing directors unless the directors are covered by D & O insurance giving the practitioner access to the funds of an insurance company.

However, there are a number of standard exclusions from D&O policies that significantly restrict the amount of ambit of their operations. These include:

- **prospectus-type liability exclusion will often be important** to directors of companies who propose to embark on a public offering.
- **Professional indemnity exclusion** excludes cover for claims alleging a breach of duty other than the professional duties owed by a director.
- **Insured versus insured exclusion** excludes claims brought by one person covered by the insurance against another, including by the company against a director. This is a significant exclusion because a director's duties owed to the company itself and actions thus brought by the company are a significant potential source of liability. Many D & O policies contain an exception to the insured versus insured exclusion. This is to prevent the manufacturing of a claim, for example, by the company directors breaching a duty and voting to sue themselves to get damages for which the company is insured.

D & O policies normally include an exclusion to extend cover to claims brought in the name of the company at the instigation of a receiver, administrator, or liquidator.

D & O insurance in the context of insolvent trading claims?

Section 199B and 199C of the ACT provide that a company must not pay an insurance premium of the company against a liability arising out of conduct involving a wilful breach of duty. So, as long as the D & O policy excludes such claims from its ambit, a company can take out effective D & O insurance for its directors and officers.

Sections 199A prevents a company from indemnifying a director against liability incurred for a pecuniary penalty order or a compensation order under s1317H.

Steps directors take to protect their assets

1. Planning your personal asset structure is fundamental to preventing assets from being disgorged by a liquidator of your company.
2. Structure ownership of your personal assets not only for taxation purposes but also for your asset protection purposes. This needs to be undertaken when you are solvent. The insolvency laws only capture transactions where it appears that they were executed when the person had or ought to have known of the insolvency of their company or themselves.
3. Directors should avoid controlling the entities in which their assets are held. One may still be held to be the beneficial owner of assets when it can be proven that one had control over the structure holding the assets.

Solutions

These solutions are not exhaustive but indicative of some of the strategies employed. The application of these strategies will be dependent on the individual's circumstances.

1. Transfer property such as your residential property to a low-risk party such as your spouse. Your spouse cannot be a director of your company if this strategy is undertaken. Recent case law has determined that even directors who take no active role in their company's management cannot avoid insolvent trading liability simply by pleading that they did not understand their role and responsibilities. This step is less effective given recent bankruptcy law changes, and caution should be exercised.

2. Transfer property into a discretionary trust allowing your family to be the beneficial owners of your property. This mechanism also protects your property if you die and your spouse commences a relationship with someone else. That person may not be able to claim a share in the property subject to the trust as your spouse may not be the beneficial owner of the property. Bloodline Testamentary Trusts may be useful in such situations.
3. They are placing contributions with a Superannuation Fund. Over the long term, Superannuation funds have provided one of the best returns compared to the stock market and property.
4. Separate your trading entities from your asset-holding entities. A basic example would be to place your assets in a discretionary trust, such as your residential property, whilst operating your business as a company.

Estate Planning

If you are entitled to receive an inheritance, then in the event of your bankruptcy, your inheritance will form part of your divisible assets amongst your creditors. Accordingly, it is prudent to advise those proposing to bequeath property to you to set up a suitable trust structure to prevent any inheritance from potentially becoming available to your creditors in the event of your insolvency. Again, a Bloodline Testamentary Trust is a useful tool in these instances.

Lastly, as the saying goes, "prevention is better than cure" is very appropriate in these circumstances. However, insolvency was unforeseen in many instances and could not have been prevented, especially in the prevailing volatile economic conditions. Accordingly, being prudent about one's financial affairs whilst solvent is becoming an issue, we may all have to deal with.

Conclusion

Directors need to be aware of their duties and obligations of holding office.

Business by necessity carries commercial risk. If they structure their affairs properly, directors can avoid losing all their assets if there is a commercial disaster. Although the above strategies protect directors in case of civil actions, there is no such protection from criminal actions. Directors must always ensure they are undertaking their duties diligently and with due care.

Withdrawal of cash from a business by directors

Asset protection advantages may be gained by extracting funds from a business structure (e.g., as dividends) even if cashflow requirements dictate that the funds be loaned back to the business. The loan-back of funds may be secured, giving the proprietor a priority over unsecured creditors in the event of business failure.

Some of the techniques to withdraw more cash from business interests include:

- distributing all profits out each year
- increasing proprietor remuneration
- increasing superannuation benefits
- reducing paid-up capital
- sale of shares to children or employees working in the business

Another area requiring innovative ideas as they relate to personal financial planning is the area of income tax planning. Many techniques available to more liquid individuals may not be available to or appropriate for business owners. A few of the planning techniques which are most relevant to these individuals are:

- leveraged purchase of business assets (e.g., real estate, machinery) leased to the business entity.
- deferred compensation arrangements (e.g., superannuation).
- insurance arrangements (e.g., "keyman").
- using a business vehicle that could provide better tax rates and/or maximise income splitting flexibility (e.g., a company or a discretionary trust).
- holding income-producing assets in a discretionary trust separate from the business vehicle.

Developments in bankruptcy law

Unincorporated business owners and partnership professionals in partnerships are likely to be the worst affected by bankruptcy rules that allow a trustee in bankruptcy to access the family home on behalf of creditors even if only one spouse goes bankrupt, regardless of whose name the property is in.

Anyone in this situation should review existing structures.

The period of time before bankruptcy that assets are accessible to a bankruptcy trustee – is four years for so-called "under market transactions", which apply to assets transferred to relatives, including a spouse, by way of a gift or sale that is less than market value,

In addition, under the new section 139EA of the act, where a home is in the name of a spouse (as is common asset-protection practice), the bankruptcy trustee could claim the mortgage repayments and the increase in the property's value for up to five years before the bankruptcy.

This could occur in circumstances where the home is in the wife's name for asset protection; the husband has been making financial contributions by paying off the mortgage; the husband used or at least obtained an indirect financial benefit from the property, or the value of the wife's interest in the property has increased by the amount by which the mortgage has decreased and the amount by which the property has increased in value.

Alternatively, if the property was bought using resources provided by the spouse being bankrupted, then, under the new section 139DA, it appears the court can make an order that the whole interest in the property vests with the trustee in bankruptcy.

In other words, the trustee gets the house, even if it is in the spouse's name. And that is not all. A recent High Court decision has taken the view that the two spouses own the two spouses who own the family home – jointly and equally, regardless of who paid for it.

That occurred on the back of a few rogue barristers who rarely completed their tax returns, paid little or no tax and declared themselves bankrupt with no apparent handicap to continuing in professional practice – not only that, but their spouses expected to hold on to the family assets in their name. That occurred on the back of a few rogue barristers who rarely completed their tax returns, paid little or no tax and declared themselves bankrupt with no apparent handicap to continuing in professional practice – not only that, but their spouses expected to hold on to the family assets in their name.

The Cummins case, in particular, concerned a bankrupt barrister who didn't lodge a tax return for 40 years.

According to the ruling: "Where a husband and wife purchase a matrimonial home, each contributing to the purchase price, and the title is taken in the name of one of them, it may be inferred that it was intended that each of the spouses should have a one-half interest in the property, regardless of the amounts contributed by them."

The good news is that in this case, a blameless spouse would still own 50 per cent of the home regardless of the names on the title or the bankruptcy laws.

That would indicate that the spouse's half would not be at risk, though the bankrupt spouse's share is.

Future cases will reveal how the bankruptcy law changes and the High Court decision would be applied in practice.

Businesses could safeguard themselves against this ruling by owning property under a family trust with a corporate trustee. But that route also comes at a cost by way of extra taxes when buying and selling the property.

It should be noted that the new bankruptcy provision considers a bankrupt spouse's direct and indirect contribution to the home.

Structuring to distinguish between working income received by a bankrupt spouse and "ownership income" received by a non-working spouse from a business could act as protection.

This applies to partners in professional firms, too, as long as no personal income is attributed to the working spouse.

If properly structured, the non-working spouse can receive income from the business as an owner as long as that income is not directly attributed to the working spouse's efforts.

This means the business carries on regardless of whether the working spouse is involved.

This could be effective where the wife receives income from her share of the business and makes all the mortgage repayments on the family home. This could be effective where the wife gets income from her share of the business and makes all the mortgage repayments on the family home.

In this case, the wife has used her income to pay for the house and maintenance. Any income received by the husband is used for investments or holidays, but not for the home.

The mistake business owners or professionals continue to make is putting everything in the wife's name, but then they continue to receive all their working income in their own name and use it to repay the mortgage.

The way to get around the new bankruptcy act provisions, in particular Section 139, which relates to direct or indirect financial contributions ––, is to distinguish as much as possible ownership income from remuneration for services as much as possible.

It was inevitable that more cases would test the Cummins decision and the first notable one is

Receiver v Huen (2007) FMCA 304.

A property was purchased by Mr & Mrs Huen in joint names in August 2003. The family moved into the property on 25 August 2003 before Mr Huen left in early September of that year, signing an "agreement" on 1 September 2003 that Mrs Huen owned 100% of the property.

Mr Huen became bankrupt on 22 August 2005. Less than 2 months later, Mr & Mrs Huen applied for a divorce, which order took effect on 31 January 2006.

The Official Receiver (OR) argued the "agreement" was void under section 120 of the Bankruptcy Act for lack of consideration. Alternatively, the OR argued that following Cummins, at all times, the bankrupt and his Wife held a one-half interest in the property and that the Cummins principle overrides any equitable doctrine of exoneration. This was to defeat the wife's argument that various amounts which she alleged had been borrowed against the property to lend to the husband's business ought not to be taken into account.

The court agreed with the trustee that the agreement was ineffective and/or void against the trustee. The Federal Magistrate applied the Cummins principle and found there was no evidence to rebut the presumption or equal ownership.

As a result of the application of the Cummins principle, the Court held that "only one result can ensure, that is, that up to the time Bankruptcy severed the joint tenancy was severed by Bankruptcy, the Bankrupt and the Respondent each had a one -half share in the Melville Property, both legally and equitably. In bankruptcy, the bankrupt's one-half share in the property is vested in the trustee in bankruptcy.

Significantly, the Court made two further observations:

1. Firstly, without discussing why, Federal Magistrate Lucev held that: "The Court is not persuaded that the principle in Cummins is a rebuttable presumption." (at 37).
2. Secondly, the Court agreed with the trustee that: "In the Court's view, the application of the Cummins (sic principle) cannot co-exist with the doctrine of exoneration."

The extent of these observations will no doubt be considered in later cases. The wife failed to prove her husband received the monies borrowed against the property, so the doctrine of exoneration was irrelevant. However, if his Honour's statement is correct, in that case, Bankruptcy Trustees will be able to recover the bankrupt's interest in the matrimonial property without having to account to the non-bankrupt spouse for the common law charge, which the doctrine of exoneration would in certain circumstances otherwise apply.

In general terms, the case also confirms the Court's willingness to follow the High Court's lead and ignore the specific contributions of husband and wife to the purchase of matrimonial property in favour of a general finding that each holds a one-half interest in the property which half will vest in the trustee in the bankruptcy of either of them.

However, it should be noted the principle of the doctrine of exoneration can change respective interests in real property ownership, depending on the conduct of one or more of its owners. For instance, when a joint owner of a real property borrows funds, secures them against the real property, and uses these funds for their own benefit at the exclusion of another owner. In applying the doctrine, each owner's interest in the property's equity is adjusted.

This can significantly impact a bankruptcy trustee, particularly where, despite a bankrupt being a registered owner of real property with equity, they have no interest in that equity because they previously borrowed additional funds and secured them against the property. It frequently applies where a person has borrowed against the family home held jointly with someone else to fund a business, and the person who has benefited from the funds is subsequently faced with bankruptcy.

The doctrine applies where a number of parties are registered owners of real property but where borrowed funds secured against it are used for the benefit of some owners but not all. The doctrine applies where a number of parties are registered owners of real property but where borrowed funds secured against it are used for the benefit of some owners but not all.

For example, Michael and Clare, who are husband and wife, own their home, subject to a mortgage. The mortgage is for the benefit of both of them. However, Michael takes out an additional loan for his own benefit and secures it against the family home. Under the doctrine, Michael's additional loan is for his benefit alone, and Clare's interest in the property's equity is adjusted to reflect this. The doctrine applies in any such similar instance between co-owners regardless of relationship status.

Commissioner of Taxation v Bosanac (no 7) [2021] FCA 249 (22 march 2021) (Mckerracher)

The doctrine of exoneration and various other "presumptions" were tested in the Bosanac case and showed the Commissioner's willingness to test the law in this area. Let's consider a summary:

- Mr and Ms Bosanac were married in 1998.
- Mr Bosanac described his business activities as a 'self-styled venture capitalist'.
- In May 2006, Ms Bosanac purchased a property in Perth, Western Australia, for $4,500,000. She paid a $250,000 deposit from a joint bank account held with Mr Bosanac.
- In November 2006, the property sale was settled, and title to the property was transferred into the name of Ms Bosanac as the sole proprietor.

- The property was the family home for Mr and Ms Bosanac and their three children.
- The purchase price was fully funded by two new joint loans from Westpac Bank: one of $3,500,000, the other of $1,000,000. The loans were secured over the Perth property and other properties they jointly owned.
- In mid-2015, Mr Bosanac moved out (they had formally separated in 2013).
- In 2015, the Commissioner of Taxation audited Mr Bosanac's financial affairs and discovered that he hadn't lodged tax returns from 2006 to 2013.
- On 12 August 2016, the Federal Court entered judgment for a tax debt of $9,344,111.89 plus costs against Mr Bosanac.

Here it should be noted the wife was the sole registered proprietor of the family home. This didn't stop the Commissioner from attempting to enforce the judgment against the Perth home.

There was a "presumption of resulting trust" where Mr Bosanac had a 50% beneficial interest in the home. Ms Bosanac relied on the "presumption of advancement", successfully claiming a 100% beneficial interest in the home.

Presumption of resulting trust

A "presumption of resulting trust" can arise when a person purchases property in the name of another or in their joint names, but the other person contributes none of the purchase money, or the contribution is by two people jointly, but the property is registered in the name of only one person.

Without evidence to the contrary, a resulting trust may arise because "it is presumed that the person who contributed to the payment of the purchase price payment did not intend to gift their contribution to the other person".

Presumption of advancement

This means in some relationships, such as marriage, it is presumed that the husband intended to gift the property to his wife. This presumption is archaic as it precludes females from gifting to the male in a marriage; excludes de facto partners and same-sex marriages.

In the Bosanac case, the Commissioner argued that the presumption of advancement did not apply to a matrimonial home; and was rebutted by evidence of the husband's intention when purchasing the property.

The Commissioner's arguments

- The Commissioner claimed it would make little sense as a co-borrower to owe a substantial debt if Mr Bosanac didn't intend to retain his beneficial interest.
- Mr and Ms Bosanac took out two other loans, secured by the Perth property's mortgage, which Mr Bosanac used to trade his shares.
- Mr and Ms Bosanac shared bank accounts and other property assets. It follows the same approach to ownership that would extend to the family home.

The Court's findings

- The presumption of advancement can apply to the matrimonial home.
- The fact that Mr Bosanac incurred a substantial loan debt did not conclusively show he intended to retain a beneficial interest. Where a bank requires two signatures, the person seeking to rebut the presumption of advancement is burdened with showing that the other person's signature was merely a formality as opposed to evidence of an intention to confer a beneficial interest on that person.
- Although the loan Mr Bosanac used for share trading was secured by the property, Ms Bosanac explained she had no issue with this because she trusted her husband. This loan was also secured by a separate property where Ms Bosanac was the sole registered proprietor.
- The Court observed that Ms Bosanac's registration as the sole owner might have been made for many reasons, but the evidence as to the intent of either party was very scant. Ultimately, the Court held that the Commissioner had not provided sufficient evidence of Mr Bosanac's intention to retain a beneficial interest in the property.
- While the Bosanac case involves a creditor claim (the ATO), the issues apply to bankruptcy scenarios where a co-owner is bankrupt, and the bankruptcy trustee may claim an entitlement to the property. In the Bosanac case, the property was acquired several years earlier, and no evidence suggested that the property title's transfer was to prevent, hinder or delay the property being available to Mr Bosanac's creditors.
- To improve the relevant spouse's ability to rely on the presumption of advancement, consider using a deed to confirm the husband has gifted the property to his wife; has no beneficial interest in the property; and, if a joint borrower on the purchase loan, that he has no rights of contribution against the wife in respect of the loan and mortgage.
- If mortgage payments are paid from the wife's income, then that would be very helpful. Clearly, the Commissioner is testing the waters, and there is no room for complacency.

Bosanac's case highlighted that the presumption of advancement remains an effective asset protection strategy if there is no evidence to suggest that the husband retains a beneficial interest in the property or has done so intending to defeat creditors' claims.

When it comes to asset protection, the family home is nuts and bolts stuff. If purchasing a new family home, do not assume it is sufficient to put the asset in the name of the "low-risk" spouse. Consider your unique circumstances and seek specialist advice. Existing arrangements should be carefully reviewed.

Consequences of joint tenancy and tenancy in common arrangements

On the death of one joint tenant, the asset automatically passes to the other or others, regardless of the terms of the will of the joint that died.

If a joint tenancy is severed (that is, converted to a tenancy in common))), each owner can then direct how their share in the property is passed following their death by making provisions in their will.

Example 1 - Tim and his sister Tiffany bought a small investment property together as joint tenants before either was married. After getting married, Tim decides to change the arrangement to a tenancy in common so that his interest could pass to his wife rather than his sister after his death.

Example 2 - Tim and Betty purchased their family home as joint tenants. A few years later, Betty establishes a business and is concerned about losing everything if the business fails. While Tim is alive, Betty would prefer the house to be owned in his name.

Betty does not want the house to be owned 100% in her name if Tim dies. Her preference is for it to be in a testamentary trust. Betty and Tim should sever the joint tenancy arrangement and convert their ownership to tenants in common so that Tim can at least deal with his interest in the property under his will.

As there is no property ownership change, transfer duty and tax are not payable. The only transaction cost is generally Government registration fees.

There can be significant differences in the treatment of real property upon a person's death, depending on whether their ownership is structured as joint tenants or as tenants in common.

We all need to understand how property ownership is structured and ensure that it is appropriate for our circumstances.

Discretionary trust uses gifts and loans back

The 'gift and loan back' approach involves the asset owner of an asset gifting their equity in the property equity to a family trust (or low-risk spouse).

The family trust then lends money to the owner and takes a secured mortgage over the property. The family trust then lends money to the owner and takes a secured mortgage over the property.

For example, assume that Tony holds 100% of an investment property and the home's current value of the home is $1,600,000. There is an existing mortgage of $600,000.

Therefore, Tony's equity is $1 million.

Tony gifts the amount of equity in his property to a trust.

The trust subsequently lends the amount back to Tony and takes security over the property.

Under a gift and loan back, any net equity in a property is protected by a registered mortgage. If the property is currently mortgaged to a bank, the family trust will take a second registered mortgage. The bank still has priority under its first registered mortgage.

The family trust will take a first registered mortgage if the property is unencumbered. In both cases, the property's full value is protected by registered mortgages.

The gift and subsequent loan would ideally involve a physical transfer of funds via electronic transfer. If this is not possible, other alternatives may be available depending on the circumstances.

If the value of the property increases or debt to an external financier is reduced, the loan arrangement may be 'topped up'. If the value of the property increases or debt to an external financier is reduced, the loan arrangement may be 'topped up'.

This can be achieved by Tony gifting further amounts equal to the increased equity amount to the trust. It is important to note that the gift of the increased equity will be considered a separate transaction for bankruptcy clawback period rules.

The advantages of utilising a gift and loan back, compared to a straight transfer of the property, can include:

- The arrangement achieves broadly equivalent protection for the asset compared with a straight transfer; and

- There is no change in the legal ownership of the property. As such, transfer duty and capital gains tax usually do not apply. The only transaction cost is a relatively small mortgage registration fee.

The disadvantages of utilising a gift and loan back approach, compared to a straight transfer of the property, are:

- The arrangement is more complex than a simple transfer and involves the preparation of additional documentation. This includes a deed of gift, loan agreement and security/mortgage documentation.
- It only protects the amount of net equity in the asset at the time of the gifting. It does not protect against increases in the value risk the individual holds in the asset.

The gift and loan back strategy may be an effective method of increasing asset protection where a direct transfer of an asset is not desirable or appropriate, for instance, due to prohibitive tax and stamp duty costs.

Of course, the normal Bankruptcy "clawback" provisions apply to such arrangements as this.

Director guarantees

Reg Ansett famously told his son Bob "never give a personal guarantee." Reg Ansett famously told his son Bob "never give a personal guarantee." Most of us do not have a choice. However, it is essential to note who has given personal guarantees in asset planning within a family group. However, it is essential to note who has given personal guarantees in asset planning within a family group. This will affect asset protection planning decisions.

Get a release!

It is not uncommon for a person to resign as a director and then sell their shares in a company, usually to a business partner who continues in the business. At this time, it is crucial to obtain a business release from any director's guarantees given is crucial. If not, these guarantees may continue indefinitely, and you may be in for a shock. Say 15 years later when the business fails. You can be sued personally, and if the directors' guarantees have been well-drafted, it may be very tough to overturn.

The takeout

A director's guarantee is not just a piece of paper you sign to get credit – it has the potential to cause you real financial harm and should be taken very seriously. Make sure you keep a register of all directors guarantees you sign.

Registered charges

Often asset protection is difficult for families who have given personal guarantees and encumbered the family home. The truth is that many small businesses in Australia are undercapitalised.

Others are in a more enviable position. They may have been in a position to advance their loan funds to a family company being that entity's main lender.

A simple and effective way to secure their position and be 'first in line' when the creditors are being paid (in the event of failure) is to register a secured charge over the company's assets. A lawyer can prepare the documentation and ensure the change is registered with ASIC.

Some lenders take securities over assets to protect their exposure to borrowers. Most of these lenders are aware that Section 262 of the Corporations Act requires certain charges over company assets to be registered with the Australian Securities and Investments Commission (ASIC), and these include:

- floating charges
- charges on personal chattels (this does not extend to certain ships which require separate registration)
- changes over goodwill and patents or trademarks
- changes over book debts; and
- a charge over crops, wool, or stocks.

A charge over land is slightly different. They are registered in a State or Territory Lands' Titles Offices and do not require registration with ASIC.

A fixed and floating charge over all a company's assets would also cover any real property owned by the Company. To be safe, lenders should ensure that a mortgage is lodged on the certificate of title as well as lodging the charge with ASIC. Otherwise, the lender may fall behind other lenders that have registered their charges on the property's title.

Details on any charges that require registration must be lodged with ASIC within 45 days of its creation.

263(1) Where a company creates a charge, the company must ensure that there is lodged within 45 days after the creation of the charge:263(1) Where a company creates a charge, the company must ensure that there is lodged within 45 days after the creation of the charge:

(a) a notice in the prescribed form setting out the following particulars

A charge is voidable against a Liquidator or Administrator if it is registered outside the 45-day period unless it is registered more than 6 months before an appointment. A lender can apply to have the Court extend the 45-day period, but a creditor will need a very good reason why it was not registered in time, and these applications are not automatically granted.

266(1) Where:

(a) an order is made, or a resolution is passed for *the winding up of a company; or*

(b) an administration of a company is appointed under section 436A, 436B or 436C; or

(b.a) a company executes a deed of company arrangement;

A registrable charge on property of the company is void as security on that property as against the liquidator, the administrator of the company, or the deed's administrator, as the case may be, unless:

(c) notice in respect of the charge was lodged under section 263 or 264, as the case requires:

(i) within the relevant period; or

(ii) At least 6 months before the critical day; or

Charges are put in place to secure a company's indebtedness to a lender. The charge gives the lender tangible security over a company's property of a company should the loan fall into default. It is a form of insurance. If lenders fail to correctly register a charge correctly, the charge may not be worth the paper it is written on, and the loan may be unsecured.

The use of liens

Liens can entitle a creditor to hold goods hostage until payment has been received and, in some cases, to assert this right in priority to secured creditors with security perfected under the PPSA.

Usually, a perfected security interest has priority over all other unperfected security interests in the same collateral under section 66 of the Personal Property Securities Act (PPSA). Usually, a perfected security interest has priority over all other unperfected security interests in the same collateral under section 66 of the Personal Property Securities Act (PPSA).

However, this is not always the case. Under section 93 of the PPSA, common law or a statutory lien over goods lives outside the PPSA priority regime. It has priority over all security interests in those goods if: Under section 93 of the PPSA, common law or a statutory lien over goods lives outside the PPSA priority regime and has priority over all security interests in those goods if:

a. the materials/services provided which gave rise to the lien were provided in the ordinary course of business

b. no other Act prevents the lien from having priority; and

c. the holder of the lien did not know that a security agreement relating to those goods prohibited the creation of the lien.

Generally speaking, a lien allows a person to retain possession of another's property pending satisfaction of the lien holder's claim against that person.

Examples of statutory liens include the unpaid seller's lien under the *Sale of Goods Act 1908* and the carrier's lien under the *Carriage of Goods Act 1979*. Examples of statutory liens include the unpaid seller's lien under the *Sale of Goods Act 1908* and the carrier's lien under the *Carriage of Goods Act 1979*.

Common law liens can be 'general' or 'particular'. A 'general' lien allows a person to retain possession of goods until all sums payable by the owner of the goods are satisfied, not just sums payable in respect of work performed on those goods held hostage.

These are relatively rare and must be established by strict proof of custom or usage - an example is a solicitors' lien which allows a solicitor to retain a client's documents until payment of all debts owed to the solicitor by the client.

In contrast, a 'particular' lien only secures obligations incurred regarding the hostage goods. An example is a 'workers lien' concerning payment for work done to improve a chattel, such as a mechanic's right to hold your car until you have paid for the work done on it.

The following cases consider liens and their place in the personal property securities pecking order.

McKay v Toll Logistics (NZ) Limited (HC) [2010] 3 NZLR 700; Toll Logistics (NZ) Limited v McKay (CA) [2011] NZCA 188; Stockco v Walker HC Napier CIV-2011-441-110, 24 June 2011.

Practical tips

- Secured creditors should ensure that their written security agreements prohibit the creation of liens over the secured property and, where commercially practical, could give notice of such prohibition to any third parties that commonly take possession of assets for improvement from the debtor.
- Where an owner passes possession of goods to another party for that party to work on or improve the goods, the owner may prevent a lien from arising by ensuring that the obligation to pay for the improvements arises after the goods are returned.

Inadequate security due to faulty documentation

This case study clearly shows the dangers of not taking the time to prepare proper legal documentation.

M Pty Limited operates a restaurant from the premises they own. They find a buyer for the restaurant, JT. JT is a sole trader and needs some assistance with funding the purchase. He pays $190K for the restaurant, of which $130K is vendor financed by M Pty Limited. In addition to a contract for the sale of the business and a lease, a Deed is entered into between the parties in respect of the vendor finance arrangement.

JT got into tax trouble and went bankrupt. M Pty Limited has entered into various agreements outlined and surely has adequately protected and secured its position in the event of a default. Sadly, this is not the case.

The terms of the Deed (which is pre-PPSA) appear standard for such a vendor finance arrangement, but clearly, the document has not been tailored to reflect that the Purchaser/Borrower is a sole trader.

The relevant section in the Deed in relation to the provision of security reads as follows:

Suppose either the Borrower or Guarantor is a company. In that case, each of them agrees if requested in writing by the Lender, within 21 days of such request and at the Borrower's own cost and expense to give to the Lender a first fixed and floating charge over their assets referred to in the second schedule and undertaking duly signed and to cause notification of such charge to be registered in the office of the Australian Securities and Investments Commission and otherwise as may be required.

So, there should be no security, but there surely should be a guarantor to the agreement? Not the case, in that, using a Deed that was intended for a corporation, the guarantor of the Borrower's obligations is none other than the Borrower himself!

M Pty Limited became an unsecured creditor in bankruptcy, in which they saw a small return on their outstanding vendor finance when they could have been a secured creditor with a third-party guarantee. M Pty Limited became an unsecured creditor in bankruptcy, in which they saw a small return on their outstanding vendor finance when they could have been a secured creditor with a third-party guarantee.

All in all, a very expensive mistake when any competent lawyer could have dealt with this properly.

Inter-entity loans

Some people have their asset protection issues for non-business assets all sorted with a 'low-risk spouse' or, better still, an asset protection trust.

Their concern with asset protection lies within their trading entities and protecting these business assets from creditors.

This may be achieved by carefully managing how the trading entity is financed within the company group.

The lender should take security over trust assets – if the trading entity becomes insolvent, that security can be enforced.

Legal advice is essential to ensure all formalities are met.

It is recommended that relevant security interests be registered on the Personal Property Securities Register (PPSR). Note that only a 'security interest' over personal property such as intellectual or business assets other than the rental property can be registered – see above commentary.

It is wise to regularly review inter-entity loans in the context of trading conditions.

The perils of loan accounts

Liquidators reviewing the company's financial accounts of the company prepared by the company's accountant are always pleased to see a debit (asset) loan account. Usually, such loan accounts are due by a director of the company. When quizzed by the liquidator, the director often is unaware of the 'loan'.

Often various transactions associated with a director are put through a loan account rather than allocated to wages or directors fees to avoid the complications of PAYG tax, worker compensation and reporting requirements. However, these sometimes-frequent transactions can build up to a sizeable loan account which is potentially recoverable by a liquidator.

Advisers and directors alike should ensure any benefits taken by a director, whether in the form of cash wages or benefits, are accounted for as 'wages. While this may increase PAYG tax and reporting implications, it will more accurately reflect the amount being drawn by the director in benefits and avoid building up a sizeable loan account.

Furthermore, it will avoid arguing with the liquidator about why the loan account should not exist or even having to defend an action brought by the liquidator.

We are dealing with sloppy business practices that can have dire consequences. This leads to our next topic – Sham Contracting.

Sham contracting

We covered this part earlier in the Contractors, Employees and Workcover edition.

A real danger for business owners is the notion that because an asset protection structure is in place, there is no exposure.

Sound business practices underpin such a structure, and we see above the importance of proper management of loan accounts.

Indeed, directors' loan accounts often arise because of excessive drawings and/or not paying the business owner a consistent and realistic wage.

Sadly, this mismanagement sometimes extends to staff, with the business owner falsely treating employees as "contractors".

We have outlined above the importance of proper planning and budgets, and here we see employers who believe the administration of PAYG, Superannuation and Workers' Compensation is too onerous.

Realistically such a business has little prospect of long-term success.

Exposures include but are not limited to:

- ATO demanding pay as you go tax (PAYG) be paid after the event
- Superannuation Guarantee Charge assessments
- The business is liable for Workers Compensation claims
- If over the relevant threshold, payroll tax assessments at the state government level.

We can now add the Fair Work Ombudsman (FWO) to the list with its continued focus on Sham Contracting. The recent cases below indicate the Courts are now prepared to impose substantially harsher penalties than we have seen.

We direct you to the following cases:

- Director of the Fair Work Building Inspectorate v Linkhill Pty Ltd (2014) FCCA 1124;
- The Director of The Fair Work Building Industry Inspectorate v Linkhill Pty Ltd (No.7) (2013) FCCA 1097 (20 December 2013); and
- Fair Work Ombudsman v Global Work and Travel Co (2015) FCCA 495.

Such adverse assessments can all come at once, rendering a business insolvent, and if the director owes the business money, then the director is personally liable!

One last observation, the most common cause of personal and business insolvency is the lack of provision for taxation liabilities. Many people are simply incapable of doing this, and if an employer falsely treats an employee as a contractor, you may be placing them in harm's way. It is not just failing to comply with the Statutes – employers have a duty of care to their employees.

Business budgets beat bankruptcy

Leading Insolvency expert Ivor Worrell has over 40 years of experience, has been involved in thousands of insolvencies, and has observed a close relationship between business failure and a refusal to budget.

He observes the start of the financial year is the ideal time to prepare meaningful budgets.

Budgets assist in:

- determining direction
- forecasting outcomes
- allocating resources
- promoting forward-thinking
- turning strategic objectives into practical reality
- establishing priorities
- setting targets in numerical terms
- providing direction and co-ordination
- communicating objectives, opportunities and plans to various managers

All these things are functions that failed businesses have usually bypassed. Not all businesses with budgets prosper, but most businesses without budgets will fail.

Elements of a good business budget

Soundly based budgeting principles:

- realistically reflects external and internal factors. It is not wishful thinking
- detailed and comprehensive - all aspects of the business incorporated
- recognises seasonal fluctuations
- consults with stakeholders
- provides for cash flow forecasts
- allows for ease of comparison to actual
- reflects the enterprise's policies and investment criteria

As we have just started a new financial year, now is an excellent time to prepare a budget.

Is your balance sheet accurate? covid-19 makes this more critical than ever

Ensure your debtor's ledger is accurate and current. Focus on converting those invoices into cash.

Accounting practitioners will tell you a common theme when reviewing those balance sheets is:

- The debtors often make up a substantial portion of the business's assets.
- Rarely are the debtors accurate or reflective of the actual recoverable balance.

This results in the business's balance sheet looking much better than it is. This is a dangerous position because while there may be some COVID-19 safe harbour protections from insolvent trading and an extension of the six-month moratorium on creditors being able to wind up a company, exposures for a director's personal liability remain. These include personal liability for:

- personal guarantees
- the Australian Taxation Office's (ATO) director penalty notices (DPN),
- director's duties breaches.

To procure an accurate balance sheet, review the debtor's ledger and identify any bad debts to be written off. These include:

- Aged debtors—it is not unheard of to have debtors on the ledger that are 12-18 months old. Consider whether these are recoverable.
- Fictitious accounts / false invoices.
- Debtors simply titled "cash".
- Mysterious debtor-loan accounts (usually "window dressing" at financial year-end).
- Friends and family loan debtors will not be collected. Friends and family loan debtors will not be collected.
- Confusion between "work in progress" and debtors.
- Prepaid customers appear as debtors.
- Factored debtors that are no longer the business's debtors to recover.
- Debtors are known to be disputed and remain on the accounts. Debtors are known to be disputed and remain on the accounts.
- No structured debtor recovery process.

Once the debtor ledger is accurate, work hard to convert your debtors ledger into cash. The following measures should be considered and actioned if appropriate:

- Check your terms of trade and take immediate action.
- Don't automatically extend credit terms.
- Obtain security or a personal guarantee.
- Make it very clear to your clients that you don't stand for late payments. Be persistent and follow up, follow up, follow up. Personal and direct contact is your best opportunity here.
- Give options to your debtors to find a solution. Settlements, payment arrangements, discounts, all these options are more cost-effective than litigation or liquidation.
- Engage stop supply or cash-on-delivery tactics.
- Outsource the debt collection process to a professional. While there will be a fee, there is a greater chance of recovery. While there will be a fee, there is a greater chance of recovery.
- Litigate if necessary; recovery proceedings are a useful tool to settle protracted claims quickly.
- Consider debt factoring / /trade finance. Selling your debtors ledger can assist with immediate cash flow but comes at a cost.
- Consider trade credit insurance. If you're worried about the credibility of your debtor, discuss with your insurer / /broker your options to insure against that risk.
- Initiate insolvency proceedings (last resort option) to bankrupt or wind up (liquidation). While an insolvency appointment will unlikely lead to a quick and healthy return, the mere making of the application will let the debtor know that you are serious and will often lead them to act swiftly to avoid being placed into liquidation or bankruptcy.

Different Business Structures – A Cautionary Tale

People starting out in business often do not want to consider that their venture may fail. Indeed, having a positive outlook is often necessary to battle through the early years. And yet, experience tells us that giving some consideration to all possible outcomes is no bad thing.

Generally, when setting up a structure to operate a business through, the first two considerations are minimising costs (including establishment costs and ongoing costs) and minimising taxation. The third consideration, which is sometimes overlooked, is what type of structure will provide the best asset protection in the event of failure.

At bO2 Corporate Essentials, we sometimes see the good and bad of business structures and what structures may have been better in hindsight. Here are a few useful examples that we have seen in recent times:

Retail Children's Store

A husband and wife had an opportunity to purchase a children's retail business. The husband was an employed tradesman, and a simple partnership purchased the business. The business was profitable for several years, and then hard economic times and a supplier issue caused cash flow difficulties.

The business became unviable, and its doors closed after it could not be sold.

As the husband and wife were operating a partnership, they were jointly and severally liable for the business's debts.

They had to sell their home with just enough equity to cover the creditors. They were fortunate not to go bankrupt.

Whilst there is no guarantee that a different structure may have enabled the husband and wife to save their house, their personal exposure would likely have been reduced by operating the business through a corporate structure. Although the wife could have operated the business as a sole trader, half their assets would have still been at risk

Consulting business and Restaurant

A husband and wife were directors of a company that operated as a successful consulting business. The husband was the sole employee of the business. An opportunity arose to purchase a restaurant. A discretionary trust was established through which the restaurant would operate. The existing company operating the consulting business became the trustee of the trust. Using the company for this purpose meant it would not be necessary to spend the money on getting a new company and would also mean only one annual review cost.

However, the restaurant operated at a loss and fell behind in paying its tax obligations. After considerable losses, a decision was made to sell the business. Although a sale was achieved, all the proceeds from the sale were paid to the bank under various securities.

As directors of the corporate trustee, the husband and wife were both issued Director Penalty Notices (DPNs) by the ATO in respect of an accumulated PAYG withholding debt. As directors of the corporate trustee, the husband and wife were both issued Director Penalty Notices (DPNs) by the ATO in respect of an accumulated PAYG withholding debt.

The directors were forced to put the company into liquidation or voluntary administration to avoid the ATO pursuing them personally for the amounts under the DPNs. The ATO debt is related only to the restaurant business.

Although placing the company into liquidation enabled the directors to avoid personal liability to the ATO, it damaged the reputation of the consulting business that the company had been operating before becoming a trustee of the trust.

Whilst liquidation may have been inevitable for a corporate entity operating the restaurant, and the consulting business became a casualty due to using the existing company as a trustee when the incorporation of a new corporate trustee was required.

This would have avoided having unrelated businesses trading under the same company structure. Also, if possible, the sole director option should have been taken.

Licensed Bar and Electrical Business

Two tradesmen operated a successful electrical business through a company structure and decided to purchase a bar. In doing so, they set up a new company to purchase and operate the bar, which started to lose money.

The losses were funded by the profits from the electrical business. The bar continued to make losses, and as a result, both companies fell behind in their tax obligations. The landlord took possession of the premises after the rent fell behind.

Creditors of each company were pressing for payment. The directors sought advice and decided to place the bar company into liquidation.

This then left the directors needing to address their electrical company, which now had a significant tax debt due to attempting to prop up the bar.

Due to the electrical business being profitable, the directors were able to put forward a proposal to their creditors to enter into a Deed of Company Arrangement (DOCA) and therefore continue to trade. Again, this business's reputation of this business suffered as a result due to the DOCA.

In this case, separating businesses into different corporate entities enabled the poor-performing business to be isolated and the profitable business retained. But the directors almost came unstuck by the decision to support the loss-making business with the cash flow of the profitable business. Not only did this decision tend to negate the decision to separate the businesses, but it was arguably a breach of their duty as directors of the profitable company.

And so, there is a common theme in the above three case studies and the case of the "individual trustee. We would suggest a lack of care and thought with a lack of willingness to incur some relatively minor expenses to ensure a proper structure.

An aversion to spending $1,000 - $1,500 could have terrible consequences. Also, we would suggest that when a business is not profitable, do not procrastinate.

Do budgets and make objective decisions - only fund the loss-making business if you can afford to do so. Lastly, do **not** fund the loss-making business with the money you hold on trust for the ATO and/or your staff. Here we are talking about GST, PAYG tax and Statutory Superannuation.

Asset protection for young professionals

Here we consider the situation of Andrew, a single, self-employed Civil Engineer operating as the sole director/shareholder of a Pty Ltd company.

Andrew's company owns $25,000 in plant and equipment with $140,000 in cash and has $12 million in Professional Indemnity (PI) insurance.

For lifestyle reasons, Andrew would like to buy a boat for $80,000, gain an initial portfolio of shares, and then start trading some shares.

He owns no other assets and is renting his office and home. Eventually, after accumulating enough assets, he would like to become a full-time share trader.

In a litigious society, Andrew is genuinely worried about being sued if anything goes wrong on a job. PI Cover may be ineffective as insurance companies do not always pay up.

What is wrong with the current structure? Well, Andrew is the sole individual sole shareholder of a company with at least $165,000 in value – possibly more if the company has any goodwill or other intangible assets. Most of us know that a shareholder is usually not liable for the debts of a company.

However, if Andrew is the personal defendant in any action, he individually owns shares worth at least $165,000, making him a potential target for litigation.

It goes without saying that as Andrew's business prospers, these figures will be much higher, and the problem will only become worse.

Arguably a company is not the ideal structure from a tax viewpoint either, given a company pays at least 26% in company tax – to extract the funds from the company to purchase the boat, he could wind up paying as much as 47% in tax or run the gauntlet of Division 7A (deemed dividends).

Further, the corporate veil of a company is proving increasingly less effective, with many directors being sued personally.

Solution

Andrew has a clear firewall between two newly created trusts – one a business trust and the other an asset accumulation trust, and both have corporate trustees.

The business trust owns the business name but does not accumulate assets or cash.

With appropriate decisions made on appointors of trusts, the business risk should be contained to the business trust. If, in time, the business expands, and operations company can operate the business under licence from the trust to incur the risks involved in creating engineering designs, employing people, and not offending environmental laws et al.

Andrew as an individual, may not be completely safe from litigation, but the bulk of his future assets, i.e., shares, investments, and boats, will be at least safe in an asset protection trust. This trust must not incur any unnecessary risk or engage in commercial activity.

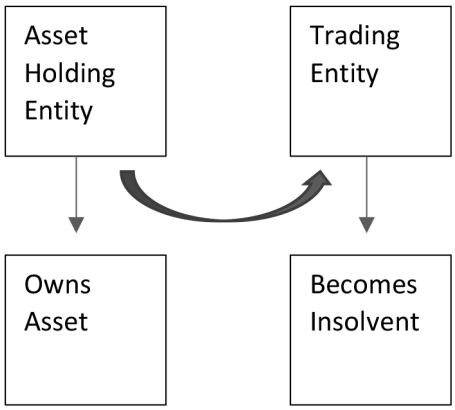
If there is any risk perceived from owning a boat regarding third-party claims, then, of course, a separate entity would own the boat, and in fact, we would recommend this.

Note that the structures stand 'side-by-side', and no subsidiary company exists. Avoid this situation under Section 588V of the Corporations Act 2001, a. A holding company can become liable in the event of insolvent trading by a subsidiary company.

Asset protection structures exposed under the PPS act

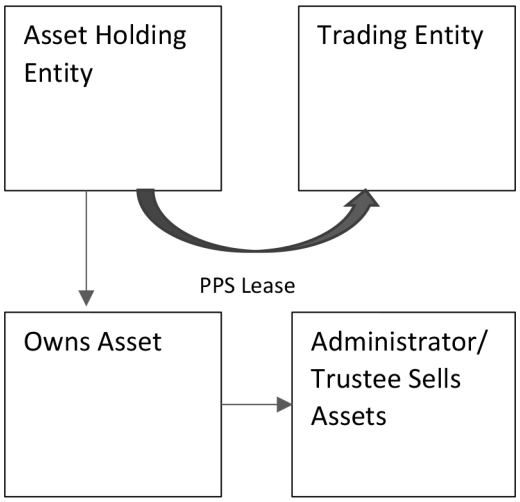
The Personal Property Securities Act ("PPS Act") commenced on 30 January 2012. The PPS Act's potential impact the PPS Act will have on commonly used asset protection structures is outlined on the following page.

These structures usually involve a corporate group structure, where assets used in conducting the business are held in one or more "Asset Holding Entity/ies", separate from the "Trading Entity", which carries the risks associated with trading a business. The Asset Holding Entity will lease/hire/rent the assets to the Trading Entity to enable it to carry on its business. As set out below, this structure protects those assets if the Trading Entity becomes insolvent as ownership vests with the Asset Holding Entity.



Under the PPS Act, such arrangements will be deemed security interests (defined as a PPS lease) and require perfection, usually by registration on the PPS Register. Failure to perfect will negate these asset protection strategies due to the following:

- An unperfected security interest vests in the grantor on the grantor's insolvency (section 267 of the PPS Act); and
- A perfected security interest has priority over an unperfected security interest, where there are competing security interests (section 55(3) of the PPS Act).



Under Section 20, several pre-conditions exist to perfect a security interest, including the grantor's need for a written security agreement signed or adopted by the grantor. As set out above, many asset protection structures are loose arrangements and not formally documented. These arrangements typically occur in small to medium-family companies, and the law currently dictates that ownership of those assets is paramount (as opposed to possession under the PPS Act). Under the prior legislation, the assets were generally not at risk ononin an insolvency event of the Trading Entity, assuming ownership could be proven.

This has now changed because of the vesting provisions on insolvency (Section 267) and the priority rules for competing security interests (Section 55(3)). Based on these changes, the above asset protection structures must be documented in writing and perfected by registration on the PPS register. The PPS Act contains strict timelines for registration on the PPS Register, which must be complied with.

Failure to do so means that upon insolvency of the Trading Entity, ownership of the assets will be transferred automatically to the company in administration/liquidation of the bankrupt estate, and the asset protection structure will not protect such assets. The assets would also be lost to a secured creditor with a competing security interest (such as a bank), provided the creditor perfected their security interest in compliance with the PPS Act.

In summary, asset protection structures as set out above will fall under the ambit of the PPS Act and require perfection on the PPS register. In addition:

1. Arrangements in place before registration commencement time may enjoy temporary perfection, even if not documented in writing and may be capable of maintaining continuous perfection if perfected within 24 months of registration commencement time. However, legal advice should be sought on any arrangements which are in existence before the registration commencement time, and
2. arrangements entered into post -registration commencement time must be documented in writing and perfected by registration on the PPS register. As noted above, the PPS Act contains strict timelines for registration on the PPS Register, which must be complied with.

Given the complexity of these provisions, all businesses should review their asset protection structures and strategies to ensure they can withstand the commencement of the PPS Act. This will include providing all existing arrangements qualify for temporary perfection

under the transitional provisions (and are subsequently perfected within 24 months to maintain continuous perfection). Advisers should note that any ongoing asset protection advice to clients should properly consider the impact of the PPS Act.

The practicality of PPSA Legislation Tested

For any goods supplied before the PPSA commences, the creditor has a two-year transitional period in which to register their charge.

For goods supplied after the commencement of the PPSA, the creditor must register their security interest before the goods are delivered to the customer. If the registration is not completed, the charge is then technically invalid. In the case of a liquidator being appointed, goods supplied after the start of the PPSA become company assets regardless of ROT clauses if no charge is registered. That is, there is no protection for suppliers if the registration does not occur before the delivery of goods to the customer.

PPSR registration – more fallout from defects

Recently we have observed a fundamental shift in protection, and the fallouts of ineffective registration are still making waves, particularly in the event of an insolvency of the grantor.

We note that the PPSA and its accompanying Personal Property Securities Register (PPSR) have increased the search fees, but the attention to detail that must be applied by parties seeking to secure their interest has also increased maturity.

When doing a liquidation, the leading insolvency firm Worrells, when doing a liquidation conducted a PPSR search for a motor vehicle and found an error in the VIN number used to identify the vehicle. Someone misplaced an “H” with an “X” in the VIN number. The ramifications of this simple mistake were severe.

In summary:

- The collateral must be described by serial number (Section 153(1) of the PPSA).
- There is a defect in the registration if collateral must be described by serial number and the search of the serial number is unable to identify the registration (section 165(a) of the PPSA).
- Motor vehicles must be described by serial number (Paragraph 2.2 of Schedule 1 of the Regulations).
- A serial number includes the VIN, the chassis number or the manufacturer’s number (Paragraph 2.2(3) of Schedule 1 of the Regulations).
- Registration is ineffective if there is a defect according to Section 165 (Section 164(1)(b) of the PPSA).
- The vehicle vests in the grantor immediately before a resolution for the winding up of a company if the security interest is unperfected (Section 267(2) of the PPSA).

The vehicle registration was unperfected and, therefore, ineffective because there was a misplaced “X” instead of an “H” in the VIN registration. The vehicle registration was unperfected and, therefore, ineffective. Under section 267 of the PPSA, the vehicle vests in the liquidator. The liquidators sold the vehicle free without any security interest and kept the proceeds of just over $32,500.

A simple typo costs the finance company dearly.

So, take care with all registrations, particularly those that require an exact match to an identifiable serial number like a vehicle VIN. So, take care with all registrations, particularly those that require an exact match to an easily identifiable serial number like a vehicle VIN.

Contractors and the personal property securities act 2009

Construction contractors need to be aware that registering Personal Property Security Interests (“PPSI”) is not only useful for plant hire companies and could also benefit them.

PPSI registrations can help construction contractors in the event of their principal’s insolvency by:

- Enabling suppliers of materials that have not yet been incorporated into building works to take back those materials if they have not been paid for; and
- Enabling suppliers of building materials and copyrighted plans and drawings to be paid the price for those supplies in priority over the principal’s other creditors.

But PPSI registration will only have this effect if it is done on time and properly. This requires a practical understanding of the PPSA Act and effective internal systems and procedures.

Seek expert advice before doing this.

Business succession

The structure adopted by business owners will often be in a compromise between the immediate requirements of the business on inception, those requirements in the midlife of the business (together with competing asset protection, flexibility, and tax efficiency outcomes), and the ultimate exit option to be pursued by the business owner. Seldom is there one structure that can always fulfil all these roles in a tax-effective way.

For this reason, analysis of your business structures should be undertaken regularly and, at a minimum, whenever the business is about to undergo a significant event. For this reason, analysis of your business structures should be undertaken regularly and, at a minimum, whenever the business is about to undergo a significant event.

Succession planning

Wills

Depending upon the approach taken when structuring assets, there may well be very little to be dealt with under the will of an individual.

This may be the desired outcome if you are concerned about a disgruntled relative bringing a claim against the estate. The issue, as always, is finding an appropriate person to hold assets.

Where a couple has structured their assets in a way such that one party, who has a low-risk profile, is the 'asset holder', it is essential to ensure that his or their will is drafted in such a way that the good prior planning is not undone if the 'low risk' partner dies before the partner who has a high -risk profile. Rather than having assets pass to the partner with exposure, consider transferring the assets to a discretionary trust or retaining the assets in a testamentary discretionary trust, where the surviving partner is a beneficiary in either case.

The issue of control, always an issue in the estate planning context, will again be raised. The death of the spouse whom the surviving partner had confidence in to 'do the right thing' may make the question of who should control the assets more difficult. Control, in this instance, may not be appropriate that control in this instance passed to the children. However, there may be similar asset protection issues regarding the children's own exposure. They may not be willing to take on the role, or the surviving partner may not have confidence in the children acting in their best interests.

Enduring Power of Attorney

Having in place enduring powers of attorney is vitally important. The issue is not so much for the 'high risk' individual – presumably, they have taken steps to minimise their level of asset-holding. The real issue is that the party that has control of assets. Consider a wife holding the matrimonial assets wholly in her own name. If she becomes incapacitated and has not appointed an enduring power of attorney with powers to make gifts and allow the husband to occupy the family home, there is a real prospect of the Public Trustee being called upon to administer the wife's affairs, and they may not have regard to the needs of the husband when making decisions. This could lead to unintended outcomes that are not favourable to either party.

Expectancies

Usually, the more important consideration in making wills is not the will of the 'high risk' person but rather the other party who holds the valuable assets.

The 'high risk' person will generally not welcome the fact that they have an individual expectancy under another person's will of another person – typically their spouse or parents. Their estate planning exercise might be rendered ineffective if a person holding assets dies at a time when a claim is pending against another person who is a beneficiary of the estate.

Again, consider whether assets should be transferred to a discretionary trust or retained in a testamentary discretionary trust established under the will, with the at-risk party merely a beneficiary of that trust. Again, consider whether assets should be transferred to a discretionary trust or retained in a testamentary discretionary trust established under the will, with the at-risk party merely a beneficiary of that trust.

Insurance

Similar considerations arise when nominating beneficiaries under insurance policies, whether they flow from life and TPD cover (if not already in a superannuation fund) as well as other insurances, such as income protection insurance.

Control of entities

Although a person may no longer be an asset holder, they may still hold some level of control over entities. Examples include shareholdings in corporate trustees, direct trusteeships or powers of appointment contained in a trust deed.

Control via shareholdings can usually be dealt with easily by diverting the shares. Control via shareholdings can usually be dealt with easily by diverting the shares.

Where the individual acts as a trustee, refer to the trust deed. The deed may allow the individual trustee to appoint a successor under their will.

In cases where the individual has a power of appointment under a trust deed to appoint and remove the trustees or beneficiaries (or both) – usually, that person is called the Appointer, Principal or Guardian of the trust – you should refer to the deed to establish whether a successor can be appointed under the Appointer's will.

Testamentary trusts and asset protection

We have already discussed the importance of nominating a "high-risk" spouse for asset protection purposes, but what happens when a "low-risk" spouse dies suddenly?

Essentially a Testamentary Trust (TT) is a trust created by the express terms and conditions of a valid will. Some TTs are fixed trusts (e.g., $50,000 to be held on trust for Tom until he reaches 25 years))), while others have the features of a normal discretionary trust.

TTs can protect a testator's assets for future generations. Rather than bequeath assets directly to a beneficiary, a TT may be created to hold assets for the benefit of a beneficiary to provide:

- Asset protection against the spouse of a beneficiary in the event of separation and marital breakdown.
- Asset protection for the beneficiary of a deceased estate at risk from creditors' claims.
- Asset protection for vulnerable beneficiaries, i.e., those with substance abuse issues or gambling problems.

Always ensure the TT is drafted correctly, allowing it to be effective – this means seeking advice from a competent legal practitioner.

Peter is a Chartered Accountant and is the high-risk spouse from an asset protection perspective. He is married to Clare, the low-risk spouse – accordingly, the family home and investment portfolio have been acquired in her name.

Peter and Clare have not undertaken any estate planning and have only prepared basic DIY wills.

If Clare were to die suddenly, the assets held in her name would transfer to Peter pursuant to her will. Consequently, these assets could be at risk as Peter, a high-risk person, now holds them. If Peter decides to transfer the assets out of his name, there will likely be adverse CGT and stamp duty implications for such a transfer, with the bankruptcy clawback rules also a potential issue.

The above situation could have been avoided if Clare had directed that the family home and investment portfolio is held in a testamentary trust for a range of beneficiaries, including Peter and their family. So, these assets would be legally owned by the trustee of the TT, with Peter and other family members receiving distributions of capital and income from the TT.

Managing the risk of claims against estate – asset protection post mortem

You must have an open discussion with your lawyer on how to minimise the risk of challenges to your estate as estate litigation is becoming increasingly prevalent in Australia.

Leaving an estranged child, a 'nominal amount' in their will does not necessarily mean the child cannot challenge their will. Leaving an estranged child, a 'nominal amount' in their will does not necessarily mean the child cannot challenge their will.

Nor does leaving your estate equally to your children mean children cannot challenge their will.

In addition, many people struggle to understand why someone should be able to make a claim against an estate - particularly an estate where the deceased left a valid will. For example: "Dad made a will. How can someone challenge how he wanted to leave his estate? His will set out what he wanted, and that should be it."

As part of a comprehensive estate plan, you should carefully consider the people, in your circumstances, you are obliged to make adequate provision, who consequently will have the right to claim your estate if adequate provision is not made.

The risk of inheritances

Here we are talking about after-acquired property in bankruptcy and, more generally, the risk of inheritances.

Leading insolvency firm Worrells published an article that serves as a warning to those considering bankruptcy or advisers who have a client considering bankruptcy, where there's a chance that they or their client may receive an inheritance (otherwise known as a bequest). Leading insolvency firm Worrells published an article that serves as a warning to those considering bankruptcy or advisers who have a client considering bankruptcy, where there's a chance that they or their client may receive an inheritance (otherwise known as a bequest).

The below examples relate to one small regional office of Worrell's over 12 months. The examples below relate to one small regional office of Worrell's over 12 months.

1. An uncle that never changed his Will despite the bankrupt telling him to—$259,000 recovered, and they're expecting a further $100,000.
2. A mother that didn't have the capacity to change her Will—$100,000 recovered.
3. A brother that died intestate (i.e., no Will) without any children or a partner—$97,000 recovered.
4. A mother who did not know about the bankruptcy because her daughter was too scared to tell her—expecting to recover $120,000 in the next month.
5. A grandmother whose Will we were unaware of recovered $55,000 and expected a further $170,000 in the next six months.

The concept of after-acquired property is set out in section 58 of the Bankruptcy Act 1966 and essentially provides that any assets that devolve upon a bankrupt during bankruptcy (i.e., the bankrupt becomes entitled to during bankruptcy) will vest in the bankruptcy trustee. The two best-known types of property that vests as after-acquired property are:

- Prize winnings – e.g., lotto.
- Inherences from deceased estates.

For those wanting to prevent the "family fortune" from falling into the bankruptcy trustee's hands, the options include:

1. Amend Wills to exclude the bankrupt for at least the standard bankruptcy period (three years). Once the bankrupt is discharged from their bankruptcy, those Wills can be changed again to include the bankrupt receiving a benefit from the deceased estate.
2. Amend Wills to leave the assets to a discretionary testamentary trust whereby the bankrupt can be a beneficiary, but it's at the trustee's (of the testamentary trust) discretion whether to distribute anything to the bankrupt during the bankruptcy period.

Employee entitlements – Important changes

Many of us know people who have found themselves in the unenviable position of being owed statutory superannuation wages, holding pay and long service leave by companies that have gone into liquidation or been abandoned by the Directors.

Winding up abandoned companies by ASIC

The Corporations Amendment (Phoenixing and Other Measures) Act 2012 (Cth) commenced on 1 July 2012. In summary, this Act amended the Corporations Act 2001 to provide ASIC with discretionary power to place a company into liquidation when certain criteria are met. This new power provides a process to wind- up a company to facilitate payment of employee entitlements where a company has been abandoned.

GEERS now 'Fair Entitlements Guarantee Scheme'

From 5 December 2012, the Fair Entitlements Guarantee Act 2012 (Cth) commenced operation and replaced the Federal Government's General Employee Entitlements Redundancy Scheme (GEERS) with the Fair Entitlements Guarantee (FEG) scheme.

In the main, the FEG replicates the assistance provided to employees through the previous GEERS administrative scheme. The key changes under the FEG include limiting the lodgement of claims to 12 months from the end of employment or the date of insolvency, restricting access to the FEG to Australian citizens, and providing claimants with the ability to seek a review of a claim decision by the Administrative Appeals Tribunal.

Options for dealing with unmanageable debt?

The website of the (AFSA), www.afsa.gov.au, contains valuable information for individuals with debt issues.

You may have unmanageable debt and need help to work out what to do. Some people can help you look at all your options before you make a final decision.

To ensure you make the right decision for your situation, learn about:

- people who can help and advise you
- formal options under the Bankruptcy Act 1966
- other options - some of which may be legally enforceable, others not
- a creditor is making you bankrupt.

AFSA manages the bankruptcy of individuals. If you need information about an insolvent company, contact the Australian Securities Investments Commission (ASIC).

Go to *https://www.afsa.gov.au/insolvency/i-cant-pay-my-debts/what-are-my-options*, as the page contains relevant links to address all the issues.

The advice to a friend or colleague facing these issues must be clear, address the matter immediately and seek good advice from a specialist in the field.

We often see people in business throwing more personal money into an unsustainable business, losing more than they should or even jeopardising their solvency.

As for personal debt, some arrangements can be made once the issue is addressed. Not resolving the issue can take a serious toll on people.

We stress the importance of doing the research yourself and being well informed as, in June 2018, ASIC warned consumers about companies that claim they can fix a poor credit rating. In June 2018, ASIC ran a month-long campaign with other Commonwealth, state, and territory agencies, to help consumers understand that by using credit repair and debt management firms, they may end up paying high fees.

Consumers should be aware these companies often fail to fix credit and debt issues, which can leave people in a worse financial situation.

People experiencing debt problems can seek free help and guidance from financial counsellors and the National Debt Helpline on 1800 007 007 or go to ndh.org.au.

Comprehensive reform of the debt agreement system

In 2018, the Federal Parliament passed legislation to reform debt agreements to help more people avoid personal bankruptcy and provide greater protection for debtors and creditors.

The Bankruptcy Legislation Amendment (Debt Agreement Reform) Bill 2018 is the first comprehensive overhaul of Australia's debt agreement system in a decade.

Debt agreements are an important and popular alternative to bankruptcy for individuals facing financial difficulties.

The number of new debt agreements doubled in the last decade, while bankruptcies have significantly reduced.

Debt agreements give people time to clear their debts and get back on their financial feet while avoiding the formal process of bankruptcy and its potential longer-term impact on their financial circumstances.

These reforms ensure debt agreements are based on an affordable payment schedule by linking repayments to a certain percentage of income. The percentage will be determined with key industry bodies, consumer groups and creditor representatives.

Other key measures include:

- Limiting the length of a debt agreement proposal to three years allows debtors to manage their debts in the short term and work towards a fresh start while maintaining flexibility to allow extensions if debts remain unpaid. Limiting the length of a debt agreement proposal to three years allows debtors to manage their debts in the short term and work towards a fresh start while maintaining flexibility to allow extensions if debts remain unpaid.
- Doubling the current asset eligibility threshold (from $111,675.20 to $223,350.40) in recognition of the growing value of Australia's property market, opening the debt agreement option to more people who are facing financial difficulty.
- The Official Receiver in Bankruptcy can reject proposed debt agreements that would cause undue financial hardship to the debtor.
- Deterring unscrupulous practices by a small minority of debt agreement administrators by setting stricter practice standards; tougher penalties for wrongdoing (such as a new three-month period of imprisonment if an administrator offers a creditor money to influence their vote) and granting the Inspector-General in Bankruptcy additional investigative powers to address misconduct.
- Ensuring greater professionalism in the industry by requiring debt agreement administrators to hold and maintain professional indemnity and fidelity insurance as a requirement of registration.

Unregistered administrators will have a year to register as an administrator or trustees if they wish to continue administering debt agreements.

These reforms commenced on 27.6.2019 after giving the debt agreement industry time to prepare for the reforms.

This legislation makes the debt agreement system fairer and more efficient for debtors and creditors alike and will protect people in a vulnerable financial position from financial exploitation.

Insolvency checklist

A solvent person is defined in Section 95A of the Corporations Act and Section 5(2) of the Bankruptcy Act as **being one that** can pay all the person's debts as and when they become due and payable.

These definitions support the proposition that solvency is determined by reference to cash flow. In addition, key operational and financial practices may put a company at risk of becoming insolvent. In addition, key operational and financial practices may put a company at risk of becoming insolvent.

Set out following is our Insolvency Checklist. If you answer "Yes" to one or more of the following questions, your business may be insolvent or at risk of becoming insolvent.

1. Are creditors being paid outside their normal terms of trade (e.g., 30 days)?
2. Has the entity conducting the business received final demands for payment from creditors?
3. Has the entity received:
   - Letters from collection agencies/solicitors for payment of debts.
   - Statutory Demands for payment?
4. Has the entity been placed on COD terms with essential suppliers?
5. Does the entity pay one supplier in priority to another to receive goods/services?
6. Have any of the BAS/IAS of the entity been lodged significantly later than the due date and/or are there any outstanding BAS/IAS?
7. Are there any outstanding statutory liabilities of the entity, Including PAYG/GST.
   - Compulsory superannuation.
   - Workers Compensation.
   - Payroll Tax?
8. Has the entity entered into an instalment payment plan with any of its creditors and/or the ATO?
9. Has the entity made any payments to creditors for round lump sum amounts, which are not reconcilable to specific invoices?
10. Has the entity withheld cheques until monies become available and/or issued post-dated cheques to creditors?
11. Have any cheques and/or payments of the entity been dishonoured?
12. Is the entity's overdraft (if applicable) steadily increasing or at its maximum limit?
13. Is the entity unable to raise further finance and/or sell surplus assets?
14. Are you unable to inject additional capital into the entity?
15. Are the current liabilities of the entity over its current assets?
16. Are the entity's total liabilities in excess of its total assets?
17. Does the entity have accumulated trading losses?
18. Has the entity failed to prepare timely financial information to allow management to review its trading performance and financial position?
19. Has the entity or its accountant failed to prepare a set of annual financial statements and a tax return in the past 12 months?
20. Has the entity failed to prepare budgets and corporate plans?

If you have answered yes to any of the above questions, you should carefully consider your position and consider seeking professional advice.

Human Resources Corner

Using KPIs for Salary Determination

In the last edition, we discussed KPIs in general, and in this edition, we are talking about using KPIs for salary determination. Salary determination plans can cover the below specifics.

- Pay Structures: Spells out how companies will compensate workers in different roles.
- Variable Compensation: The amount workers might earn above their base salary based on their performance.
- Performance Ratings: Measures workers' accomplishments and can be used to determine salary increases or other incentives.

Salary determination metrics help companies monitor whether their pay policies and benchmarks are on track. Here are five metrics that a company should measure in any salary compensation analysis.

1. Total Cost of Workforce

The total cost of the workforce tallies up all the money you spend on staffing and related expenditures. While labour is a huge cost for most businesses, many leaders aren't aware of how much they spend on their workforce.

Some business leaders also add in the operating costs to run the Human Resources department, and we recommended including the cost to outsource tasks to other types of contractors, consultants, and contingent, temporary workforce members, too.

2. Market-Ratio

Any Salary determination should evaluate market data to determine the market rate for a company's target employees. Data points can come from Hays, who deliver annual salary review updates. The market ratio is the current pay divided by the market equivalent

So, say you hire a manager for $100,000, and the market rate is $105,000. In this instance, the market ratio would be $100,000/$105,000, or 0.91.

The above is an example only, and it does not mean that any wage structure has to mirror the market 100% because the market is constantly shifting. But it would help if you had an idea of the market, so you know what your competitors are doing.

3. Pay range

The pay, or salary, range sets the boundaries for a particular position — its starting point and the outer limit. Within the pay range is the midpoint of the salary range, which is the average of the minimum and the maximum pay for a position and is typically considered a job's market rate. Understanding the pay range, including the midpoint, will guide you through setting new hires' salaries or evaluating pay raises for existing employees.

4. Comparison-Ratio

The comparison ratio considers how much an employee makes and where their compensation falls compared to the midpoint of a salary or, often, the average market rate.

Mathematically, the calculation would be the employee's salary divided by what the employer is comparing the salary to and would look like: Salary/the midpoint of the salary, for example.

Another way to consider pay is by looking at the salary range penetration; it compares an employee's salary within their position's total pay range. That calculation would be -

First, deduct the salary from the lower value in the pay range, and then that figure is divided by the difference between the lowest and highest values in the range. Finally, multiply the result by 100 to get the percentage. So, for somebody making $100,000 within a pay range that stretches from $95,000 to $105,000, the salary range penetration calculation would go like this: ($100,000-$95,000)/ ($105,000-$95,000) x 100 = 50%. With it, you can understand where the worker's salary falls within the pay boundaries of their position — and if they are toward the bottom, in the middle, or at the top.

5. Internal Equity

Internal equity is the metric used to measure what people in the same role are paid compared to employees in similar positions across an entire company. Business professionals should use this information to ensure pay equity — offering equal pay for equal work — and eliminate the historical practice of paying some individuals less based on their gender, race, or other protected areas under the law. Calculating internal equity allows employers to uncover and resolve discriminatory pay practices and demonstrate that their pay practices are fair. Calculating internal equity requires audits, an HR-led process that should happen every few years.

As you dive into salary compensation metrics, it is important to remember that employee salaries should not be your sole focus as you search for ways to boost workforce engagement and retention.

Remember, people are no longer taking employment decisions on simply who will pay top dollar. They want to be where they feel valued. A higher salary is essential but is not the most important thing.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