Bankruptcy and trusteeship

Bankruptcy affects people in many ways and superannuation is often an afterthought. However, having an undischarged bankrupt as a trustee of a superannuation fund can have significant implications for clients with self managed super funds (SMSFs).

Trusteeship

An undischarged bankrupt is a disqualified person under the *Superannuation Industry (Supervision) Act 1993* (SIS Act) and is not eligible to be a trustee of a superannuation fund. If a trustee of a superannuation fund becomes an undischarged bankrupt, they would need to retire as a trustee. While this may be distressing for an individual who acts as a trustee for a retail, corporate or industry fund, it is unlikely to affect the overall management and operation of that fund. However, in an SMSF the results are far more significant.

Once an individual is declared to be an undischarged bankrupt, they are no longer eligible to be a trustee of the SMSF, which also means that they are unable to be a member of that fund while it remains an SMSF.

If an SMSF trustee becomes an undischarged bankrupt, they are required to notify the Australian Taxation Office (ATO) immediately and make alternative arrangements for their SMSF within six months. If alternative arrangements are not made, the SMSF risks becoming a non-complying superannuation fund resulting in some assets and income of the fund being taxed at the top marginal tax rate.

In addition to the risk of non-compliance and the associated tax penalties, civil and criminal penalties may also apply.

When considering alternative arrangements for the SMSF, clients may choose to roll their SMSF over to a retail, corporate or industry fund. However, the rollover of the SMSF to these types of funds will trigger a capital gains tax (CGT) event. In addition, the client's fund will generally lose the ability to carry forward any capital losses. When the client is discharged from bankruptcy and regains the ability to become a trustee, they may elect to convert the fund back to an SMSF and resume the trustee responsibility, however, this will also trigger a CGT event.

The alternative

To avoid subjecting the SMSF to CGT, clients may choose to transfer the trusteeship to a professional licensed trustee thereby changing the structure of the fund from an SMSF to a small APRA fund (SAF). This type of fund offers clients the same level of investment flexibility and choice but without the trustee responsibilities. Appointing a new trustee is not a CGT event; the fund's entity continues and therefore no CGT is incurred. Existing cost bases and any CGT losses can be carried forward. When the client regains their ability to become a trustee, they are able to convert their fund back into an SMSF structure, again without incurring any CGT.

Case study 1

Brian is the sole director of the corporate trustee of his SMSF and has just been declared bankrupt. Brian must immediately notify the ATO that he has become a disqualified person and must also make arrangements to wind up his SMSF.

Brian's superannuation assets include an investment property worth $400,000 along with shares, managed funds and cash valued at $600,000. The unrealised capital gains are $200,000 on the property and $150,000 on the shares and managed funds. If Brian elects to roll over his fund to a retail, corporate or industry fund he will trigger a CGT event. As he has capital gains he will need to pay tax. If he had capital losses they would not generally be able to be carried forward.

In addition, Brian may have difficulty finding a retail, corporate or industry fund that will accept his investment property.

If Brian elects to transfer his SMSF to a SAF, there is no CGT event. Assuming that the trustee of the SAF accepts all of Brian's assets as acceptable investments, Brian will simply be able to appoint a new licensed trustee to his fund via a deed of retirement and appointment that will also convert the fund to a SAF.

Case study 2

Beccy and her husband Steve are individual trustees of an SMSF the B&S Super Fund and Beccy is about to be declared bankrupt. Beccy must immediately notify the ATO when she has become a disqualified person and she and Steve must make alternative arrangements for their SMSF. They have three options:

Option one

They can transfer Beccy's entitlement to another fund and have Steve continue as the sole member of the SMSF. Under this option, a CGT event will occur for Beccy as her only option is to roll her fund over; she cannot utilise the change of trustee option since the B&S Super Fund is continuing as an SMSF, with Steve as the sole member. Steve will need to appoint another individual trustee or be the sole director of a corporate trustee. If Beccy has capital gains, tax will need to be paid. If she has capital losses, they will not generally be able to be carried forward.

Option two

They can wind up the SMSF and each make alternative arrangements. Under this option a CGT event occurs for both Beccy and Steve. Any capital gains will attract tax and any capital losses will not be able to be carried forward.

Option three

They can appoint a licensed trustee and both continue membership of the B&S Super Fund. The appointment of a new trustee to the B&S Super Fund is not a CGT event. The fund will continue as a SAF rather than as an SMSF.

Summary

The consequences of bankruptcy can have a serious affect on superannuation, where the trusteeship of SMSFs is involved. It is important that clients understand the potential implications to their superannuation and act early to avoid serious penalties.

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