



2024/25 Guide to
Personal Insolvency



FOCUS

ON THE SOLUTION

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The sooner you
seek options,
the more
you'll have.

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In the face of
adversity lies an
opportunity for

TRANSFORMATION

When you open the 2024 Guide to Personal Insolvency, you are not just accessing a resource - you are drawing on more than 50 years of our insolvency and restructuring experience that supports individuals and businesses in difficult times.

In today's world, financial distress is a reality that many people face. The aftermath of the global pandemic, rising living costs, stagnant wage growth and overseas conflicts have left individuals and businesses grappling with unprecedented challenges. The stronger collection policy of the Australian Taxation Office (ATO), seeking to recover historic level of debt, has led to an increase in both personal and corporate insolvencies. This situation, understandably, brings about significant mental and emotional strain. It's during such times that seeking financial help is crucial, and we are here to offer just that.

Facing the challenge of personal insolvency is difficult and taking proactive steps towards a solution requires support from a trusted adviser.

Worrells is here to provide clear, practical advice and guidance to debt solutions. Our proprietary technology is designed to streamline and simplify the process of insolvency, ensuring that you have access to the best tools and resources available. However, technology alone is not enough. What sets us apart is our unwavering commitment to understanding and addressing the human aspect of financial distress.





Our 2024/25 Guide to Personal Insolvency is designed to be a valuable resource, providing you with the answers you need, when you need them most. This guide is not intended to be read cover to cover. Instead, it serves as a reference to assist you in finding specific answers as questions arise, to support your decision-making process, provide reassurance, and empower you to achieve different outcomes throughout the course of a bankruptcy. Our aim is to help in shift focus from the problem to the solution, to empower individuals to commence financial rehabilitation.

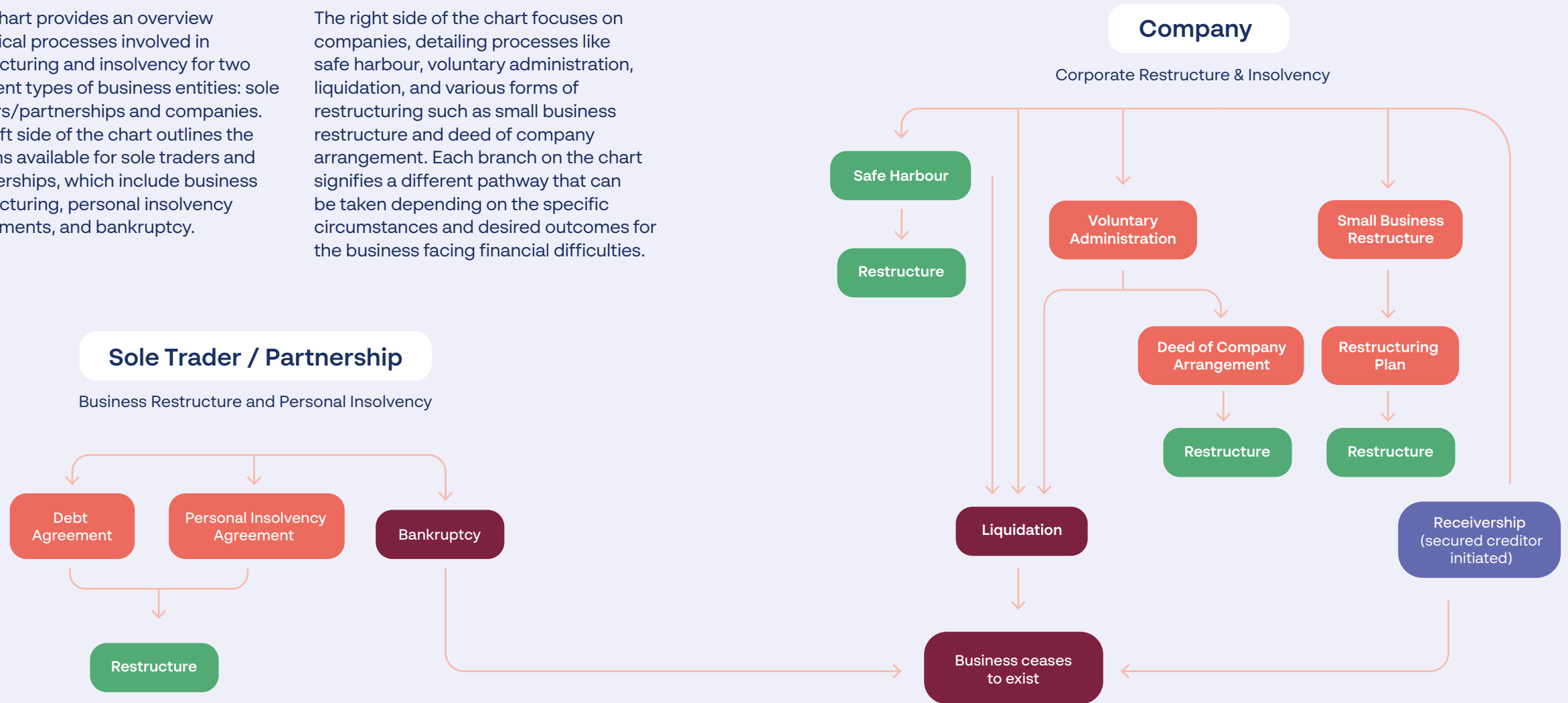
Positive options start by having a conversation.

Our strength is augmented through the resources of a national brand. At the same time, we're accessible in both the major cities and regional areas, providing local knowledge and homegrown experience.

Typical Processes for Restructuring & Insolvency

This chart provides an overview of typical processes involved in restructuring and insolvency for two different types of business entities: sole traders/partnerships and companies. The left side of the chart outlines the options available for sole traders and partnerships, which include business restructuring, personal insolvency agreements, and bankruptcy.

The right side of the chart focuses on companies, detailing processes like safe harbour, voluntary administration, liquidation, and various forms of restructuring such as small business restructure and deed of company arrangement. Each branch on the chart signifies a different pathway that can be taken depending on the specific circumstances and desired outcomes for the business facing financial difficulties.



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Not all paths are mutually exclusive
 Green: Business solvent and may still trade
 Coral: Business solvent or insolvent and may still trade
 Maroon: Business insolvent and cannot trade

Thresholds

These are the key monetary amounts and limits that apply to relevant personal insolvency appointments.

Bankruptcy

Income contributions (after tax)		Asset allowances	
\$71,826.30	No dependants	\$4,350.00	Tools of trade
\$84,755.03	1 dependant	\$9,400.00	Motor vehicle allowance
\$91,219.40	2 dependants	\$6,962.00	Obtaining credit without disclosure
\$94,810.72	3 dependants		
\$96,247.24	4 dependants		
\$97,683.77	5+ dependants		
\$4,406.00	Maximum dependant income		

Part IX

Eligibility thresholds	
\$107,739.45	Income after tax
\$287,305.20	Available assets after secured debts
\$143,652.60	Unsecured creditors

These are the key monetary amounts and limits that apply to relevant personal insolvency appointments.

These amounts are updated by the Australian Financial Security Authority (AFSA) each financial year, as well as 20 March and 20 September.

To check current amounts, scan the QR code:



Meeting periods

Notice period for bankruptcy meeting	Not less than 10 business days.
Deadline for virtual meetings	Bankruptcy trustee to specify a time which is at least 15 business days from the date the notice is given.
Holding Part X meeting	Not more than 30 business days from date of appointment.

Bankruptcy Act offences

Concealing property from bankruptcy trustee	section 263—1 to 5 years
Creditor lodging false claims to vote	section 263C—6 months
Failure to disclose property to bankruptcy trustee	section 265—1 to 5 years
Failure to attend interview with bankruptcy trustee	section 267D—6 months
Bankrupt obtaining credit above the statutory limit without advising of bankruptcy	section 269—3 years
Failure to keep proper Books and Records	section 270—1 to 3 years
Bankrupt leaving Australia with intention of not returning	section 272—3 to 5 years

Dividends & claims

Notice period for creditors to lodge Proofs of Debt	At least 21 days before declaration.
Deadline for virtual meetings	Bankruptcy trustee to specify the end of voting.
Minimum dividend	\$50.00 to any creditor.
Priority claim for employee	Wages and superannuation as a priority claim are capped a maximum dividend of \$5,150. Any amount above this cap is a non-priority debt. Annual & long service leave also have a priority.
Default remuneration for bankruptcy trustee	The bankruptcy trustee can draw default remuneration without approval to an amount of \$6,349.00 (ex GST).

QUEENSLAND

Local team, national support.

Before being appointed, we always provide a clear picture of the options a business or person may have. Shifting the mess of stress into a space of empowered clarity is how we help people to deal with these challenges.

We're here to support and guide you in those discussions, and ready to listen to your story and help write the next chapter.



To view the full team profiles, scan here.

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Bankruptcy

What is Bankruptcy?

Bankruptcy is a legal process where a bankruptcy trustee is appointed to administer an insolvent person's affairs to provide for a fair distribution of that person's divisible assets to their creditors. Bankruptcy is a legitimate and just way for a debtor to resolve their debt problems, and it is one way for creditors to take action against someone for their unpaid debts.

WHY CHOOSE BANKRUPTCY?

The *Bankruptcy Act 1966* exists to protect debtors (i.e. the bankrupt) and creditors.

The debtor is protected from being pursued by creditors and, with limited exceptions, is released from their debts upon their discharge from bankruptcy. Bankruptcy aims to provide a debtor with a fresh start.

Bankruptcy protects creditors' interests by having an independent, qualified professional control and investigate the bankrupt's affairs, and collect and distribute the bankrupt's divisible assets.

HOW DOES A PERSON BECOME BANKRUPT?

A person may become bankrupt in one of two ways.

1. **Self-initiated: debtor's petition**
A person can bankrupt themselves by filing a 'Bankruptcy Form' (which incorporates a debtor's petition' and a Statement of Affairs) with the Official Receiver. This process is referred to as 'lodging a debtor's petition'. A person is made bankrupt when the Official Receiver processes the debtor's petition and issues an estate number.
2. **Creditor-initiated: creditor's petition**
A creditor can apply to the court through a 'creditor's petition'. In most instances, a creditor must have a court judgment for their debt and have served a 'bankruptcy notice' on the debtor. If the debt remains unsatisfied at the bankruptcy notice's expiry, the creditor may file a creditor's petition with the court seeking a sequestration order — a court order bankrupting the debtor.

WHAT IS A STATEMENT OF AFFAIRS?

A Statement of Affairs must be completed by all bankrupts and sets out their personal and financial information. A Statement of Affairs is an important document for two reasons:

1. It is the financial disclosure of a bankrupt's assets and liabilities, and this information is used by the bankruptcy trustee in administering the estate.
2. The date the Statement of Affairs is lodged will determine when the bankruptcy ends (i.e. the date of discharge).

CAN A DEBTOR BE MADE BANKRUPT IF THEIR ASSETS EXCEED THEIR DEBTS?

Yes. A person is insolvent if they are unable to pay all their debts as and when they become due and payable. If a debtor owns sufficient assets to cover their debts; but is unable to liquidate them (i.e. sell them or borrow against them) to actually pay the debts, they can be made bankrupt.

The Official Receiver has the discretion not to accept a debtor's petition if they consider the debtor is solvent and could satisfy their debts.

WHO LOOKS AFTER A BANKRUPT ESTATE?

When a person is made bankrupt, a bankruptcy trustee is appointed to administer the person's bankruptcy estate.

The bankruptcy trustee is an appropriately qualified and registered specialist who is either an officer of the court (i.e. a registered bankruptcy trustee) or a public servant (i.e. the Official Receiver).

A person presenting a debtor's petition or a creditor's petition may choose to obtain a 'Consent to Act' from a bankruptcy trustee of their choice. If no consent is obtained, the Official Receiver will be the bankruptcy trustee.

WHAT ARE THE TRUSTEE'S POWERS?

A bankruptcy trustee has the power to:

- sell any divisible property of the bankrupt
- investigate the affairs of the bankrupt
- examine the bankrupt and their associates under oath
- conduct and sell any business of the bankrupt
- admit debts
- distribute dividends.

The bankruptcy trustee can exercise all the rights and powers that the bankrupt had before they became bankrupt. The bankruptcy trustee also has recovery powers that the bankrupt does not have.

In summary, the bankruptcy trustee will:

- identify and protect the divisible assets of the bankrupt
- realise those assets
- conduct investigations into the bankrupt's financial affairs and any suspicious transactions
- make appropriate recoveries
- report to creditors
- report any offences to the Australian Financial Security Authority (AFSA)
- distribute surplus funds to creditors.

HOW DOES BANKRUPTCY AFFECT SOMEONE?

A person is an 'undischarged bankrupt' from the date of bankruptcy until they are either discharged or their bankruptcy is annulled.

During this period a bankrupt:

- cannot act as a company officer
- cannot trade under a registered business name without advising people that they are bankrupt; however, they can trade under their own name
- must make all their divisible assets available to the bankruptcy trustee
- cannot incur credit over an indexed amount (\$7,032) without disclosing to the lender that they are bankrupt
- must obtain permission to travel overseas
- must make all books, records and financial statements available, including those of associated entities (e.g. companies and trusts).

CAN A BANKRUPT CONTINUE TO EARN INCOME?

Yes, a bankrupt may continue to earn an income, and should be encouraged to do so.

If the income earned by a bankrupt exceeds the annualised indexed threshold limits (as prescribed by the AFSA), a contribution from this income must be paid by the bankrupt to the estate. Income under these provisions includes personal income, certain benefits provided by third parties, income from superannuation funds and distributions from trusts. The total income is then reduced by the income tax payable, appropriate business expenses, and any child support payments.

Once an income liability has been assessed, the bankruptcy trustee has a range of powers to collect the amount due, including garnisheeing the bankrupt's wages or the use of a supervised account. The obligation to pay an assessed income liability to the estate survives the bankrupt's discharge from their bankruptcy and is enforceable by the bankruptcy trustee as a debt. The bankrupt may be made bankrupt a second time by the bankruptcy trustee for non-payment of an assessed income liability.

 MORE INFO **Income Contributions in Bankruptcy** p37

HOW DOES BANKRUPTCY AFFECT PROPERTY?

A bankrupt's assets include property that is defined under the Bankruptcy Act as 'divisible', i.e. property that can be divided among creditors. A bankruptcy trustee controls all a bankrupt's divisible property. This includes all property owned at the time of bankruptcy and all property received after the date of bankruptcy, but before discharge. This latter property is called 'after-acquired property'. Some property is not 'divisible', such as:

Some property is not 'divisible', such as:

- necessary clothing and household items
- tools of trade to an indexed amount (\$4,350)
- a motor vehicle to an indexed amount (\$9,400)
- life assurance or endowment policies (subject to some limitations)
- certain damages and compensation payments
- sentimental property (as defined in the Bankruptcy Act)
- superannuation payments (subject to certain limitations).

 MORE INFO **Divisible Property in Bankruptcy** p30

 MORE INFO **Voiding Superannuation Contributions** p47

CAN A TRUSTEE RECOVER PROPERTY SOLD BEFORE BANKRUPTCY?

Maybe. A bankruptcy trustee considers any sales or transfers of property within the five years before bankruptcy. If these transactions appear improper, undervalued, or had the purpose of attempting to defeat creditors, that property or its value may be recovered from the recipient.

A bankruptcy trustee may also recover monies from creditors who received payment of their debts in the six months before bankruptcy. Such payments are commonly referred to as 'preferential payments'.

 MORE INFO **Void Transactions in Bankruptcy** p40

HOW DOES BANKRUPTCY AFFECT JOINTLY OWNED REAL PROPERTY?

A bankruptcy trustee may place their name on the registered title in place of the bankrupt. This is called 'entering transmission'. Usually, the bankruptcy trustee invites the property's co-owner to either buy the bankrupt's interest; or join the bankruptcy trustee in selling the property.

If the co-owner does not cooperate or if they cannot agree on a satisfactory arrangement, the bankruptcy trustee can force the sale of joint property.

CAN BANKRUPTCY AFFECT A FAMILY TRUST?

Yes. A bankruptcy trustee can recover any property that a bankrupt has given or sold to a Trust at less than its true value and may also collect any monies owed to the bankrupt by a Trust.

Usually, a trustee of a Discretionary Trust will not make distributions to someone who is bankrupt. However, trustees of Fixed Trusts and Unit Trusts do not have this discretion.

WHAT IS THE EFFECT ON CREDITORS?

When a person is made bankrupt, their creditors exchange the right to enforce their claims against the person for a right to prove for a dividend in the bankrupt estate. All creditors with a provable debt at the date of bankruptcy can prove for a dividend.

 MORE INFO **Proofs of Debt and Securities** p68

ARE THE RIGHTS OF SECURED CREDITORS AFFECTED?

Bankruptcy does not affect secured creditors' rights relating to their security. A secured creditor can enforce their charge or security and may then prove for any deficiency in the bankruptcy estate. Special provisions outline how secured creditors may prove for shortfalls before the secured assets are sold.

WHAT ARE NON-PROVABLE DEBTS?

Certain debts, called non-provable debts, cannot be claimed in bankruptcy, and are not released at the end of the bankruptcy. These debts include:

- some portions of a HECS and HELP debts (government student loans)
- court-imposed fines
- the remainder of maintenance agreements under the *Family Law Act 1975*
- unliquidated debts (a debt where debtors and their creditors are yet to determine the amount).

Full details of provable debts are set out in section 82 of the Bankruptcy Act.

CAN THE TRUSTEE PAY DIVIDENDS?

Yes. Ultimately the bankruptcy trustee's role is to distribute the bankrupt's divisible assets to creditors. Section 109 of the Bankruptcy Act sets out the order of priorities in which dividends must be paid. Certain payments and debts must be paid before dividends are paid to unsecured creditors.

 MORE INFO **Dividends** p70

WHEN DOES BANKRUPTCY END?

The bankruptcy period automatically ends (i.e. the bankrupt is discharged) three years and one day after the filing date of the Statement of Affairs. However, the administration of the estate may continue for some time afterwards.

A bankruptcy's term can be extended for up to eight years. To extend a bankruptcy, a bankruptcy trustee lodges 'an objection to discharge' with the Official Receiver. Reasons to object a discharge include:

- if the bankrupt fails to cooperate
- leaves Australia without permission
- manages a company (without the leave of the court)
- engages in misleading conduct relating to an amount over an indexed sum.

WHAT IS AN ANNULMENT OF BANKRUPTCY?

An annulment is a cancellation of bankruptcy and reinstates a debtor's affairs as if the bankruptcy had not occurred. An annulment can be obtained by:

- a court order on the basis that the bankruptcy should not have occurred
- the bankrupt's debts and the administration's costs being paid in full, or
- a section 73 proposal being accepted by creditors.

 MORE INFO **Discharge and Annulment** p76

 MORE INFO **Section 73 Proposals** p24

CAN A TRUSTEE BE CHANGED?

Yes. The Bankruptcy Act provides two ways to change a bankruptcy trustee:

1. The creditors can pass a resolution to change a bankruptcy trustee, or,
2. The court may replace a bankruptcy trustee if convinced it is proper to do so. Usually, the court only forms this opinion if the bankruptcy trustee has done something incorrect and a new bankruptcy trustee needs to take over the estate.

If a bankruptcy trustee retires or dies, the Official Receiver will replace the bankruptcy trustee.

GOVERNMENT CHARGES (REALISATION CHARGE AND INTEREST CHARGE)

Bankrupt estates attract government charges. A realisations charge is payable at seven percent of the gross monies received into the estate, less payments to secured creditors, trade on costs and other minor amounts. Monies held by bankruptcy trustees for an estate must be held in interest bearing accounts with any interest earned paid (as an interest charge) to the government.

IS A BANKRUPTCY ON PUBLIC RECORD?

Yes. A bankruptcy's status and a debtor's personal information is permanently recorded on the National Personal Insolvency Index (NPII). The NPII is a publicly available and permanent electronic record of all personal insolvency proceedings in Australia. The NPII is updated with the status of the bankruptcy: current, and discharged.

Getting out of Bankruptcy

How does a Bankruptcy end?

A bankruptcy usually ends with the bankrupt being discharged from bankruptcy, which is the end of the legal process. No action is required by bankrupt nor the bankruptcy trustee to obtain a discharge, as it is purely an operation of the *Bankruptcy Act 1966* three years after a Statement of Affairs is lodged. The bankrupt estate may continue after discharge while the bankruptcy trustee finalises the estate, and the discharged bankrupt may have some ongoing obligations, but they will no longer be 'bankrupt'.

WHEN IS A BANKRUPT DISCHARGED?

A bankrupt is automatically discharged three years and one day after their completed Statement of Affairs is filed with the Australian Financial Security Authority (AFSA)—unless the bankruptcy trustee files an 'objection to the discharge'.

If the bankruptcy commenced via a debtor's petition (i.e. a voluntary bankruptcy, where a person chooses to bankrupt themselves), the Statement of Affairs must have been filed at the same time, therefore the bankruptcy ends three years and one day after the debtor's petition is accepted.

If the bankruptcy commenced via a sequestration order (an order of the court), the Statement of Affairs would not have been filed at that time. The bankrupt must complete and lodge a Statement of Affairs with AFSA. The longer the delay in filing the Statement of Affairs, the longer the three-year bankruptcy period is delayed. If the Statement of Affairs is never filed, the bankruptcy will continue until the bankrupt dies; however, the estate's conduct will continue until completed.

 MORE INFO **Discharge and Annulment** p76

CAN A BANKRUPT GET OUT OF BANKRUPTCY BEFORE DISCHARGE?

Yes. The bankruptcy can be annulled. An annulment reverses the bankruptcy, as if it never happened.

HOW IS A BANKRUPTCY ANNULLED?

There are three ways of annulling a bankruptcy:

1. The bankruptcy trustee obtains sufficient monies to pay all of the estate's debts and costs.
2. A section 73 proposal is accepted by the bankrupt's creditors.
3. The bankrupt convinces the court that the bankruptcy should never have been commenced.

WHAT ARE THE DEBTS AND COSTS OF THE ESTATE?

The costs and debts are:

- All the provable debts of the estate.
- The realisations charge, which is currently seven percent and is payable to AFSA.
- The bankruptcy trustee's expenses and remuneration.
- Any other charges or statutory costs of the estate.

For a bankruptcy to be annulled by all debts and costs being paid, the bankruptcy trustee must have sufficient money to satisfy all the pre-bankruptcy debts, the bankruptcy costs and the statutory charges. Generally, this type of annulment happens when the sale of an asset provides enough money to pay these costs, or when a friend or relative provides the funds.

WHAT IS A SECTION 73 PROPOSAL?

A section 73 proposal is a formal proposal presented to creditors under section 73 of the Bankruptcy Act. It provides a mechanism for bankrupts to put forward a proposal to their creditors as an alternative to the bankruptcy continuing. If creditors accept a section 73 proposal, the bankruptcy is exchanged for an agreed obligation under the section 73 agreement.

 MORE INFO **Section 73 Proposals** p24

WHY WOULD THE COURT ANNUL A BANKRUPTCY?

Usually, the court will only annul a bankruptcy when it can be shown that the bankruptcy should never have been commenced. This happens:

- where the proper legal process was not followed in initially bankrupting the person
- if there was no debt outstanding to a petitioning creditor at the time, or
- if the bankrupt is actually solvent (with liquid assets or borrowing capacity).

A bankrupt who successfully obtains an annulment through the court should be aware that the now ex-trustee has the right to use assets in their possession to pay outstanding remuneration and outlays, and if the net value is insufficient, they may seek payment from the now ex-bankrupt.

Section 73 Proposals

What is a Section 73 Proposal?

During a bankruptcy, a bankrupt may be in a position to make a proposal to their creditors to satisfy their debts and consequently end their bankruptcy early. Section 73 of the *Bankruptcy Act 1966* provides a bankrupt with a mechanism to make that proposal.

If a section 73 proposal is accepted, it indicates that the creditors expect to receive a larger distribution when compared to the continued bankruptcy.

HOW DOES A BANKRUPT MAKE A PROPOSAL?

The bankrupt must send a written proposal to their bankruptcy trustee and request that a meeting of creditors be called to consider the proposal. The proposal's particulars are set out in the written request. The bankruptcy trustee will investigate the proposal's benefits as necessary, then issue a report that compares the likely returns from the proposal to the bankruptcy's continuation and calls a meeting for the creditors to vote to accept or reject the proposal.

The bankrupt will usually be required to pay the bankruptcy trustee to undertake this process, as there is no requirement for the bankrupt estate's funds to be used for this purpose.

If the proposal is accepted, the bankruptcy will be annulled from the acceptance date. If the proposal is not accepted, the bankruptcy will continue as if the proposal had never been put to creditors.

COMPOSITION OR ARRANGEMENT?

A section 73 proposal can be structured as either:

- a composition
- a scheme of arrangement.

A composition is an agreement to pay money to the bankruptcy trustee. The composition can be for any amount and can be paid over any period.

A scheme of arrangement can contain almost any lawful provision. It can contain provisions for the payment of monies, the sale of certain assets, and payments from third parties.

DELAYS IN CALLING A MEETING OF CREDITORS

A bankruptcy trustee can decline to call a meeting of creditors if the proposal does not provide for the bankruptcy trustee's approved fees and expenses or costs to be paid. Prior to the proposal being examined, the bankrupt may be required to pay an amount (called a surety) to cover the bankruptcy's costs and fees to investigate the proposal, and to call and hold the meeting.

HOW IS THE PROPOSAL ACCEPTED?

The proposal is put to a meeting of creditors under the same provisions as bankruptcy meetings. Only the creditors present or represented by proxy at that meeting vote on the proposal. It must be accepted by a special resolution, which is both a majority in number of creditors (present and voting), and at least 75 percent of the dollar value of the creditor's debts (present and voting). So, it is in every creditor's best interest to attend and vote on a section 73 proposal.

If the proposal is accepted, the bankruptcy is consequently annulled. The now 'ex-bankrupt' will be bound by the agreement terms. The agreement binds all creditors, regardless of whether they attend or vote at the meeting.

WHO ADMINISTERS A SECTION 73 PROPOSAL?

The proposal must include a provision for a trustee to administer the agreement. Usually, the bankruptcy trustee will administer the agreement; however, a different trustee can be appointed under the agreement. The trustee's role is to:

- ensure that the ex-bankrupt complies with the agreement's terms
- enforce the provisions as necessary
- pay dividends.

WHAT ABOUT THE TRUSTEE'S ACTIONS DURING THE BANKRUPTCY?

Section 74 of the Bankruptcy Act provides that the bankruptcy trustee's actions during the bankruptcy period remain valid. For example, any preference payments recovered, any property sold during the bankruptcy administration.

CAN THE TRUSTEE PAY DIVIDENDS?

Yes. The trustee of the agreement will make distributions under the agreement's terms. If the agreement does not stipulate these provisions, the trustee will make distributions when practical and when the agreement is likely to end.

WHEN DOES A SECTION 73 AGREEMENT END?

The agreement ends when the debtor (the now ex-bankrupt) satisfies the agreement terms in full.

WHAT IF THE DEBTOR DEFAULTS?

If the debtor does not satisfy the agreement terms, section 76B of the Bankruptcy Act provides enforcement provisions. All powers that are available to a bankruptcy trustee under Part X of the Bankruptcy Act (in the enforcement of personal insolvency agreements) are available to a trustee of a section 73 agreement for either a composition or scheme of arrangement structure.

These powers include terminating the agreement either:

- automatically through the agreement terms
- with creditors' consent
- by creditor resolution
- by court order.

Any application to the court to terminate the agreement can also include an application to bankrupt the debtor to initiate a new bankruptcy.

GOVERNMENT REALISATIONS CHARGE

The administration of section 73 proposals attracts a government charge known as a 'realisations charge'. The current rate is seven percent of gross monies received into the administration, less payments to secured creditors and trade on costs. The realisations charge is payable in priority to any dividend to creditors.

IS A SECTION 73 PROPOSAL ON PUBLIC RECORD?

Yes. A section 73 proposal and a debtor's personal information is permanently recorded on the National Personal Insolvency Index (NPII). The NPII is a publicly available and permanent electronic record of all personal insolvency proceedings in Australia. The bankruptcy is updated on NPII with the status of 'annulled'.

Part X Personal Insolvency Agreements

What is Part X of the Bankruptcy Act?

Part X (Part 10) of the *Bankruptcy Act 1966* allows a debtor to enter into a personal insolvency agreement (PIA) with their creditors to satisfy their debts without being made bankrupt.

WHAT IS A PERSONAL INSOLVENCY AGREEMENT?

A personal insolvency agreement (PIA) is a formal agreement between a debtor and their creditors that sets out how the debtor will satisfy their debts. Once executed by the debtor and their controlling trustee—and when creditors accept the proposal—it forms a deed.

The proposal can contain almost any lawful term and condition. Usually, it will provide for the repayment of monies over time and in some cases, the sale of assets. It also usually contains a moratorium (or freeze) from creditor's claims for the term of the agreement, and payment of a sum that is less than the full amount in full satisfaction of their claims.

WHY CHOOSE A PART X AGREEMENT?

A debtor may use a personal insolvency agreement to:

- get relief from their debts
- ensure a fair distribution of their assets to creditors
- provide a higher dividend than would be available in bankruptcy
- maintain their source of income that may be affected by bankruptcy
- avoid the restrictions of bankruptcy.

HOW IS THE PROCESS STARTED?

A debtor must choose a controlling trustee (e.g. a solicitor or a registered bankruptcy trustee) and provide them with three documents:

1. An authority under section 188 of the Bankruptcy Act giving the controlling trustee control over their assets and requiring them to call a meeting of creditors to consider the proposal.
2. A Statement of Affairs detailing all their assets, liabilities, and other personal information.
3. A draft personal insolvency agreement detailing the proposal being made to creditors.

The controlling trustee will sign a 'consent to act' and forward the documentation to the Australian Financial Security Authority (AFSA) for registration on the official record (the National Personal Insolvency Index). AFSA will then allocate an 'estate number' to the PIA.

HOW IS THE PROPOSAL ACCEPTED?

Once appointed, the controlling trustee must hold a meeting of creditors within 30 business days. At the meeting, the creditors will decide whether to accept or reject the proposal. For the proposal to be accepted there must be a majority in both the number of the creditors and more than 75 percent in value (i.e. creditors holding over 75 percent of the debt) in favour. This type of vote is called 'a special resolution'.

If the required majority does not accept the proposal, the creditors may resolve that the debtor become bankrupt, but they cannot actually bankrupt the debtor at that meeting. However, creditors can resolve that the debtor be released from the control of the controlling trustee, which allows creditors to commence recovery action or bankruptcy proceedings.

IS SIGNING A SECTION 188 AUTHORITY AN ACT OF BANKRUPTCY?

Yes. During the Part X process a debtor will commit several 'acts of bankruptcy', including signing the section 188 authority, calling a meeting of their creditors and obtaining a special resolution by creditors. Any creditor can use these actions to apply to the court to have the debtor made bankrupt if the proposal is not accepted.

HOW ARE CREDITORS AFFECTED BY THE PERSONAL INSOLVENCY AGREEMENT?

Secured creditors' rights under their valid securities remain intact. They can exercise their rights regardless of whether the proposal is accepted or not. Unsecured creditors with debts provable in bankruptcy exchange their right to enforce their claims for a right to share in the PIA proceeds. If the proposal is accepted by the required majority, all unsecured creditors will be bound by the agreement regardless of whether they attended the meeting, and whether they voted in favour of the proposal.

HOW DOES THE AGREEMENT AFFECT THE DEBTOR'S PROPERTY AND INCOME?

Only property that is included in the PIA is affected. Property that is excluded from the agreement is unavailable to creditors. The debtor is only required to contribute part of their income if the agreement includes terms requiring them to do so.

CAN THE TRUSTEE PAY DIVIDENDS?

Yes. The trustee will make distributions in accordance with the agreement terms. When dividends are paid will depend on the agreement duration and when funds become available. If the duration is expected to be short, the trustee will usually pay a dividend when all the assets have been realised and all funds collected. If the agreement extends over a long period, the trustee may make interim distributions as funds become available.

 MORE INFO **Dividends** p70

WHEN DOES A PART X END?

The agreement ends when the debtor satisfies the deed's requirements in full.

WHAT HAPPENS IF THE DEBTOR DOES NOT COMPLY WITH THE AGREEMENT TERMS?

If the agreement terms are not satisfied, then the agreement is deemed to be in default. Usually, a default notice is issued to the debtor within a few days and, if not rectified, the agreement will be breached and may be terminated by one of the following methods:

- The provisions of the agreement, automatically terminating the agreement.
- The trustee terminating the agreement with the consent of creditors.
- The passing of a special resolution at a meeting of creditors.
- A court application to terminate the agreement and possibly bankrupt the debtor.

WHO ADMINISTERS A PERSONAL INSOLVENCY AGREEMENT?

The proposal for an agreement must include the appointment of a registered bankruptcy trustee or the Official Receiver to administer the agreement. If no one is nominated, the Official Receiver will be the trustee. Their powers and obligations will be set out in the agreement and in conjunction with the Bankruptcy Act. Fundamentally, their role is to enforce the agreement terms, sell any assets, collect any monies and make a distribution to creditors.

DOES SIGNING A SECTION 188 AUTHORITY AFFECT A CREDIT RATING?

Yes. Credit agencies will record that the debtor has signed a section 188 Authority. But this may be more favourable to the debtor than having outstanding writs, defaults, and a bankruptcy on their file.

CAN A DEBTOR CONTINUE TO ACT AS A DIRECTOR OF A COMPANY?

No. A debtor cannot act as a director while subject to the terms of a PIA. This restriction is lifted when the agreement has ended.

GOVERNMENT REALISATIONS CHARGE

The administration of a PIA attracts a government charge known as a 'realisations charge'. This charge is payable at the rate of seven percent of gross monies received into the administration, less payments to secured creditors and trade on costs (i.e. normal business trading expenses). The realisations charge is payable in priority over any dividend payable to creditors.

IS A PART X ON PUBLIC RECORD?

Yes. A Part X and a debtor's personal information is permanently recorded on the National Personal Insolvency Index (NPII). The NPII is a publicly available and permanent electronic record of all personal insolvency proceedings in Australia. The NPII shows the status of a debtor that has signed a controlling trustee authority (a section 188 authority).

2



Recoveries

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Divisible Property in Bankruptcy

Introduction

In simple terms, bankruptcy trustees sell a bankrupt's assets and distribute the proceeds to the bankrupt's creditors. This section looks at which assets a bankruptcy trustee can sell (i.e. are divisible). It does not look at assets that may be recovered from other parties through other provisions relating to void transactions under the *Bankruptcy Act 1966*. Further information on void transactions can be found under "Void Transactions in Bankruptcy" in this book.

Not all the bankrupt's assets are available to a bankruptcy trustee. The Bankruptcy Act distinguishes 'divisible' from 'non-divisible' assets. Understandably, whether an asset is divisible is often a contested issue.

Items that are held on trust or loaned to a bankrupt—or that do not belong to a bankrupt—do not vest in a trustee as they are not the bankrupt's property and therefore cannot be divisible.

VESTING OF THE 'PROPERTY OF THE BANKRUPT'

Upon bankruptcy, any divisible property of the bankrupt automatically vests in the bankruptcy trustee. Under section 58 of the Bankruptcy Act, a bankruptcy trustee is not required to take any action for this 'vesting' to occur. Where applicable, legal title to some property may have to be registered in the bankruptcy trustee's name, but the equitable title will vest automatically (e.g. real property).

Assets acquired by a bankrupt after the bankruptcy commenced but before discharge may also vest in the bankruptcy trustee when they are acquired. These assets are called 'after-acquired property'.

After-acquired property includes any property that the bankrupt acquires or inherits on or after the date of the bankruptcy, and before discharge, being property that is also divisible among their creditors. Non-divisible, after-acquired property does not vest in the bankruptcy trustee.

There are two important factors in defining after-acquired property:

1. The property must have been acquired during the bankruptcy's term.
2. The property would otherwise be classified as divisible property.

If existing owned property is not deemed as 'divisible' at the commencement of bankruptcy, it is not divisible if acquired during bankruptcy.

One purpose of section 58 of the Bankruptcy Act is to immediately protect assets from individual creditors who attempt to recover their debts by exercising securities against assets. Creditors cannot take these assets from a bankrupt, or from the estate, under enforcement actions (unless they have leave of the court). Once an asset has vested in a bankruptcy trustee, only they can deal with that asset, as the bankrupt is no longer the legal owner. This allows for an orderly and fair distribution of the bankrupt's assets between the proper creditors.

Two exceptions allow creditors to commence or continue action against property:

1. Secured creditors have a right to exercise their security over any asset covered by their security. Section 58 of the Bankruptcy Act only provides protection to divisible assets that are not covered by a valid security.
2. Creditors can exercise their rights against non-divisible property for debts under maintenance orders or agreements. Non-divisible property does not fall under the bankruptcy trustee's control or protection, as it does not vest in the bankruptcy trustee.

BANKRUPTCY ACT 1966 – SECTION 58

Vesting of property upon bankruptcy—general rule:

- (5) *Nothing in this section affects the right of a secured creditor to realise or otherwise deal with his or her security.*
- (5A) *Nothing in this section shall be taken to prevent a creditor from enforcing any remedy against a bankrupt, or against any property of a bankrupt in respect of any liability of the bankrupt under:*
- (a) *a maintenance agreement; or*
 - (b) *a maintenance order; whether entered into or made, as the case may be, before or after the commencement of this subsection.*

All divisible property not secured to a particular creditor is solely under the bankruptcy trustee's control. But deciding what is divisible property is not always straightforward.

REGISTRATION OF INTERESTS

In some cases, registration is necessary to record vesting of property in the bankruptcy trustee. This is usually the case with real property, where the title of the property must be transferred to the bankruptcy trustee to legally deal with the property.

This process is known as 'entering transmission' (i.e. transmitting legal ownership). The equitable interest will vest in the bankruptcy trustee; however, the legal interest will also need to be transferred. Usually, in the case of real property, a bankruptcy trustee will initially protect the estate's interest by lodging a caveat on title—vesting of the property provides a 'caveatable' interest. However, a bankruptcy trustee can only sign transfer documents when the property title is transferred into their name.

NEW TRUSTEES

Occasionally, a bankruptcy trustee will change during a bankruptcy. Any property remaining in an estate automatically vests in the new bankruptcy trustee when the change takes effect. The same transmission rules apply, so the new bankruptcy trustee may need to enter transmission of the relevant property into their name.

While a change of bankruptcy trustee is uncommon, the mechanism is in place to allow a smooth transfer of the rights to property.

WHAT IS DIVISIBLE PROPERTY?

Section 58 of the Bankruptcy Act does not define what is or is not divisible property, only that all divisible property vests in the bankruptcy trustee. A bankruptcy trustee considers divisible property as all of the bankrupt's property, then, eliminates non-divisible assets from the list. Section 116 of the Bankruptcy Act broadly defines divisible property as follows:

- All property owned at the time of bankruptcy, or acquired during the bankruptcy.
- Any rights or powers over property that existed at the date of bankruptcy, or during the bankruptcy.
- Any rights to exercise powers over property.
- Any property that vests because an associated entity received the property as a result of personal services supplied by the bankrupt (section 139D of the Bankruptcy Act).
- Monies recovered from an associated entity due to an increase in the net worth of the entity as a result of personal services supplied by the bankrupt (section 139E of the Bankruptcy Act).
- Monies recovered from a regulated superannuation fund further to a 139ZQ notice being sent to the superannuation fund's trustee (section 128C of the Bankruptcy Act); or via a court order (section 128K of the Bankruptcy Act).
- Monies paid to the bankruptcy trustee under an order relating to rolled-over superannuation interests etc. (section 139ZU of the Bankruptcy Act).

WHAT IS NON-DIVISIBLE PROPERTY?

Determining what is not divisible property is a difficult area. The Bankruptcy Act provides that some property types will not be divisible. Section 116(2) of the Bankruptcy Act summarises what is not classified as property divisible among creditors.

In some instances, assets that would be non-divisible in bankruptcy, but which were converted to cash/assets before bankruptcy— can become divisible property.

The list of non-divisible property is extensive and only some are common because they are necessary for a standard of living. These can be grouped into the following areas:

1. Property held by the bankrupt on trust for another person (i.e. not owned by the bankrupt).
2. The bankrupt's household property prescribed by Regulation 27 of the *Bankruptcy Regulations 2021* or identified by a resolution passed by the creditors before the bankruptcy trustee realises the property.
3. Personal property that has sentimental value to the bankrupt and is identified by a special resolution passed by the creditors before the bankruptcy trustee realises the property.
4. The tools of trade that the bankrupt uses in earning income by personal exertion—subject to an amount indexed by the Australian Financial Security Authority (AFSA).
5. A vehicle used by the bankrupt as a means of transport—subject to an amount indexed by AFSA.
6. Policies of life assurance or endowment assurance covering the life of the bankrupt or their spouse, whether the proceeds are received on or after the date of the bankruptcy.
7. The bankrupt's interest in a regulated superannuation fund (or approved deposit fund or an exempt public sector superannuation scheme). And any payment to the bankrupt from such a fund (received on or after the date of the bankruptcy) if the payment is not a pension within the meaning of the *Superannuation Industry (Supervision) Act 1993*.

8. A payment to the bankrupt under a payment split under Part VIII B 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*.
9. 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*.
10. A payment to the bankrupt under a payment split under Part VIII B 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*.
11. 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 facto partner, or family member.
12. Amounts paid to the bankrupt under a rural support scheme as prescribed by the Act.
13. 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.
14. Property that was purchased or acquired with protected money.
15. Any property that, under an order—under either Part VIII, or Part VIII AB of the *Family Law Act*—the bankruptcy trustee is required to transfer to the bankrupt's spouse or a former spouse, or former de facto partner.
16. The bankrupt's property that is a support for the bankrupt that was funded under the National Disability Insurance Scheme (NDIS), or NDIS amount as defined in that Act.

EXEMPT ASSETS

Some divisible property is subject to statutory value limits. Property valued under these limits is exempt or non-divisible to the extent of the limit. These limits change periodically, in line with the Consumer Price Index (CPI) or the base pension rate, as prescribed by AFSA.

The limits are designed to allow the bankrupt to maintain a standard of living (the household property limitations) and maintain their employment (the tools of trade and motor vehicle limitations).

SENTIMENTAL PROPERTY

The Bankruptcy Act defines what is sentimental property, and whether it is exempt. Sentimental property must be non-monetary, have real sentimental value to the bankrupt, or be an award for sporting, cultural, military or academic achievement. If it does not fall into these categories, it cannot be classified as sentimental and usually becomes divisible.

Creditors must also resolve by special resolution at a meeting of creditors (or a virtual meeting) that this property is sentimental. If creditors do not approve it as sentimental property, it becomes divisible property to the estate.

TIME LIMITS FOR REALISATION

Section 129AA of the Bankruptcy Act sets out the periods that divisible assets must be dealt with. A bankruptcy trustee must realise any divisible assets disclosed by a bankrupt within six years after the bankrupt is discharged. This period can be extended up to three years at a time by giving written notice to the bankrupt prior to 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 bankruptcy trustee has six years after the bankrupt's discharge date to deal with the property. For any after-acquired property the bankrupt discloses after discharge, the bankruptcy trustee has six years commencing on the date of disclosure to realise the property. Again, a bankruptcy trustee can extend these periods.

If the assets are not dealt within the required period, they can revert to the bankrupt.

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

Bankruptcy and the Home

Introduction

How the *Bankruptcy Act 1966* applies to a bankrupt's home is often misunderstood. Understandably, if a bankrupt loses their home, it's an extremely stressful and saddening position to be in. If dependants and partners/spouses are also impacted, this disrupts and affects them too. Bankruptcy trustees must approach a realisation of a bankrupt's interest in their home with tact and understanding, while protecting creditors' rights and interests.

IS THE HOME PROTECTED?

No. A home is not a protected asset under the Bankruptcy Act. If there is equity in the property after paying any proper mortgagee and selling costs, the bankruptcy trustee is obliged to realise (i.e. sell) the property.

WHAT ABOUT JOINT OWNERSHIP?

The realisation process is relatively straightforward when the bankrupt is the only owner of the home, or all owners are bankrupt. However, often the bankrupt and their non-bankrupt partner/spouse will own the home as 'joint tenants'. When the bankrupt and a non-bankrupt co-owner jointly own the home, the bankruptcy trustee can still insist on realising the bankrupt's share of the equity.

WHAT HAPPENS TO JOINT TENANCIES ON THE BANKRUPTCY OF ONE OR MORE OWNERS?

A joint tenancy is automatically severed upon the bankruptcy of any one of the joint tenants—at least as far as it relates to the bankrupt's ownership interest. This occurs due to the 'involuntary alienation'—or severing of the owner's fundamental legal rights—that are necessary to create a joint tenancy. This practice is long established with reference to the 1862 case of

Paten v Cribb. The trigger to this alienation of legal rights is the property vesting in the bankruptcy trustee at the bankruptcy's commencement.

After the joint tenancy is severed, those interests in the property are held as 'tenants in common', which is critical if a bankrupt dies during the bankruptcy. If the joint tenancy had not been severed, the bankrupt's share of the property—and the equity attached to that share—would automatically vest in the co-owner upon the bankrupt's death, and the bankruptcy estate would lose the equity in the property.

HOW IS THE EQUITY IN A PROPERTY DETERMINED?

The bankruptcy trustee will get the property valued to determine the equity. Secured debts (e.g. mortgages etc.) are deducted from the property's value and the bankrupt's share of the equity is calculated.

WHAT IF THERE IS NO EQUITY IN THE PROPERTY?

When there is no equity in a property and the debts secured against the property are greater than the current property value, the mortgagee may still exercise their rights and sell the property.

If mortgagees don't exercise their rights, the bankrupt—and possibly other parties—can continue to service the loan. The property vests in the bankruptcy trustee at the time of bankruptcy and remains vested regardless of whether the bankruptcy trustee takes action to sell the property, or whether there is any equity in the property. The property remains vested in the bankruptcy trustee when the bankrupt has been discharged from bankruptcy.

The bankruptcy trustee may review the property's equity position periodically, and can realise any equity generated after the date of bankruptcy, even if that equity is generated by the bankrupt or another owner continuing to meet the mortgage payments. Mortgage payments attributed to the bankrupt's share are deemed to be rental payments to use and occupy the property.

HOW ARE PROPERTIES REALISED?

Where the bankruptcy trustee is the only owner, they can offer the property for sale. Where there is a co-owner, the bankruptcy trustee will usually take the following approach:

1. Give the co-owner the opportunity to buy the estate's interest in the property.
2. Invite the co-owner to join the bankruptcy trustee on agreed terms to market and sell the property.
3. Ask the court to appoint a 'statutory trustee for sale' over the co-owner's interest to force a sale of the property, if there is no agreement to sell the property with the bankruptcy trustee.

The appointment of a statutory trustee forces the sale of the home, even if the co-owner is solvent and has not contributed to the bankruptcy in any way. While the court will often try to soften the effect of such an order by allowing the co-owner time to relocate, the outcome is that the property will be sold.

WHAT IS ENTERING TRANSMISSION?

'Entering transmission' is the legal process to have the bankruptcy trustee's name placed on the certificate of title in place of the bankrupt's name. This step is necessary to enable the bankruptcy trustee to execute a sale contract and transfer forms when selling the property.

Usually, a bankruptcy trustee will only enter transmission if satisfied that there is equity in the property. In the interim, a bankruptcy trustee can lodge a caveat over the title to protect the estate's interests for the short term, giving the bankruptcy trustee time to determine how to deal with the property.

WHAT ABOUT MORTGAGEES?

The majority of homes are subject to a mortgage. The mortgage may be enforced during the bankruptcy, even when the mortgage payments are up to date, as the bankruptcy itself may constitute a default under the terms of the mortgage. Although mortgagees have the right to sell the bankrupt's home, in most cases they will leave this task to the bankruptcy trustee.

WHAT IF THE BANKRUPT CAN CONTINUE WITH MORTGAGE REPAYMENTS?

If the bankrupt has the capacity to continue making mortgage repayments, usually the mortgagee will not insist upon possession of the property—preferring that the loan repayments continue. The bankruptcy trustee and bankrupt may negotiate payment for any equity in the property to the estate.

This type of arrangement benefits everyone concerned: the bankrupt's creditors benefit from the property's equity in the estate; the mortgagee retains a performing loan; and the bankrupt avoids losing their home.

However, the bankruptcy trustee can sell the property at any time, even if the mortgage repayments are up to date. This means that the estate will benefit from the extra equity generated in the property from additional repayments.

WHAT ABOUT GETTING VACANT POSSESSION?

Normally, the bankruptcy trustee will need to provide vacant possession to sell a property. A bankruptcy trustee would not usually expect a bankrupt to vacate the property immediately upon bankruptcy; in normal circumstances, some weeks would be allowed for alternative arrangements to be made.

In some cases, the bankruptcy trustee may allow the bankrupt to stay in residence during the selling period provided the bankrupt agrees in that process, pays a fair rent, maintains the property, and provided the bankruptcy trustee is satisfied of the bankrupt's continued cooperation in the bankruptcy process.

HOW ARE THE PROCEEDS OF SALE DISTRIBUTED?

If the bankrupt wholly owns the property, the estate will receive the entire surplus of the sale after any mortgagee and selling costs are paid. If the property is co-owned, the bankruptcy trustee will share the surplus with the co-owner (non-bankrupt) as per the legal entitlement on the title deed.

Although the title to a property may be held equally, situations arise where unequal contributions have been made towards acquiring or developing the property. This may lead to one party holding the property for the other party in a constructive or resultant trust, and potentially alter the sale distribution. The sharing of equity may also be altered under the 'doctrine of exoneration' if one owner on title uses loans secured over the property, and not the other.

WHEN DOES THE DOCTRINE OF EXONERATION APPLY?

The property may be encumbered by a mortgage that secures a loan for the sole benefit of one owner, even though all owners have agreed to the mortgage. The doctrine of exoneration says that the person who received the benefit of the loan should have the first obligation to repay the loan—and the co-owner should only be considered a surety (guarantor) and their share should only be used to meet any shortfall.

A simple example of the doctrine is a home worth \$400,000 owned by the bankrupt and a nonbankrupt partner/spouse. Prior to bankruptcy they agreed with the bank taking a mortgage over their property to support an advance of \$150,000 for the bankrupt's business. Upon sale of the property, \$250,000 would be available for distribution to the owners (i.e. \$400,000 sale price less the \$150,000 mortgage). Because each owner had an equal share in the legal title to the property it might be thought that they should each receive \$125,000. However, the doctrine of exoneration can require that the amount due under the mortgage should be deducted from the bankrupt's equity so that the following equitable distribution would apply:

Bankrupt's share = \$200,000
less \$150,000 = \$50,000
Spouse's share = \$200,000

The bankruptcy trustee must find compelling evidence that the doctrine of exoneration should apply.



MORE INFO **Doctrine of Exoneration**

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IS THERE A TIMEFRAME FOR THE SALE OF THE PROPERTY?

Section 129AA of the Bankruptcy Act requires bankruptcy trustees to realise property within a period ending six years after the discharge of a bankrupt. This allows nine years to arrange these sales. If the bankruptcy trustee does not sell within the timeframe, the property could potentially revert in the discharged bankrupt.

The six-year rule only applies to property disclosed to the bankruptcy trustee. If the property is not disclosed to the bankruptcy trustee, the bankruptcy trustee will have 20 years to deal with the property.

WAR SERVICE HOMES

A bankrupt or a debtor under Part X of the Bankruptcy Act cannot have a war service home taken from them under the *Defence Service Homes Act 1918*, except in extraordinary circumstances.

Although the Department of Veterans' Affairs has the discretion to allow a bankruptcy trustee to sell the bankrupt's property, in practice this discretion is rarely exercised. In our experience, the Secretary will not exercise their discretion even when the bankrupt has incurred substantial business debts. It may be that some bankrupts take these business risks—which they would otherwise have avoided—in the knowledge that they cannot lose their war service home. This is inequitable as far as creditors are concerned, but it is currently the law.

SUMMARY

1. A bankrupt's home can be sold even if the bankrupt only has a part interest in the property.
2. The bankruptcy trustee will normally offer the property for sale to any co-owner prior to having the property placed on the market.
3. The bankruptcy trustee will normally sell the interest in the property without undue delay.
4. The bankruptcy trustee must recover the value for the property but has a wide discretion regarding how to sell.
5. The bankruptcy trustee will normally allow the bankrupt some time to arrange alternative accommodation/a new residence.
6. The doctrine of exoneration may adjust the distribution of the sale proceeds.
7. War service homes are excluded from realisation.

Income Contributions in Bankruptcy

Can a bankrupt work during their bankruptcy?

Yes. A bankrupt can earn an income during their bankruptcy. Subject to some provisions and exceptions, a bankrupt is encouraged to earn an income, as there is no logical reason why they should not be entitled to earn an income and benefit from it. However, the *Bankruptcy Act 1966* states a bankrupt must pay contributions from their income to their estate if the amount earned is over the relevant threshold prescribed by the Australian Financial Security Authority (AFSA).

WHAT ARE INCOME CONTRIBUTIONS?

Under section 139P of the Bankruptcy Act, a bankrupt may be liable to make income contributions (subject to indexed thresholds and number of dependants), to their bankrupt estate from income earned during their bankruptcy. It is appropriate that some of the income from the bankrupt's efforts during the bankruptcy is used to satisfy their past debts.

WHAT INCOME IS ASSESSED FOR CONTRIBUTIONS?

A bankrupt's income is assessed to determine whether contributions must be paid. Section 139L of the Bankruptcy Act sets out the definition of income to be assessed. The definition of 'income' is the same as under the Taxation Acts, but also includes amounts that have not been earned from physical exertion or investments and amounts that may not even be taxable income. These 'other incomes' include loans made to the bankrupt, items that fall under the fringe benefit tax provisions, annuities, and pensions, as well as some insurance payments.

IS ALL MONEY EARNED INCOME?

No. Many amounts are not income for contribution assessment purposes. These are set out under paragraph (b) of section 139L of the Bankruptcy Act.

ARE ANY AMOUNTS DEDUCTIBLE FROM AFTER-TAX INCOME?

Yes. Deductions are available for payments made to support a child, if paid under a *Family Law Act 1975* maintenance agreement or order. Deductions are also available for certain business expenses under section 139N of the Bankruptcy Act.

HOW DOES THE TRUSTEE OBTAIN INFORMATION ABOUT A BANKRUPT'S INCOME?

A bankrupt is required under the Bankruptcy Act to provide details of their income to their bankruptcy trustee. A form is usually sent to the bankrupt on each bankruptcy date anniversary, which must be completed and returned with any documentation supporting the income earned and deductions claimed.

WHAT IF THE BANKRUPT DOES NOT COMPLETE THE FORM?

Under the Bankruptcy Act, it is an offence if a bankrupt does not cooperate with their bankruptcy trustee and complete their income assessment form. If a bankrupt does not cooperate, the bankruptcy trustee can object to the bankrupt's discharge from bankruptcy (i.e. extend their bankruptcy period) and estimate the bankrupt's income and assess it accordingly.

CAN THE TRUSTEE INVESTIGATE THE BANKRUPT'S INCOME INFORMATION?

Yes. While a bankruptcy trustee can make an assessment on what they reasonably believe is a bankrupt's income, in practice they investigate thoroughly before making an assessment. If the bankrupt supplies inadequate or questionable information, a bankruptcy trustee will seek further information.

If appropriate, a bankruptcy trustee can conduct an examination and request that the bankrupt provide further information to clarify any matter. If further information is not forthcoming, the bankruptcy trustee can make their assessment and the onus is then on the bankrupt to disprove the assessment.

HOW IS THE INCOME CONTRIBUTION CALCULATED?

The contribution calculation is made on assessed income, which is the amount of income left after tax, the Medicare levy and proper deductions. A contribution is payable if the assessed income is more than AFSA's current statutory threshold. The threshold amounts are based on how many dependants the bankrupt has during that assessment period.

The bankruptcy trustee is entitled to receive 50% of the balance over the threshold amount (i.e. the 'over threshold after tax income' is divided equally between the bankrupt and bankruptcy trustee).

The formula is (Assessed Income – Actual Income Threshold Amount) ÷ 2.

HOW IS THE ASSESSMENT MADE?

The bankruptcy trustee assesses the estimated income based on information the bankrupt supplies at the beginning of the assessment period. An assessment (called a 'determination') is made on these estimates and the bankrupt becomes liable to pay any contributions to the bankruptcy trustee from the assessment date.

At the end of the assessment period, the bankrupt must supply the past year's actual income amount, along with their estimate for the next year. The past year's assessment is adjusted if necessary, then a new assessment is made for the next year's estimated income and the process starts again.

HOW OFTEN ARE THE ASSESSMENTS MADE?

Each assessment period runs from the date of the bankruptcy or its anniversary and ends on the day before the next anniversary. Assessment periods continue until the bankrupt is discharged, including when a bankruptcy is extended through an objection to discharge.

WHAT HAPPENS TO THE MONEY PAID UNDER AN ASSESSMENT?

Money paid under these provisions is paid into the estate funds for the benefit of the bankrupt's creditors.

WHAT OBLIGATIONS DOES THE BANKRUPT HAVE?

A bankrupt must provide information about their income and deductions and give the bankruptcy trustee access to all required books and records. If the bankrupt refuses or fails to supply requested books or records, the bankruptcy trustee can lodge an objection to the bankrupt's discharge and AFSA may prosecute the bankrupt for an offence.

HOW DOES THE BANKRUPT GET A NOTICE OF THE ASSESSMENT?

Once a determination is made, the bankruptcy trustee gives a notice to the bankrupt setting out the amount payable and particulars on how the determination was calculated. Usually, a bankruptcy trustee will include a schedule of contribution payments over the remaining months of the assessment period.

IS AN ASSESSMENT NOTICE A LEGAL OBLIGATION?

Yes. Issuing an assessment notice creates a legal obligation to pay the contribution. A bankruptcy trustee can nominate when the payments are due and can be collected from the bankrupt as a debt due. These rights remain after the bankrupt has been discharged, which means that the bankrupt can be re-bankrupted for non-payment of any contribution.

CAN THE ASSESSMENT BE REVIEWED?

Yes. The Bankruptcy Act provides a mechanism for any assessment to be reviewed by the Inspector General, but the request must be made within 60 days of the assessment. Upon receipt, the Inspector-General has 60 days to decide whether the assessment should be reviewed and make a ruling. The decisions handed down by the Inspector-General can be reviewed by the Administrative Appeals Tribunal.

WHAT CAN THE TRUSTEE DO TO ENFORCE COLLECTION?

If an assessment is made and the bankrupt refuses or fails to pay, the bankruptcy trustee can:

- issue notices to employers or other people that owe the bankrupt money to garnishee those monies (i.e. order third parties to withhold monies owing to the bankrupt)
- issue an objection to the discharge of the bankrupt, extending the bankruptcy period
- prohibit the bankrupt from travelling overseas
- re-bankrupt a discharged bankrupt, if the refusal to pay occurs after the bankrupt has been discharged
- issue a notice under the Bankruptcy Act's supervised account regime provisions.

WHAT IS THE SUPERVISED ACCOUNT REGIME?

Bankruptcy trustees may determine that the supervised account regime is needed. This requires a bankrupt to open a supervised account where they must deposit all their income. The bankruptcy trustee then supervises all withdrawals from that account to ensure that income contributions are made.

Void Transactions in Bankruptcy

What are the provisions designed to do?

Bankruptcy trustees investigate pre-bankruptcy transactions when they suspect the transaction improperly transferred assets away from the bankrupt that would otherwise be available to creditors. *The Bankruptcy Act 1966* will in some cases allow voiding these transactions and require the other party to return an asset or make a payment to the bankruptcy trustee.

WHO MAY RECOVER MONEY UNDER THESE PROVISIONS?

Trustees of bankruptcies and personal insolvency agreement's (PIAs) may use the provisions to void transactions. However, a PIA must give the bankruptcy trustee this right, as it may be excluded in some agreements.

WHAT MUST THE TRUSTEE DO TO BE ABLE TO MAKE A RECOVERY?

To void a transaction, the bankruptcy trustee must do the following:

1. Identify the transaction.
2. Identify the other party to the transaction.
3. Prove the transaction occurred within a specific period, or while the bankrupt was insolvent (i.e. as a debtor pre-bankruptcy).
4. Prove the transaction was either undervalue or had the required intention.
5. Show the transaction did not involve protected property.

WHY DO TRUSTEES VOID SOME TRANSACTIONS?

A bankruptcy trustee must ensure that all the bankrupt's divisible assets are available to distribute to creditors. Part of this obligation is to investigate whether the bankrupt entered into a transaction that reduced the amount of assets available for distribution. The bankruptcy trustee seeks to recover these assets and void any transaction that provided an advantage to any creditor, so that they can make a more equitable distribution to all creditors.

Sometimes when debtors face bankruptcy, they try to protect some of their assets by hiding, moving, or transferring assets to a third party to hold during the bankruptcy period. The void transaction provisions attempt to deter debtors from moving assets at their creditors' expense and rightful recovery.

WHAT TYPE OF TRANSACTIONS MAY BE VOIDED?

The Bankruptcy Act enables the bankruptcy trustee to void:

- undervalued transactions (section 120 of the Bankruptcy Act)
- transfers done with the intention to defeat creditors (section 121 of the Bankruptcy Act)
- transfers where the consideration was paid to a third party (section 121A of the Bankruptcy Act).

UNDERVALUED TRANSACTIONS – SECTION 120

What are undervalued transactions?

Asset transfers at less than market value are deemed 'undervalue'. Sometimes a debtor will sell or transfer assets to third parties shortly before their bankruptcy and attempt to make the transaction look commercial. Undervalue transactions may take the form of the following:

- A sale for less than the asset's market value—moving a valuable asset to another party.
- A purchase of something at a greater consideration than its value, thus moving money to another party.

Examples of these transactions include a debtor:

- selling their share of their home to their spouse for \$1 or 'natural love and affection'
- granting a mortgage or security to a party in exchange for monies that were lent previously
- purchasing an asset of limited worth but paying a price well over market value.

A bankruptcy trustee can void property transfers—including money—within five years before the bankruptcy commenced.

Are some transfers of assets protected?

Yes. The Bankruptcy Act protects some transfers from being voided when all three of these conditions are present:

1. The transfer occurred over two years prior to the bankruptcy's commencement.
2. The transfer did not involve a party related to the debtor.
3. The debtor was solvent at the time of the transfer and remained solvent after the transaction.

Transactions undertaken with non-related parties while the debtor was solvent should be protected, as this would not be prejudicing creditors by transferring these assets. The other party to the transaction has the onus of proving that the bankrupt was solvent at the transaction time and remained solvent immediately thereafter.

Is the timing different if the other party is related to the bankrupt?

Yes. The two-year period extends to four years (i.e. prior to bankruptcy) if the other party to the transaction is related to the bankrupt.

This means that any undervalue transactions that took place four years before the bankruptcy's commencement are automatically void if they involve related parties, as defined as 'related entities' in the Bankruptcy Act.

Is insolvency important?

A person is solvent if they are able to pay all of their debts as and when they become due and payable. A person who is not solvent is therefore insolvent.

A transfer under section 120 of the Bankruptcy Act is not void against a bankruptcy trustee if it took place more than two years before the bankruptcy's commencement date and the debtor was solvent. Therefore, a bankruptcy trustee must demonstrate the bankrupt was insolvent where the transfer took place between three and five years before the bankruptcy's commencement. For related-party transactions, this two-year period is extended to four years. A court will usually look to the bankruptcy trustee to provide some evidence to substantiate the insolvency at the time of the transfer. Consequently, the onus of defending these claims and therefore declaring solvency lies with the party seeking to rely on a defence. The Bankruptcy Act provides for a presumption of insolvency if the debtor did not keep proper financial records during that period, but this presumption is rebuttable (i.e. it can be disproved by positive evidence of solvency). This can be quite difficult if there are truly no records of the bankrupt's financial affairs.

Are some transfers exempt?

Yes. Some transfers of property will not be void. The Bankruptcy Act protects tax payments, payments made under family law agreements, and payments under Part IX debt agreements (i.e. Part 9 of the Bankruptcy Act).

A transfer is exempt when it is:

- a tax payment under Commonwealth, State or Territory law
- a transfer to meet all, or part, of a liability under a maintenance agreement or order a transfer of property under a Part IX debt agreement
- a transfer of a kind described in the Bankruptcy Regulations
- a transfer made under maintenance agreements or orders made in the Family Court of Australia.

The Family Court would have to overturn an original maintenance order before a bankruptcy trustee could make any recovery under section 120 of the Bankruptcy Act. Getting the Family Court to overturn its decision to allow a bankruptcy trustee to recover assets from an ex-spouse can be difficult.

The trustee must refund the consideration received

Section 120 of the Bankruptcy Act voids the entire transaction, not just the recovery of an asset or money. This means that to get the transferred asset back, the bankruptcy trustee must refund any consideration the bankrupt received as part of that transaction. Consequently, each party is back to the position they held before the transaction was undertaken. Otherwise the estate would have both the consideration and the asset that was transferred.

What is not consideration?

Some things are not deemed consideration and cannot be refunded. These include:

- the transferee being related to the transferor
- the transferee being a spouse or de facto spouse of the transferor
- the transferee's promise to marry or to become the de facto spouse of the transferor
- love or affection
- the transferee granting a spouse a right to live at the transferred property.

How long does the trustee have to take the recovery action?

A bankruptcy trustee must commence recovery action within six years of a person becoming bankrupt.

TRANSFERS TO DEFEAT CREDITORS – SECTION 121**What are transfers to defeat creditors?**

Sometimes debtors transfer property primarily to protect it from their creditors. The Bankruptcy Act allows such transfers to be voided where the bankrupt's intention was to stop divisible assets becoming available to creditors, or to defeat or delay the proper distribution of assets to creditors.

What makes a transfer fall into this category?

To be a transaction to defeat creditors, it must involve the following:

- Property that in all likelihood would have become part of the estate—or been available to creditors—and is made unavailable to the bankruptcy trustee because of the transfer.
- The intention of making that property unavailable to creditors, permanently or temporarily.

What types of transactions are caught?

There must be a transfer of property. Something must pass from the bankrupt that would have become a divisible asset in the estate. However, a transfer can also be property created by the debtor that results in someone becoming the owner of something that did not previously exist. For example, the creation of a mortgage, securities, or other interests over property owned by the bankrupt, where the security would stop the property becoming available to the bankruptcy trustee.

How do you determine the bankrupt's intention?

One of the transaction's main purposes must be to protect the asset from creditors. This is subjective and usually inferred from the transaction's circumstances, the bankrupt's financial position at that time, and the result of the transaction. However, intention can also be deemed by the debtor's actual or impending insolvency (i.e. if it can be shown the bankrupt was—or was about to become—bankrupt at the time of the transaction). If the debtor was solvent at the time and remained solvent thereafter, it may be difficult to connect the transaction to the knowledge of insolvency.

Is insolvency important?

A person is solvent if they can pay all of their debts as and when they become due and payable. A person who is not solvent is insolvent. A court will usually look to the bankruptcy trustee to provide some evidence of insolvency at the time of the transfer if the bankruptcy trustee is using the deeming provisions.

Transfers are not void if done in good faith

The Bankruptcy Act protects transfers where the transferee acted in good faith. To be able to rely on the good faith defence, the other party to the transfer must show all three of these conditions:

1. Provided consideration at least to market value, calculated at the time of the transfer.
2. Had no knowledge of—or could not have reasonably inferred—the bankrupt's intention.
3. Could not have inferred at the time that the transferor was insolvent, or about to become insolvent.

To be able to use this defence, the other party must have been completely unaware of the debtor's financial position and intention. As many of these transactions are done with relatives or other related parties, this lack of knowledge may be difficult to prove. Transactions examined under section 121 of the Bankruptcy Act are rarely undertaken with complete strangers.

How long does the trustee have to take the action?

Actions under section 121 of the Bankruptcy Act can start at any time after the bankruptcy trustee discovers the transaction. Unlike other recovery provisions under the Bankruptcy Act, a section 121 transaction has no time limits.

TRANSACTIONS WHERE CONSIDERATION GIVEN TO A THIRD PARTY – SECTION 121A**Who else may be involved in these actions?**

Third parties that are not directly involved in a transaction between the bankrupt and another party can be subject to a bankruptcy trustee's recovery actions. Section 121A of the Bankruptcy Act allows a bankruptcy trustee to collect money from a third party where that party received money that should have been paid to the bankrupt.

In these third-party scenarios, it is not essential that the original transaction was undervalued or intended to defeat or delay creditors, as it is the payment of consideration to the third party that is examined. For example, did the third party give valuable consideration

to the bankrupt for the money, or was the bankrupt's intention to direct the payment to the third party done to defeat creditors?

What can be done?

The Bankruptcy Act deems that when a third party receives consideration, it should be viewed as a transfer of property by the bankrupt. That consideration therefore constitutes the property transferred, and the transfer may be reviewed under sections 120 and 121 of the Bankruptcy Act. If that payment of consideration is deemed void for the reasons set out in the sections above, the consideration will be recoverable from the third party.

A bankruptcy trustee can take action against the original party to the transaction and separately against the third party that received the consideration.

PROTECTION OF CERTAIN TRANSFERS**What protection does the Bankruptcy Act provide?**

The Bankruptcy Act provides some protection to people transacting with a debtor before bankruptcy. A transaction is not automatically void because the debtor becomes bankrupt. Essentially, people who had no knowledge of the impending bankruptcy and acted in normal business circumstances can be protected.

Who gets this protection?

Section 124 of the Bankruptcy Act protects an innocent, unknowing party who entered in a commercial transaction in ordinary dealings with the bankrupt, if the following conditions are met:

- The transaction happened before the bankruptcy—as the bankrupt does not have the right to deal with their assets after bankruptcy.
- The other party was unaware of the impending bankruptcy.
- The transaction was done in good faith and in the ordinary course of business.

The conditions of 'good faith' and 'ordinary course of business' may be difficult to prove. The other party must not have acted in any manner that would give the impression that they were not acting in good faith. The ordinary course of business must be held in the ordinary course of the relevant industry, not the ordinary course of the particular creditor.

The burden of proof rests with the party attempting to gain this protection.

Preferences in Bankruptcy

What are preferential payments?

Preferential payments or ‘preferences’ are payments or asset transfers to creditors that give them an advantage over the other creditors. Bankruptcy trustees can recover these payments or transfers under the provisions of the *Bankruptcy Act 1966*. Preferences are usually payments of money, although a variety of transfers of assets can be deemed as preferential.

WHO MAY RECOVER PREFERENTIAL PAYMENTS?

In personal insolvency administrations, only trustees of bankrupt estates and personal insolvency agreements—where the agreement allows—can claim the return of preferential payments.

WHY DO TRUSTEES VOID PREFERENTIAL PAYMENTS?

The bankruptcy trustee’s main role is to distribute a bankrupt’s assets fairly between their creditors. To do so, they must identify whether any creditor received a distribution—prior to the bankruptcy—that was not equitable when compared to the distribution to other creditors in the bankruptcy. Bankruptcy trustees can void transactions that involve one creditor to make a more equitable distribution to all creditors.

WHAT ARE THE ELEMENTS OF A PREFERENTIAL PAYMENT?

Before a court will void a payment or transfer, it must be satisfied that:

- a transfer of property was made (usually a payment of money)
- something passed from the bankrupt to a creditor, or on the creditor’s instructions
- it occurred at a specific time when the bankrupt was insolvent
- it occurred within the relevant period before the bankruptcy
- the transaction gave the creditor an advantage over other creditors—usually determined by the creditor receiving more than if they had proved for that amount in the bankrupt estate
- the creditor suspected—or should have suspected—that the bankrupt was insolvent at the time.

WHEN IS SOMEONE INSOLVENT?

The Bankruptcy Act defines being insolvent as “not being able to pay all your debts as and when they become due and payable”. To have a preference voided, the bankrupt must have been insolvent at the time of the transfer or payment. The reasoning is that a solvent person has the capacity to pay all their debts (regardless of whether they did pay), and therefore no creditor could have been advantaged over other creditors by receiving the transfer or payment.

WHO HAS TO PROVE INSOLVENCY?

The onus of proving insolvency is on the bankruptcy trustee.

MUST THERE BE A DEBTOR–CREDITOR RELATIONSHIP?

Yes. The transaction must involve or have been done at the direction of a bankrupt’s creditor and must have satisfied a debt that would have been provable in the estate if the transaction had not been undertaken.

MUST THERE BE A TRANSFER OF AN ASSET?

Yes. There must have been a transfer of some property between the parties. Commonly a transfer is a payment of money, but any asset passing from the bankrupt to the creditor—even an asset that is created by the transaction, e.g. a security—is sufficient to be a transfer of property. The amount of the preference claim is the value of the asset transferred.

WHAT IS THE RELEVANT PERIOD?

The transfer of the asset must occur during a specific period before bankruptcy, which depends on how the bankruptcy was commenced:

- Creditor’s petition—six months before it was filed.
- Debtor’s petition—six months before it was presented.
- Debtor’s petition where a creditor’s petition is pending—on the commencement of bankruptcy, which is the earliest act of bankruptcy within the six months before the creditor’s petition was filed.

MUST THE DEBT BE UNSECURED?

Yes. A preference cannot be given to a creditor holding a security over assets. However, if the security was not properly created (i.e. not valid), or the value of the security is less than the payment amount, then the transfer, or the excess value over the security’s worth, may be deemed as preferential.

HOW IS PREFERENTIAL TREATMENT DETERMINED?

The creditor must have received more than if they had refunded the monies and proved for that amount in the bankruptcy. This is purely a mathematical calculation. If the creditor did not receive more in the payment than they would have received from a dividend in the bankruptcy, there is no advantage or preferential treatment.

WHAT STATUTORY DEFENCES ARE AVAILABLE TO CREDITORS?

There are three conditions of statutory defence:

1. The transfer was in the ordinary course of business.
2. The recipient acted in good faith.
3. The recipient gave market-value consideration, or at least market value.

The recipient gave market-value consideration, or at least market value. The creditor must prove all three conditions of the defence, otherwise the entire defence fails. The transfer is not voidable if it was made following a maintenance agreement or order under the *Family Law Act 1975* or was made under a Part IX debt agreement under the Bankruptcy Act.

WHAT IS THE ORDINARY COURSE OF BUSINESS AND GOOD FAITH?

The creditor must not have acted in any manner that would give the impression that they were not acting in good faith or under normal trading conditions. For example, actions that may refute good faith are issuing proceedings or statutory notices to the debtor (prior to being a bankrupt) or ceasing supply of goods and services. The creditor must not have forced the payment by way of threat or action.

WHAT IS MARKET VALUE CONSIDERATION?

Usually, the easiest condition to prove is that a creditor gave market-value consideration.

If the creditor is a trade creditor, the initial supply of goods or services that created the debt provides the market-value consideration. A loan creditor can rely upon the initial loan to the bankrupt. A creditor will only have to show that they have given something of similar value in consideration for receiving the payment.

WHEN WILL THE STATUTORY DEFENCES NOT BE AVAILABLE?

A creditor cannot rely on the statutory defences when they knew—or had reason to suspect—that the bankrupt was insolvent, and that the transaction would give them a preference over the other creditors.

WHAT SHOULD CREDITORS DO IF A TRUSTEE CLAIMS A PREFERENTIAL PAYMENT?

Broadly, creditors should make sure that:

- the transaction happened within the relevant period
- they are not a secured creditor
- they were a creditor when the payment was made and that it was not a cash-on-delivery type transaction
- the bankruptcy trustee shows that they received an advantage over the other creditors.

The following points are more detailed and complex to determine:

- Whether the creditor gave extra credit to the debtor after the payment in question was received. The claim may be reduced, or eliminated, by the amount of extra credit the creditor granted. This is commonly known as the 'running account defence'.
- That the bankruptcy trustee can show insolvency at the time of, or before, the payment was received.
- Whether the creditor is likely to convince a judge that all three of the statutory defences are available to them.

WHAT CAN CREDITORS DO IF THEY HAVE TO REFUND MONEY TO A TRUSTEE?

Creditors that refund preferences can lodge a proof of debt in the bankruptcy for the amount refunded. Creditors may also have rights under any guarantees given by other parties that support that debt.

HOW LONG DOES THE TRUSTEE HAVE TO MAKE A CLAIM?

A preference claim must be commenced within six years after the bankruptcy commenced. A bankruptcy trustee must issue legal proceedings within the six-year period—not just make a formal demand.

Voiding Superannuation Contributions

Introduction

Bankruptcy trustees investigate pre-bankruptcy transfers or transactions when they believe the transaction improperly dissipated or removed assets that would otherwise be available to creditors. *The Bankruptcy Act 1966* will in some cases permit voiding these transactions and require the other party to return an asset or make a payment to the bankruptcy trustee. Sometimes, contributions made by or on behalf of the bankrupt (pre-bankruptcy) to superannuation funds fall into this category.

To void this type of transaction, the bankruptcy trustee must show:

1. A transaction was entered into.
2. They can identify the other party to the transaction.
3. The transaction occurred within a specific period, or while the debtor was insolvent.
4. The transaction was either undervalued or had the required purpose of improperly removing assets from a bankrupt estate.
5. It does not involve protected property.

This Guide deals with contributions that are made prior to bankruptcy that have all these factors.

REASONS FOR VOIDING THESE TRANSACTIONS

A bankruptcy trustee must ensure that all of a bankrupt's divisible assets are available to distribute to their creditors. Part of this obligation is to find whether a bankrupt entered into a transaction before they became bankrupt that reduced the assets available for distribution. For this reason, the bankruptcy trustee seeks to recover these assets. The Bankruptcy Act provisions give bankruptcy trustees the power to recover monies paid to eligible superannuation funds in the period before the bankruptcy.

Occasionally when debtors face bankruptcy, they try to protect some of their assets by hiding, moving, or transferring assets to a third party to hold during the period of bankruptcy. Sometimes debtors make payments to their superannuation fund, as superannuation is generally an exempt asset

The Bankruptcy Act provisions attempt to deter debtors from moving assets into their superannuation fund at their creditors' expense and allow bankruptcy trustees to recover the money from the fund when payments fall under the relevant conditions.

 **MORE INFO** **Divisible Property in Bankruptcy** p30

VOIDING THE BANKRUPT'S SUPERANNUATION CONTRIBUTIONS

Various sections of the Bankruptcy Act are designed to void transactions or transfers of property to provide a fair distribution of a bankrupt's assets to their creditors. Section 121 'transfers to defeat creditors' is designed to void transfers where the intention of that transfer is to move the property out of reach of the bankruptcy trustee or creditors.

Subdivision B of Division 3 of Part VI of the Bankruptcy Act is aimed at voiding transfers of property to eligible superannuation funds where the intention of the transfer was to defeat creditors. The main provisions are very similar to section 121, but target superannuation funds, as the Bankruptcy Act generally excludes monies in superannuation funds from being divisible property.

Under section 128B of the Bankruptcy Act, transfers made by a debtor are void if they occurred after 28 July 2006, and:

- they are made to eligible superannuation funds of the bankrupt
- the property would have formed part of the bankrupt estate if the transfer had not been made
- the main purpose of the transaction was to keep an asset from falling into the bankruptcy trustee's hands and being available to creditors.

Most people will initially consider payments as transfers, but any property transfers can be subject to these provisions. Section 128B goes one step further to include any transaction that creates new property. This is usually in the form of securities or equitable/legal interests over assets the bankrupt still owns i.e. creating a charge in favour of the superannuation fund may be deemed a transfer of property.

A bankruptcy trustee will examine payments to superannuation funds and any other assets created and will assess whether the payment falls within the provisions. The inherently difficult part to determine is the debtor's intention at the time of the transfer.

CONTRIBUTIONS BY A THIRD PARTY

Transfers to superannuation funds made by third parties on the debtor's behalf may also be caught under these provisions. Third parties may also hold assets that belong to the debtor or owe money to the debtor. Paying that money into a superannuation fund on the debtor's instruction will be a transaction that can be examined. Again, the intention of the transfer must be to defeat creditors.

Under section 128C, transfers made by third parties are void if:

- They are made to eligible superannuation funds of the bankrupt.
- The property would have formed part of the property available to creditors in a bankrupt estate (usually as a debt due) if the transfer had not been made.
- The transfer occurred under a scheme that the debtor was a party to—effectively, it was done under the debtor's direct or implied instructions.
- The main purpose of the transaction was to keep that asset from falling into the bankruptcy trustee's hands and becoming available to creditors.

INTENTION

One of the main purposes of the transaction must be to protect the asset from creditors—to defeat creditors' interest in the property. This intention only needs to be one main purpose of the transaction, not the only purpose. This is subjective, and is usually inferred from the transaction's circumstances, the debtor's financial position at that time, and the result of the transaction.

This intention can be deemed by the debtor's (i.e. pre-bankrupt) actual or impending insolvency, but only if it can be shown that the debtor was—or was about to become—bankrupt at the time of the transaction. If the debtor was solvent at the time and remained solvent for some time after the transaction—with no indication of an impending bankruptcy—it would be difficult to connect the eventual insolvency to the transaction.

It is common for debtors to undertake transactions with this intention when legal action against them is pending and it appears likely or inevitable that judgment will be made against them.

Alternatively, a loan or other agreement that has been breached could lead to a demand that a debtor cannot meet. In these circumstances, showing or deeming that the intention existed may be quite easy. Most bankrupts who undertake transactions to protect assets, usually only do so close to the time of bankruptcy.

The bankruptcy trustee will also examine the debtor's history of personal contributions to eligible superannuation funds. If the payment is one of a series of similar payments over a long period, there could be an argument that the required intention did not exist. If the payment is a once-off large payment—especially if significantly larger than any previous payments—it is more likely that the intention existed.

THIRD PARTY CONTRIBUTIONS

The same deeming provisions apply to transfers by third parties. If it can be shown that the debtor was insolvent, or was about to become insolvent at the time, the intention can be deemed. The same indicators can determine the debtor's intention. There is no requirement for the other party to know or suspect the insolvency, as there is no claim against that other party.

INSOLVENCY

The debtor does not need to have been insolvent at the time of the transaction for it to be void. As detailed in section 128B, it is the debtor's intention that is important, and showing insolvency or pending insolvency is a key means of showing that intention. If the bankruptcy trustee relies on that deeming provision, the court will require evidence of insolvency.

The Bankruptcy Act provides for a presumption of insolvency if the debtor did not keep proper records of their financial affairs during that period. That presumption is rebuttable, i.e. it may be disproved by positive evidence of solvency. This may be quite difficult if there are truly no records on the debtor's financial affairs. The same rebuttable presumption of insolvency applies to transfers made by third parties.

The rebuttable presumption is designed to stop bankrupts from avoiding their past transactions being overturned by simply destroying or hiding the records needed to examine the transaction. In essence, the presumption deems that the debtor is insolvent at a particular time, unless there are records that prove otherwise. As a consequence of that deemed insolvency, the transactions under examination can be said to have been done under the required intention.

PROTECTION OF OTHER PARTIES

The Bankruptcy Act goes to some lengths to ensure that innocent parties to void transactions are not prejudiced any more than necessary. The provisions that relate to the voiding of superannuation contributions are no different. The Bankruptcy Act provides protection for two parties: the bankruptcy trustee, and the superannuation fund trustee.

The first party is the trustee of the eligible superannuation fund. When a contribution is received, certain taxes and other charges are deducted and paid to the government, fund managers, etc. The bankruptcy trustee will seek the voiding of the transfer (i.e. the entire amount of the contribution). Payment of the entire contribution would leave the superannuation trustee (of the fund) out of pocket to the extent of the taxes and charges. Section 128B of the Bankruptcy Act provides that when an amount of the superannuation contribution is recovered, the amount of taxes and charges that applied to that contribution must be paid to the superannuation trustee, to ensure that they do not suffer a shortfall.

Interestingly, this protection only applies to payments that are made to the bankruptcy trustee under a section 139ZQ notice. It is debatable whether this protection applies if the superannuation trustee voluntarily returns the contribution to the bankruptcy trustee, or even if the bankruptcy trustee obtains a court order for the contribution to be returned.

Innocent parties are protected when they receive title to any property in good faith (i.e. without any knowledge of the intention of the transfer).

THIRD PARTY CONTRIBUTIONS

This protection also applies to superannuation trustees when contributions are made by other parties but are voided under the appropriate Bankruptcy Act provisions. The provisions in section 128B and 128C also apply to third party contributions, except they are referred to as 'contributions' by other parties. Section 128C(8) of the Bankruptcy Act provides protection to parties that obtain title to property without knowing the intention of the transfer when the contribution is made by another party.

PROTECTION AGAINST CRIMINAL AND CIVIL PROSECUTION

Section 128L of the Bankruptcy Act protects superannuation trustees from criminal and civil prosecution for acts done in good faith. These acts include complying with a superannuation account-freezing notice (section 139ZQ notice under the Bankruptcy Act) or a court order.

SUPERANNUATION ACCOUNT-FREEZING NOTICES

Section 128E of the Bankruptcy Act gives bankruptcy trustees certain powers to help them make these claims. One is the power to issue a superannuation account-freezing notice. The Official Receiver issues the notices when the bankruptcy trustee has satisfied to the Official Receiver that there are "reasonable grounds" that a contribution to a superannuation fund is void under sections 128B or 128C. The notice comes into force when it is given to the trustee of an eligible superannuation fund.

These notices affect the superannuation fund trustee's rights to deal with the money in the fund, except in limited circumstances. The notices are designed to ensure that money is not paid out, or otherwise disbursed, before potential void transactions are resolved.

One important point is that the notice is either directed at the money paid into the fund from the contribution under examination (the money must be traced and identified in the fund at the time of issuing the notice), or the bankruptcy trustee must apply for to the court for an order under section 139ZU in relation to rolled-over superannuation interests.

The bankruptcy trustee can also apply to the Official Receiver to issue a notice under section 139ZQ whereby the Official Receiver can seek repayment from the recipient of the funds. Because the notice is given by the Official Receiver and affects the bankrupt's rights on what would be otherwise exempt (non-divisible) property, the notice must set out why the Official Receiver believes that the contributions to the superannuation plan are void.

A superannuation account-freezing notice is not an open-ended right for a bankruptcy trustee. Section 128F of the Bankruptcy Act states that the Official Receiver can revoke the notice at any time. The notice is automatically revoked if the money is claimed under a revoked 139ZQ notice, or if the court sets aside the 139ZQ notice.

For example, if the superannuation account freezing notice was supporting a section 139ZQ notice and that notice is satisfied or revoked, the freezing notice is also automatically revoked.

The bankruptcy trustee has 180 days to take, or conclude, their action after the Official Receiver issues a freezing notice. If a bankruptcy trustee cannot provide sufficient evidence within 180 days to satisfy to the Official Receiver that a section 139ZQ notice should be issued, the freezing notice will be revoked.

Similarly, if a bankruptcy trustee seeks relief through a section 139ZU order, then the court may order:

- compliance with that order
- that the order be set aside or dismissed.

If the application for the order is withdrawn within the 180-day period, the freezing notice will be automatically revoked.

The notice is also revoked if no order under section 139ZU is made within the 180-day period. The bankruptcy trustee is bound by a 180-day period but may be extended by applying to the court.

SECTION 139ZU ORDERS

The provisions that allow bankruptcy trustees to recover money paid into eligible superannuation funds also contemplate the transfer of money (the rollover of superannuation interests) between more than one fund, or between one or more people. These provisions allow the tracing of the void money into a second fund. Section 139ZU of the Bankruptcy Act allows the court to order a payment from the second fund to the bankruptcy trustee, but there are limitations.

The first limitation is that the contribution to the first fund must be void under sections 128B or 128C. But if the money has been transferred (rolled-over) to another fund, there may be insufficient funds in the first fund to satisfy a claim.

If there is sufficient money in the first fund to pay the claim, this provision will not be necessary, but there may be a shortfall. The money, or part of it, would now be in a second fund.

The shortfall contemplated in section 139ZU is the shortfall between the money remaining in the first fund and the bankruptcy trustee's claim amount. Only the shortfall amount may be claimed from the second fund. Essentially, the bankruptcy trustee can keep tracing the money into the new fund and recover the shortfall.

3



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Doctrine of Exoneration

Overview

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, or when an interest in an asset is created.

For example, a joint owner of real property who borrows funds and secures them against the real property and uses these funds for their own benefit to the exclusion of another owner.

This Guide outlines how the doctrine of exoneration is applied to real property to adjust each owner's interests in the property's equity.

APPLYING THE DOCTRINE

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 Samantha 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 Samantha's interest in the property's equity is adjusted to reflect this. (The relationship status of Michael and Samantha is not relevant. The doctrine applies in any such similar instance between co-owners regardless of marriage, de facto relationship etc).

The doctrine can have a great impact on a bankruptcy trustee (and therefore creditors) if, for instance, the bankrupt—despite being a registered owner of real property with equity—has no equitable interest in that equity because they had previously borrowed additional funds and secured them against the property.

EXAMPLE OF THE DOCTRINE

Steve and Robin own their home as joint tenants. The house is worth \$400,000. They bought the house with a joint loan secured by a mortgage on the property. They owe \$100,000 under the mortgage.

Steve ran a business that Robin had no financial interest in. For the benefit of the business, Steve borrowed \$200,000 with a loan secured against their home.

Steve becomes bankrupt. The following questions are raised in bankruptcy:

- What is the impact on the mortgagee?
- What interest does a bankruptcy trustee have in the real property?
- What is the impact on the co-owner (Robin)?

The doctrine does not affect the mortgagee's rights. In a sale, the mortgagee is entitled to the balance of the original loan to purchase the property of \$100,000 and the subsequent loan of \$200,000. Leaving aside the sale costs, \$100,000 remains as the surplus sale proceeds.

In the absence of the doctrine, the surplus funds (of \$50,000 each) are split equally between Steve and Robin. However, because the business loan of \$200,000 was solely for Robin's benefit, the doctrine applies, and the allocation of the equity is adjusted in Robin's favour. In this example, the doctrine would apply as follows:

- The balance of the original mortgage of \$100,000 is applied first against the sale proceeds of \$400,000, leaving a balance of \$300,000.
- Theoretically, the \$300,000 is split equally between Steve and Robin, resulting in a split of \$150,000 each.
- But because the \$200,000 business loan was solely for Steve's benefit, this is applied only against his interest in the property, which means his \$150,000 allocation is extinguished.
- Therefore, all the remaining equity in the real property (the \$100,000) is entirely owned by Robin, and Steve in fact owes Robin \$50,000, and she can prove in Steve's bankrupt estate for this amount.

In this example, the bankrupt estate would receive nothing from the sale of the real property.

SUMMARY

Whenever dealing with real property interests, bankruptcy trustees are concerned with the re-allocation of equity depending on the nature and use of funds secured to a mortgagee.

Owners of real property must ensure they maintain sufficient records to properly record and explain any such borrowings secured against real property, so that they can establish any application of the doctrine to adjust the equity in real property.

 MORE INFO **Bankruptcy and the Home** p34

Capital Gains Tax and Insolvency

Overview

When an insolvency practitioner ‘realises’ (i.e. sells) assets under an insolvency administration, the sale itself can create a liability under the capital gains tax (CGT) legislation. Insolvency practitioners are concerned with three main issues:

1. When do capital gains occur in an insolvency administration?
2. What happens to capital losses available at the date of the appointment?
3. What are the tax implications on a holding company when a solvent wholly-owned subsidiary is wound up?

1. WHEN DO CAPITAL GAINS OCCUR IN AN INSOLVENCY ADMINISTRATION?

The *Income Tax Assessment Act 1997* (ITAA) includes provisions that deal with insolvent estates and capital gains that relate to bankruptcy, liquidation, or a secured creditor taking action under a security.

The provisions state that any actions or realisations that lead to a CGT liability are deemed to have been done by the company, bankrupt or debtor, and not by the insolvency practitioner.

The insolvency practitioner starts the process by looking at the ‘vesting’ or otherwise of the asset. Section 104.10 of the ITAA states that the vesting of assets in a bankruptcy or liquidation, or the providing or redeeming of a security, is not a disposal of a CGT asset and the beneficial owner (the estate) does not change.

INCOME TAX ASSESSMENT ACT 1997 – SUBDIVISION 106 B & D

Disposal of a CGT asset: CGT event A1

CGT event A1 does not happen if the disposal of the asset was done

- to provide or redeem a security; or
- because of the vesting of the asset in a trustee under the *Bankruptcy Act 1966* or under a similar foreign law; or
- because of the vesting of the asset in a liquidator of a company, or the holder of a similar office under a foreign law.

BANKRUPTCY

Section 106.30 of the ITAA confirms, in relation to CGT, “the vesting of the individual’s CGT assets in the trustee under the *Bankruptcy Act 1966* or under a similar foreign law is ignored”.

INCOME TAX ASSESSMENT ACT 1997 – SECTION 106.30

Effect of bankruptcy

- (1) For the purposes of this Part and Part 3-3, the vesting of the individual’s CGT assets in the trustee under the *Bankruptcy Act 1966* or under a similar foreign law is ignored.
- (2) This Part and Part 3-3 apply to an act done in relation to a CGT asset of an individual in these circumstances as if it had been done by the individual:
 - (a) as a result of the bankruptcy of the individual by the Official Trustee in Bankruptcy or a registered trustee, or the holder of a similar office under a foreign law;
 - (b) by a trustee under a personal insolvency agreement made under Part X of the *Bankruptcy Act 1966*, or under a similar instrument under a foreign law;
 - (c) by a trustee as a result of an arrangement with creditors under that Act or a foreign law.

Therefore, the initial vesting of property in the bankruptcy trustee is not deemed an asset disposal, so no CGT liability is automatically created. However, should the bankruptcy trustee subsequently sell the vested property, the trustee is required to calculate any CGT liability arising from the sale and to then retain sufficient funds within the estate to pay any assessed liability to the ATO pursuant to section 245 of the ITAA 1936.

SECURED CREDITORS

Section 106.60 of the ITAA deems that if people holding or appointed under security documents take actions that accrue a CGT liability, these actions are actually done by the entity that gave the security, not the entity that exercises the security. This extends to a controller appointed to assist a mortgagee in exercising a security.

It is important to note that exercising a security, or appointing a receiver or agent, does not change the asset ownership and does not accrue a CGT liability—as asset ownership does not change. Usually, controllers of property only act as agents for the owner of the assets, with powers to sell under the security. The only change is the security holder’s right to actually sell the asset on behalf of the debtor. Only the asset disposal (e.g. a sale) can create a CGT liability.

EXTERNAL ADMINISTRATION SUMMARY

The appointment of a liquidator, bankruptcy trustee, controller, or the vesting of property and the exercising of a security, does not create a deemed acquisition or disposal of a CGT asset. Without the sale of the asset (disposal), a CGT liability will not accrue to any party.

2. WHAT HAPPENS TO CAPITAL LOSSES AVAILABLE AT THE DATE OF THE APPOINTMENT?

Section 102 of the ITAA sets out how to calculate an individual’s capital gains for tax purposes. Two events can eliminate past CGT losses:

1. An individual cannot bring forward any capital losses from prior years into a year that they became bankrupt or were released from their debts. Therefore, this provision applies twice: once when the person is made bankrupt, and at discharge—which is usually three years later (when they are released from their debts).
2. An individual cannot bring forward any capital losses into a year in which they are released from their debts under a law relating to bankruptcy. Discharge from such debts occurs at the end of bankruptcy, or at the end of a Part X or section 73 arrangement.

Under section 102.5 of the ITAA, any capital losses accrued before the bankruptcy or insolvency administration are lost at the end of that administration.

The timing of either becoming bankrupt and/or the release from debts (usually at the end of a bankruptcy or an agreement) may need to be considered by the debtor.

A bankruptcy annulment eliminates the bankruptcy. Annulments obtained by payment of debts (through section 153 of the *Bankruptcy Act*) or through the court will reinstate capital losses, as there is no bankruptcy and no release of debts: they are paid. Annulments obtained through section 73 proposals still provide a release from debts, and therefore any CGT losses will be lost.

 MORE INFO **Proofs of Debt and Securities** p68

3. WHAT ARE THE TAX IMPLICATIONS ON A HOLDING COMPANY WHEN A SOLVENT WHOLLY-OWNED SUBSIDIARY IS WOUND UP?

The first thing to note is that the subsidiary being wound up must be solvent. The ITAA gives specific tax relief for a holding company that receives an asset (i.e. a roll-over of an asset) from the liquidator of a subsidiary under a members' voluntary winding up. This relief may only be a CGT reduction, not a full exemption.

This is partially because the liquidated company is solvent, and the company can pay the ATO all outstanding tax liabilities—therefore no release of debts. Under section 126.85 of the ITAA, CGT relief only applies if the roll-over of the asset was transferred due to the cancellation of the shareholding in the 100%-owned subsidiary that is being wound up. Effectively, the holding company receives the asset in consideration for the cancellation of the shares.

INCOME TAX ASSESSMENT ACT 1997 – SECTION 126.85

Effect of roll-over on certain liquidations (1) A capital gain a company (the holding company) makes because shares in its 100% subsidiary are cancelled (an example of CGT event C2: see section 104.25) on the liquidation of the subsidiary is reduced if the conditions in subsection (2) are satisfied. The reduction is worked out under subsection (3).

Because post-CGT shares in its 100% owned subsidiary are cancelled upon the liquidation of the subsidiary, the capital gain that a holding company makes from the roll-over of the asset is reduced if certain conditions are satisfied. Those conditions are:

- There must be a roll-over of at least one 'CGT asset' (i.e. acquired on or after 20 September 1985) and the asset must be disposed of (transferred) by the subsidiary to the holding company in the course of its liquidation.
- The disposal must either be part of the liquidator's distribution in the course of the liquidation or have occurred within 18 months of the dissolution of the subsidiary (if they are part of an interim distribution).
- The liquidated company must be a 100% owned subsidiary from the time of the disposal until the cancellation of the shares.
- The market value of the asset must comprise at least part of the capital proceeds for the cancellation of the shares.
- One or more of the shares that were cancelled must have been acquired by the holding company on or after 20 September 1985 (i.e. they must be post-CGT shares).

The procedure to calculate this relief is outlined in section 126.85 of the ITAA, as summarised below.

INCOME TAX ASSESSMENT ACT 1997 – SECTION 126.85

Effect of roll-over on certain liquidations (3) The reduction of the capital gain is worked out in this way.

METHOD STATEMENT

Step 1.

Work out (disregarding this section) the sum of the capital gains and the sum of the capital losses the holding company would make on the cancellation of its shares in the subsidiary.

Step 2.

Work out (disregarding this Subdivision):

- The sum of the capital gains the subsidiary would make on the disposal of its CGT rollover assets to the holding company; and*
- The sum of the capital losses it would make except for Subdivision 170-D on the disposal of its CGT assets to the holding company; in the course of the liquidation assuming the capital proceeds were the assets' market values at the time of the disposal.*

Step 3.

If, after subtracting the sum of the capital losses from the sum of the capital gains, there is an overall capital gain from step 1 and an overall capital gain from step 2, then continue. Otherwise there is no adjustment.

Step 4.

Express the number of post-CGT shares as a fraction of the total number of shares the holding company owned in the subsidiary.

Step 5.

Multiply the overall capital gain from Step 2 by the fraction from Step 4.

Step 6.

Reduce the overall capital gain from Step 1 by the amount from Step 5. The result is the capital gain the holding company makes from the cancellation of its shares in the subsidiary.

Goods and Services Tax and Insolvency

Introduction

The goods and services tax (GST) places additional tax obligations on taxpayers and on the insolvency practitioners appointed to those taxpayers. This Guide explains the more common issues arising from the appointment of external administrators and GST. It deals with who is responsible for any GST liability and when that liability will arise. However, the GST technicalities are best left to tax accountants.

When an entity becomes insolvent, particularly through vesting of assets in a bankruptcy trustee, it does not automatically give rise to any GST consequences or liabilities as neither party (i.e. the bankrupt and the bankruptcy trustee) has incurred a 'taxable supply'. However, a bankruptcy changes the entity's status for GST purposes, and the bankruptcy trustee assumes some of the taxpayer's responsibilities. This means the bankruptcy trustee must start reporting GST in their own right.

These rules are governed by the *A New Tax System (Goods and Services Tax) Act 1999* (Tax Act).

WHAT IS AN INCAPACITATED ENTITY?

An entity (i.e. the taxpayer) becomes an incapacitated entity and an external administrator becomes a "representative of the incapacitated entity" if an administrator is appointed in relation to:

- bankruptcy
- controlling trusteeship
- liquidation
- receivership—even if only appointed over some of the assets
- voluntary administration
- executing a Deed of Company Arrangement (DOCA).

An incapacitated entity is defined (section 195-1 of the Tax Act) as:

- an individual who is a bankrupt; or*
- an entity that is in liquidation or receivership; or*
- an entity that has a representative.*

The 'catch all' part of this definition is "an entity that has a representative". This effectively includes all other insolvency appointments that are not bankruptcies, liquidations or receiverships. A 'representative' of the incapacitated entity is also defined in section 195-1 of the Tax Act as:

- a trustee in bankruptcy; or*
- a liquidator; or*
- a receiver; or*
- a controller (within the meaning of section 9 of the Corporations Act 2001); or*
- an administrator appointed to an entity under Division 2 of Part 5.3A of the Corporations Act 2001; or*
- a person appointed, or authorised, under an Australian law to manage the affairs of an entity because it is unable to pay all its debts as and when they become due and payable; or*
- an administrator of a deed of company arrangement executed by the entity.*

Nearly all formal appointments over a person's or a company's financial affairs create an incapacitated entity and require the representative to register with the Australian Taxation Office (ATO). The appointment makes the representative (i.e. the practitioner) a new entity for GST purposes. Registration is only required if the incapacitated entity is, or was required to be, registered for GST purposes.

TWO REGISTRATIONS

Two parts are required to register the representative (i.e. the practitioner). The first part is the incapacitated entity's representative advising the ATO that a representative has been appointed. The second part is the representative's registration for GST, if required. GST registration is required if the entity was—or should have been—registered before the appointment, regardless of whether the entity is expected to exceed the turnover limits after the appointment. If the entity was not registered, nor required to be registered for GST the representative will not have any GST responsibilities (e.g. a bankrupt that only has credit card debt).

GOODS AND SERVICES TAX ACT – SECTION 58.20

Representatives are required to be registered

- (1) *A representative of an incapacitated entity is required to be registered in that capacity if the incapacitated entity is registered or required to be registered.*
- (2) *This section has effect despite section 23-5 (which is about who is required to be registered).*

If the representative is required to register for GST, they must lodge returns in their own right, and report various matters to the ATO.

Under section 58.25 of the Tax Act, the ATO must cancel the representative's GST registration if they believe that they do not need to be registered: "The Commissioner must cancel the registration of a representative of an incapacitated entity if the Commissioner is satisfied that the representative is not required to be registered in that capacity".

In summary, if the entity becomes incapacitated:

1. The practitioner becomes the representative of the incapacitated entity and becomes a new tax entity in their own right. They must register their status with the ATO.
2. If the incapacitated entity was—or should have been—registered for GST, the representative must register for GST.

Under section 58.30 of the Tax Act, the registration ends when the appointment ends. The practitioner (the liquidator or bankruptcy trustee etc.) must notify the Commissioner within 21 days to cancel the registration.

HOW DOES THE REPRESENTATIVE'S APPOINTMENT AFFECT TAX PERIODS?

Most insolvency appointments happen during a financial year, not as of 30 June. The incapacitated entity's tax period is deemed to have ended on the day before the appointment. A new tax period commences on the day of the appointment.

Final business activity statements (BAS) should be lodged for GST purposes as at the date of the appointment and the ATO will calculate any outstanding debt. The new tax period will end on the date that the normal tax period would have ended, and returns must be lodged separately for that period (i.e. the tax period is divided into two periods at the date of appointment).

GOODS AND SERVICES TAX ACT – SECTION 27.39

Tax periods of incapacitated entities

- (1) *If an entity becomes an incapacitated entity, the entity's tax period at the time is taken to have ended at the end of the day before the entity became incapacitated.*
- (2) *If a tax period (the first tax period) ends on a particular day because of subsection (1), the next tax period starts on the day after that day and ends when the first tax period would have ended but for that subsection.*

The representative's tax period begins on the appointment date (i.e. the date of the new divided tax period described above), and each period has the same start and end dates as the incapacitated entity. So, the initial tax period is likely to be shorter than a normal tax period unless the appointment happened on the first date of a tax period.

GOODS AND SERVICES TAX ACT – SECTION 58.35

Tax periods of representatives

- (1) *If a representative of an incapacitated entity is required to be registered in that capacity, the tax periods applying to the representative in that capacity are the same tax periods that apply to the incapacitated entity.*
- (2) *This section has effect despite Division 27 (which is about how to work out the tax periods that apply).*

The representative's obligations end when the appointment ends, but the entity may continue to exist after that date. The Tax Act provides that the entity will have a concluding tax period (i.e. its tax obligations will end) in the case of a person's death, or if it ceases to exist (i.e. for business entities).

GOODS AND SERVICES TAX ACT – SECTION 27.40

An entity's concluding tax period

- (1) *If:*
 - (a) *an individual dies; or*
 - (b) *another entity for any reason ceases to exist; the individual's or entity's tax period at the time is taken to have ceased at the end of the day before the death or cessation.*
- (1A) *If an entity ceases to carry on any enterprise, the entity's tax period at the time is taken to have ceased at the end of the day on which the cessation occurred.*
- (2) *If an entity's registration is cancelled, the entity's tax period at the date of effect of the cancellation (the cancellation day) ceases at the end of the cancellation day.*

WHO MUST LODGE THE BUSINESS ACTIVITY STATEMENT (BAS)?

Section 31.5 of the Tax Act provides that a GST representative must lodge a BAS in each tax period regardless of the activity or any GST amount owing or refund due.

This section places GST responsibilities on the representative. If the entity or representative is required to be registered for GST purposes, the obligation to start lodging returns begins upon appointment, regardless of how the representative was appointed.

WHO IS LIABLE FOR THE GST?

Under section 58.5, the general principle is that the representative is liable for the tax consequences of transactions entered into during their appointment, regardless of their capacity. If the entity ceases to be an incapacitated entity and the representative resigns, the entity is liable for further GST on transactions that occurred while it was incapacitated.

Additionally, the entity is liable for, or entitled to, any GST consequences of transactions entered into during the representative's appointment.

Further, it places liability on the representative for the entity's GST liabilities—when "within the scope of the representative's responsibility or authority for managing the incapacitated entity's affairs".

GOODS AND SERVICES TAX ACT – SECTION 58.10

Circumstances in which representatives have GST-related liabilities and entitlements

General rule

- (1) *A representative of an incapacitated entity:*
 - (a) *is liable to pay any GST that the incapacitated entity would, but for this section or section 48-40, be liable to pay on a taxable supply or a taxable importation; and*
 - (b) *is entitled to any input tax credit that the incapacitated entity would, but for this section or section 48-45, be entitled to for a creditable acquisition or a creditable importation; and*
 - (c) *has any adjustment that the incapacitated entity would, but for this section or section 48-50, have; to the extent that the making of the supply, importation or acquisition to which the GST, input tax credit or adjustment relates is within the scope of the representative's responsibility or authority for managing the incapacitated entity's affairs.*

The representative is not liable when the supply or acquisition of goods and services occurred prior to becoming the incapacitated entity's representative.

- (2) This section does not apply to the GST payable on a taxable supply to the extent that one or more of the following apply:
- the incapacitated entity received the consideration for the supply before the representative became a representative of the incapacitated entity;
 - if, under Division 83 or 84, the GST is payable by the recipient of the supply—the incapacitated entity provided the consideration for the supply before the representative became a representative of the incapacitated entity;
 - if:
 - the supply is a supply for which a voucher to which Division 100 applies is redeemed; and
 - the incapacitated entity supplied the voucher before the representative became a representative of the incapacitated entity; the consideration for the supply referred to in subparagraph (iii) does not exceed the consideration provided for the incapacitated entity's supply of the voucher.
- (3) This section does not apply to an input tax credit for a creditable acquisition to the extent that the incapacitated entity provided the consideration for the acquisition before the representative became a representative of the incapacitated entity.

The entity is responsible for GST transactions, but the representative is liable if they entered into the transaction. The representative must lodge returns at the same time as the entity, but the commencement date for the first period depends on the appointment date.

GOODS AND SERVICES TAX ACT – SECTION 58.35

Tax periods of representatives

- If a representative of an incapacitated entity is required to be registered in that capacity, the tax periods applying to the representative in that capacity are the same tax periods that apply to the incapacitated entity.
- This section has effect despite Division 27 (which is about how to work out the tax periods that apply).

It is possible that two BAS should be lodged for an entity. For example, a DOCA that has its deed administrator file a BAS for the company's tax consequences, and the company trades under its own right and lodges its own BAS for each period. Each party will report its own transactions on their individual BAS.

ADJUSTMENTS TO PRE-APPOINTMENT GST LIABILITIES

In many insolvency administrations, GST is owed to the ATO. Adjustments to the GST consequences may be required to pre-appointment transactions that can cause the ATO to increase or decrease their outstanding debt. These are called 'increasing' or 'decreasing' adjustments.

GOODS AND SERVICES TAX ACT – SECTION 19.10

Adjustment Events

- An adjustment event
 - can arise in relation to a supply even if it is not a taxable supply; and
 - can arise in relation to an acquisition even if it is not a creditable acquisition.

ACCRUAL-BASED ACCOUNTING

The two most common adjustments under accrual accounting relate to the GST consequences from:

- The non-collection of debtors where GST has been paid before the appointment (decreasing adjustment).
- The non-payment of creditors where taxable credits are adjusted through a dividend where GST has been claimed pre-appointment (increasing adjustment).

Further, if a representative is reporting on an accrual basis, the GST effects of the entity's transactions made before the representative's appointment may be attributed to the first tax period of the representative.

GOODS AND SERVICES TAX ACT – SECTION 58.40

Effect on attribution rules of not accounting on a cash basis

- If:
 - a representative of an incapacitated entity does not account on a cash basis; and
 - because of section 58-10, all or part of the amount of GST payable on a taxable supply is payable by the representative, or the representative is entitled to all or part of the input tax credit for a creditable acquisition then, to the extent that, but for this section, the GST or input tax credit would be attributable to a tax period that ended before the representative became a representative of the incapacitated entity, the GST or input tax credit is instead attributable to the first tax period applying to the representative in that capacity.
- This section has effect despite sections 29-5 and 29-10 (which are about attribution of GST on taxable supplies and of input tax credits for creditable acquisitions).

WRITING OFF BAD DEBTS

For many reasons, insolvency practitioners commonly write-off pre-appointment debtors as uncollectible. It is also possible that the insolvent entity has accrued these debts before the appointment and may have paid or accrued GST on them. If these debtors are written off, the GST on those debts should in theory be refunded. In practice: the GST is deducted from the outstanding GST debt.

GOODS AND SERVICES TAX ACT – SECTION 21.5

Writing off bad debts (taxable supplies)

- You have a decreasing adjustment if:
 - you made a taxable supply; and
 - the whole or part of the consideration for the supply has not been received; and
 - you write off as bad the whole or a part of the debt, or the whole or a part of the debt has been overdue for 12 months or more.

The amount of the decreasing adjustment is 1/11th of the amount written off, or 1/11th of the amount that has been overdue for 12 months or more, as the case requires

- However, you cannot have an adjustment under this section if you account on a cash basis

Section 21.5 of the Tax Act states the adjustment cannot be made if the representative is reporting on a cash basis.

GOODS AND SERVICES TAX ACT – SECTION 58.15

Adjustments for bad debts

- For the purposes of determining whether an adjustment arises under section 21-5 or 21-15 for the whole or a part of a debt relating to a taxable supply or creditable acquisition for which a representative of an incapacitated entity is liable to pay GST, or is entitled to an input tax credit, under section 58-10:
 - the adjustment cannot arise if, when the whole or part of the debt is written off, or has been overdue for 12 months, the representative accounts on a cash basis; but
 - it does not matter whether the incapacitated entity accounts on a cash basis at that or any other time.
- This section has effect despite subsections 215(2) and 21-15(2) (which preclude adjustments for bad debts when accounting on a cash basis).

NON-PAYMENT OF CREDITORS

Unless sufficient assets can pay all creditors in full, some part of creditors' debts will go unpaid. If the insolvent entity claimed the GST on these creditor amounts before the insolvency appointment, they should in theory refund these amounts to the ATO to the extent that the creditors were unpaid. In practice, however, the GST liability to the ATO increases.

**GOODS AND SERVICES TAX
ACT – SECTION 21.15**

Bad debts written off (creditable acquisitions)

- (1) You have an increasing adjustment if:
 - (a) you made a creditable acquisition for consideration; and
 - (b) the whole or part of the consideration is overdue, but you have not provided the consideration overdue; and
 - (c) the supplier of the thing you acquired writes off as bad the whole or a part of the debt, or the whole or a part of the debt has been overdue for 12 months or more.

The amount of the increasing adjustment is 1/11th of the amount written off, or 1/11th of the amount that has been overdue for 12 months or more, as the case requires.

- (2) However, you cannot have an adjustment under this section if you account on a cash basis.

CASH ACCOUNTING

The two most common adjustments under a cash reporting system relate to the GST consequences from:

1. The collection of debtors where GST has not been paid before the appointment (increasing adjustment).
2. The payment of creditors through a dividend where GST has not been claimed pre-appointment (decreasing adjustment).

**GOODS AND SERVICES TAX
ACT – SECTION 19.40**

Where adjustments for supplies arise

You have an adjustment for a supply for which you are liable to pay GST (or would be liable to pay GST if it were a taxable supply) if:

- (a) in relation to the supply, one or more adjustment events occur during a tax period; and
- (b) GST on the supply was attributable to an earlier tax period (or if the supply was not a taxable supply, would have been attributable to an earlier tax period had the supply been a taxable supply); and
- (c) as a result of those adjustment events, the previously attributed GST amount for the supply (if any) no longer correctly reflects the amount of GST (if any) on the supply (the corrected GST amount), taking into account any change of circumstances that has given rise to an adjustment for the supply under this Subdivision or Division 21 or 134.

COLLECTION OF DEBTORS

Sometimes practitioners collect amounts from debtors that were billed before the insolvency appointment. Under a cash reporting system, no GST would be paid on these amounts. In practice, this payment of the GST is an increasing adjustment to the ATO's owed liability.

**GOODS AND SERVICES TAX
ACT – SECTION 19.50**

Increasing adjustments for supplies

If the corrected GST amount is greater than the previously attributed GST amount, you have an increasing adjustment equal to the difference between the corrected GST amount and the previously attributed GST amount.

PAYMENT OF DIVIDENDS TO CREDITORS

Under the cash accounting system, GST is not claimed on supplies from creditors until they are paid. No GST credit will have been allowed for outstanding creditors at the time of the appointment but is allowed for when creditors are paid a dividend. The practitioner can claim the GST on dividends paid via a decreasing adjustment to the ATO liability for the dividend amount paid to relevant creditors.

 **MORE INFO** **Dividends** p70

**GOODS AND SERVICES TAX
ACT – SECTION 19.55**

Decreasing adjustments for supplies

If the corrected GST amount is less than the previously attributed GST amount, you have a decreasing adjustment equal to the difference between the previously attributed GST amount and the corrected GST amount.

SUMMARY OF ADJUSTMENTS

The table below sets out the general adjustments required for adjusting events occurring after the appointment for pre-appointment transactions.

	CASH REPORTING	ACCRUALS REPORTING
DEBTORS	Where debtors are collected by the representative under a cash reporting system, GST is attributable to the amount collected. An increasing adjustment should be made to the ATO's proof of debt.	Where debtors are written off as non-collectable (and GST has been accrued on these debtors), the amount of GST attributable to the written-off debtors becomes a decreasing adjustment to the ATO's proof of debt.
DIVIDEND TO CREDITORS	Where dividends are paid to creditors under a cash system, GST credits arise for the payment amounts. These give rise to a decreasing adjustment to the ATO's proof of debt.	Where GST credits have been claimed and those creditors will not be paid, an increasing adjustment is made to the ATO's proof of debt to add back the unpaid credits.

Representatives must notify the ATO of increasing adjustments, or the representative may become liable for the lost dividends that the ATO should have collected. The ATO then adjusts their proof of debt to reflect their debt on pre-appointment transactions once they know the result of those transactions.

SUMMARY

The points following summarise the Tax Act provisions:

- The appointment of an external administrator requires the administrator to register as a representative of an incapacitated entity.
- If the incapacitated entity is required to be registered for GST, the representative will be required to register for GST.
- The incapacitated entity's tax year ends on the date of the appointment and a final BAS must be filed.
- The representative registered for GST purposes has a responsibility to file BAS during their administration.
- The representative must notify the ATO of any increasing adjustments due to collection of debtors and payment of dividends.

4



Outcomes

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Proofs of Debt and Securities

Introduction

Secured creditors usually rely on their securities to satisfy their outstanding debts. But sometimes they may also wish to lodge a proof of debt in a bankruptcy to maximise their return. This applies when they know they will suffer a shortfall from the sale of the secured item (i.e. the value of the secured asset is less than the amount of the secured debt) and when there will be a dividend paid to unsecured creditors.

A secured creditor may also wish to vote on certain resolutions in the bankrupt estate as they may have an interest as an unsecured creditor for their shortfall amount (i.e. that part of the debt not covered by the secured asset).

Both the *Corporations Act 2001* and the *Bankruptcy Act 1966* allow secured creditors to lodge proofs of debt and vote at meetings for their shortfall amounts. But only in voluntary administrations can they vote using the full secured debt. In all other administrations, secured creditors must be careful to complete their proof of debt correctly and only vote on the appropriate dollar amount, or they risk compromising their security. This Guide looks at the position in a bankruptcy scenario.

A secured creditor can voluntarily surrender their secured asset and prove for the whole debt as an unsecured creditor; however a secured creditors would only surrender their security if they believe the security is worthless, or when a substantial dividend is being paid to the unsecured creditors.

PROVING FOR A SHORTFALL

Secured creditors can prove for the shortfall amount they have suffered—or will suffer. The shortfall is quantified once the secured asset is sold and then a secured creditor can lodge a proof of debt for any shortfall. Effectively, they become an unsecured creditor because the secured asset no longer exists. However, a secured creditor can lodge a proof of debt for an anticipated shortfall before the secured asset is sold. This can happen when the asset cannot be readily—or reasonably—

sold before a dividend is paid into the estate. If a secured creditor believes that they will suffer a shortfall from the sale, the shortfall is calculated by estimating the secured asset's value and deducting that amount from the outstanding debt.

The proof of debt can then be lodged for the balance of the debt, i.e. the estimated shortfall. The proof of debt form lodged by the secured creditor must have all relevant details and should attach any documents to support their debt and the estimated security value.

A secured creditor should have a reasonable basis for the estimated security value, as amending their valuation affects certain rights and obligations between the bankruptcy trustee and the secured creditor. These rights and obligations may cause the secured creditor to lose all, or part, of their rights under the benefit of their security.

A secured creditor can issue a notice to a bankruptcy trustee to determine whether they will redeem or force a sale of the secured asset. Once the notice is received, a bankruptcy trustee must redeem or force a sale within three months, or they will lose their rights over the asset.

AMENDMENT OF VALUATION

Occasionally, the original value estimate placed on a security is no longer appropriate. This happens when the asset's value naturally changes with market conditions, or when the value of the asset changes after the proof of debt was lodged. Alternatively, the original estimate may have been incorrect, and the correct value is now known, or capable of being estimated.

In these cases, the estimate must be corrected, whether that correction is an increase or a decrease.

An amendment is not an automatic process. A secured creditor must apply to the bankruptcy trustee, or the court, for an amendment in their claim and must show that the original estimate was reasonable at the time (i.e. under the circumstances), or that the value has changed since the estimate was made. If the amendment occurs after a dividend is paid, this may create complications. If the secured asset is sold after the proof of debt was lodged, the estimated security value must be amended to the sales amount.

ADJUSTMENT OF A PAID DIVIDEND

If the estimate of the secured asset's value is amended after a dividend is paid, the secured creditor may have to either refund any excess dividend received (i.e. if the estimate increases and the shortfall decreases), or they will be entitled to a catch-up dividend (i.e. if the estimate decreases and the shortfall increases).

The payment of a catch-up dividend is subject to money being available in the estate and cannot disrupt any past dividend paid. That is, if the amendment occurs after a final dividend, the secured creditor is unlikely to be paid a catch-up dividend.

Conversely, monies received by the bankruptcy trustee from a dividend refund will be paid into the estate.



MORE INFO

Dividends

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SUBSEQUENT REALISATION OF SECURITY

Once a secured asset is sold, the shortfall amount owed to the secured creditor can be quantified. The Bankruptcy Act automatically amends value estimates made prior to asset realisation and substitutes the net amount received by the secured creditor. This automatically adjusts the shortfall and activates the repayment of an excess dividend and the catch-up dividend provisions adjust any previous dividends received by the secured creditor.

VOTING AT MEETINGS

A secured creditor's actions may result in surrendering their security.

The Bankruptcy Act allows a secured creditor to vote for the shortfall—called the 'excess of debt'—over the estimate declared on their proof of debt form. That is, they are only allowed to vote for their shortfall amount; they cannot vote for their secured debt amount (which is secured by the secured asset's value).

Creditors must be aware of these implications before voting on resolutions as an unsecured creditor.

Dividends

Introduction

Dividends are the conclusion to most external administrations, which cannot be finalised until dividends are distributed in accordance with statutory time limits and investigations to admit or reject proofs of debt.

The Bankruptcy Act 1966 sets the minimum period to pay a dividend. If there are no complications, a personal insolvency dividend will take about two months to distribute.

If there are complexities in the admissibility of proofs of debt, the payment of the dividend can be delayed, particularly if a creditor applies to the court for a review of the bankruptcy trustee's decision to reject their proof of debt.

DIVIDENDS IN DETAIL

When there are funds to distribute, the payment of a dividend is often the only tangible output from an insolvent estate. A bankruptcy trustee withholds sufficient monies to complete the estate and determine the most appropriate time to pay dividends when considering any further anticipated realisations and the costs related to paying a dividend.

Dividends must be declared in accordance with the Bankruptcy Act requirements and be paid to creditors in order of their priority.

STEPS IN PAYING DIVIDENDS

The four basic steps required to pay dividends are as follows:

1. Calling for proofs of debt—every known creditor must have the opportunity to lodge a proof of debt and participate in the dividend.
2. Admitting proofs of debt—verify that the debt is proper and has been 'proved' to the bankruptcy trustee's satisfaction
3. Rejecting proofs of debt—to ensure only legitimate creditors participate in the dividend.
4. Paying the dividend—the bankruptcy trustee distributes the cheques.

1. CALLING FOR PROOFS OF DEBT

All creditors must be given the opportunity to lodge their claim in the form of a proof of debt. A proof of debt is a formal document used to prove that a debt exists, and it sets out the amount of the debt. Without sufficient proof that the debt exists, it will not be admitted for the stated amount—or might not be admitted at all.

A 'Proof of Debt' is a prescribed form under the Bankruptcy Act. Claims that are insufficiently detailed on the correct form can result in a creditor being excluded from a dividend.

Creditors can lodge proofs of debt at any stage in an administration. They do not need to wait until a dividend is called. Creditors should ensure that their claim has been lodged and appears in any list of proofs of debt received by the bankruptcy trustee. If creditors are in any doubt that their claim has been lodged, they should contact the bankruptcy trustee's office.

Periods for calling for proofs of debt

The bankruptcy trustee must formally notify all known, or potential, creditors of the intended dividend and request that proofs of debt be lodged by a certain time.

The Bankruptcy Act states that creditors must be given 'a reasonable period' to lodge proofs of debt. Usually a 21-day period is considered reasonable.

Definite periods to lodge proofs of debt are important to expedite dividend payments or to ensure dividends are not challenged while dividends are being calculated. The cut-off date for proofs of debt is final and the Bankruptcy Act provisions set out the creditors' and bankruptcy trustee's rights if a proof of debt is not lodged in time.

Notices to be issued for calling for proofs of debt

The Bankruptcy Act does not require bankruptcy trustees to advertise a dividend; it only requires a notice to be sent to all known creditors that have not lodged proofs of debt. A bankruptcy trustee advertises a dividend when they suspect there may be creditors not disclosed by the bankrupt—particularly when a Statement of Affairs has not been lodged, and when a bankruptcy trustee applies to the court to pay a dividend.

Dates for payment of dividends

The Bankruptcy Act does not set a maximum period after the intended date of declaring a dividend but provides that dividends cannot be paid until 21 days after the lodgement date for proofs of debt. Therefore, a bankruptcy trustee must wait 21 days to receive proofs of debt and, without further complication, wait another 21 days before they can issue dividend payments.

Non-lodgement of proof of debt

Under section 144 of the Bankruptcy Act, creditors that miss the proof of debt cut-off date can lodge a proof of debt for the next dividend distribution, and they will be paid the first dividend they missed out on (a catch-up dividend), as well as the upcoming dividend. If there are insufficient funds to pay a second dividend (a second dividend is never declared), creditors will not receive a dividend at all. Therefore, it is imperative that creditors lodge their proofs of debt before the cut-off date.

2. ADMITTING PROOFS OF DEBT

Under section 83 of the Bankruptcy Act, creditors have the burden to prove the existence and amount of their debt. The bankruptcy trustee does not need to disprove a debt, only

determines the validity and amount of the debt from the creditors' supporting evidence.

If the bankruptcy trustee considers that all or part of the debt is not sufficiently proved, they will seek further clarification and material from the creditor. Without further information, the bankruptcy trustee may reject the proof of debt in full or in part and is not required to locate sufficient information.

Creditors should attach copies (not originals) of all appropriate documents to their proof of debt.

Bankruptcy trustees must review proofs of debt within 14 days of the lodgement date and decide to admit or reject the claim or seek further information.

3. REJECTING PROOFS OF DEBT

Under section 102 of the Bankruptcy Act, if a proof of debt is rejected because a creditor does not provide sufficient evidence, a bankruptcy trustee will provide a notice outlining the reasons for rejecting the proof of debt. The creditor has 21 days to appeal the decision.

Appeals against decisions

Creditors' rights are set out in section 104 the Bankruptcy Act. Creditors can have the court review the bankruptcy trustee's decision to reject their proof of debt but only have a strict and limited time to apply. A bankruptcy trustee can amend their decision to reject a proof of debt when sufficient information is given if it is still within the required timeframe.

The court may allow an application for adjudication after the time limit period expires, but creditors should not rely on it being granted. Creditors should seek legal advice as soon as a rejection is received. Creditors have the burden to prove to the court that the claim should be admitted in the bankruptcy.

Creditors must show that the decision to reject the proof of debt was incorrect based on the information provided to the bankruptcy trustee.

Revoking a decision to admit or reject

A bankruptcy trustee can reverse their admittance or rejection of a proof of debt under section 102 of the Bankruptcy Act.

When a decision to reject a proof of debt is reversed, a bankruptcy trustee must give the affected creditor notice of the new decision and, if appropriate, adjust the dividend to be paid or, if necessary, pay a catch-up dividend.

4. PAYING THE DIVIDEND

Dividends are paid after the proof of debt lodgement date expires, after all the proofs of debt have been admitted or rejected, and after any appeals on rejections have been heard in court. The bankruptcy trustee will forward a payment to the creditor with a Form 2, which outlines the realisation and distribution of the bankrupt estate.

If dividend cheques are not banked within a reasonable period, or an EFT payment is returned, or creditors cannot be located, the bankruptcy trustee will hold monies for six months following payment, and then forward these monies to the Australian Financial Security Authority (AFSA). The creditor must then request the money from AFSA.

Priorities in the payment of dividends

Subject to specific priorities under section 109, all creditors will rank equally in insolvent estates and will be paid 'pro-rata' dividends. If there are insufficient funds to meet the estate's debts in full, they are paid proportionately.

The Bankruptcy Act gives priority to outstanding employee limited wages of \$1,500 per employee (or such greater amount as prescribed by the Regulations), long service leave, annual leave, sick leave etc. An employee creditor must clearly indicate that they are claiming as an employee and use the required proof of debt form for that purpose.

Joint bankruptcy estates

Section 110 of the Bankruptcy Act provides for joint and separate bankrupt estates. It applies when two or more bankrupts have joint and several assets and liabilities. For example, bankrupt business partners have joint partnership assets (i.e. held together), and individual assets (i.e. held separately). They may also have individual and joint creditors.

How joint and individual assets are divided among the joint and individual creditors in bankrupt estates is sometimes complex. Joint assets are used to pay joint creditors, and each bankrupt's individual assets are used to pay their individual creditors. When there are no surplus assets in either estate, the issue is irrelevant.

If there is a surplus in either individual estate, it can be used to pay joint creditors to the necessary limit of joint claims. When there is a surplus after paying both individual and joint creditors, the bankrupt is annulled from bankruptcy, and the surplus money is paid to them.

Alternatively, if there is a surplus in the joint estate, it is divided proportionately to the individual estates, and can be used to pay individual creditors. If either individual estate has sufficient monies to pay the individual creditors and still has a surplus, that bankruptcy will be annulled and the surplus is paid to them.

Surplus assets in one individual estate cannot be used to pay creditors in the other individual estate.

Objections to Discharge

What is an objection to discharge?

Normally a person's bankruptcy automatically ends three years after their Statement of Affairs is filed with the Australian Financial Security Authority (AFSA). The end of a bankruptcy is called a 'discharge from bankruptcy'. However, a bankruptcy trustee can extend the bankruptcy period by lodging an 'objection to discharge' with AFSA.

WHY OBJECT TO A BANKRUPT'S DISCHARGE?

An objection to discharge is used as a penalty for a bankrupt's actions before or during bankruptcy, or to encourage them to cooperate with their bankruptcy trustee. Often it is in creditors' interests—or the public interest—that a bankrupt is not discharged at the three-year mark if they have committed an offence under the *Bankruptcy Act 1966*.

WHEN CAN A TRUSTEE OBJECT TO A BANKRUPT'S DISCHARGE?

An objection can be lodged at any point during the bankruptcy, but before discharge, and must be within the Bankruptcy Act's statutory grounds.

HOW DOES A TRUSTEE OBJECT TO A BANKRUPT'S DISCHARGE?

A bankruptcy trustee lodges the objection notice with AFSA and gives a copy to the bankrupt. Once AFSA records the notice on the National Personal Insolvency Index (NPII)—the statutory and public register—the objection becomes legal.

HOW LONG CAN A BANKRUPTCY BE EXTENDED FOR?

A bankruptcy can be extended for two or five years, making the total bankruptcy period five or eight years. The extension period depends on the type of statutory ground for the objection. The usual discharge provisions then apply, with automatic discharge at the end of the extended period.

HOW IS THE EXTENSION PERIOD DETERMINED?

The extension period is determined by the statutory ground used for the objection. A 'non-special ground' will result in a two-year extension, and a 'special ground' will result in a five-year extension.

WHAT ARE THE GROUNDS FOR OBJECTING?

The objection must address a specific statutory ground. More than one objection can be lodged in a bankruptcy. Under section 149D of the Bankruptcy Act, the grounds for a bankruptcy trustee to object to a bankrupt's discharge are as follows.

Special grounds (five-year extension) apply if the bankrupt:

1. Fails to provide written information about their property or income.
2. Fails to disclose particulars of income or expected income.
3. Fails to pay a contribution amount to the bankruptcy trustee.
4. Fails to dispose of assets or spend monies within five years before bankruptcy without adequate explanation.
5. Fails to return to Australia when requested.
6. Fails to sign a document as required by a bankruptcy trustee under the Bankruptcy Act provisions.
7. Fails to make assets available to creditors (i.e. void transactions under sections 121, 128B or 128C of the Bankruptcy Act).
8. Fails to provide true and full information to a bankruptcy trustee (i.e. intentionally providing false or misleading information).
9. Fails to disclose a liability (intentionally) that existed at the time of bankruptcy.
10. Fails to disclose a beneficial interest in a property.

Other grounds (two-year extension) apply if the bankrupt:

1. Fails to cease managing a corporation in contravention of the *Corporations Act 2001* and without leave being granted.
2. Fails to return to Australia.
3. Fails to make assets available to creditors (i.e. void transactions under section 120 or 122 of the Bankruptcy Act).
4. Fails to act honestly in regarding amounts that exceed \$3,000 (i.e. the bankrupt's conduct is misleading involving transactions of \$3,000 or more).
5. Fails to disclose a liability that existed at the time of bankruptcy.
6. Fails to comply with section 77(1) or section 80 of the Bankruptcy Act.
7. Fails to attend a creditors' meeting under certain circumstances, or an interview, or an examination, without reasonable excuse.

WHAT IF THERE IS MORE THAN ONE GROUND?

If more than one ground applies, the extension period is based on the ground with the longest period only, i.e. these periods are not cumulative. If this ground is later removed (i.e. the bankrupt complies with their obligations), the extension period applies to the next longest period attached to any remaining ground. The extension period may not change if two special, or two non-special grounds apply, and only one is lifted.

WHAT IS THE DIFFERENCE BETWEEN OBJECTION NOTICES FOR SPECIAL AND NON-SPECIAL GROUNDS?

Special grounds do not require the reasons to be outlined on the notice to object, due to the nature of these grounds. Whereas a non-special ground requires the reasons to be outlined on the notice to object.

CAN AN OBJECTION BE WITHDRAWN?

Yes. A bankruptcy trustee can withdraw an objection at any time. Bankruptcy trustees normally withdraw the objection if the grounds are satisfied. But there is no requirement to withdraw it, especially concerning a special ground. If all grounds have been satisfied, the notice of objection can be completely withdrawn. The objection lodgement and the withdrawal are recorded on the NPII.

WILL WITHDRAWING AN OBJECTION END THE BANKRUPTCY?

Sometimes. If the normal three-year bankruptcy passed while the objection was in force, withdrawing the objection will automatically discharge the bankrupt as at the objection withdrawal date—not the original bankruptcy discharge date. If the objection is withdrawn during the normal three-year bankruptcy period, the bankruptcy will end by automatic discharge at the end of that three-year period.

CAN THE OBJECTION BE REMOVED BY A HIGHER AUTHORITY?

Yes. The Bankruptcy Act provides that a bankrupt can apply to the Inspector-General in Bankruptcy to review the bankruptcy trustee's decision to object to a bankrupt's discharge. The application for review must be made within 60 days of the bankrupt receiving the notice of objection. If the Inspector-General agrees to review the objection, a decision must be made within 60 days of receiving the application.

The Inspector-General must review the objection on the following basis:

1. Whether the ground exists under the Bankruptcy Act.
2. Whether sufficient evidence supports that ground.
3. The bankrupt's conduct before the objection was lodged.

However, as special grounds do not require reasons to be outlined in a bankruptcy trustee's notice to object, the Inspector-General cannot consider the evidence, or the bankrupt's conduct, therefore obtaining a decision to cancel these objections is difficult. Even if the bankrupt subsequently complies with the bankruptcy trustee's requests, the bankrupt's conduct will not automatically mean an objection is removed or withdrawn. To get an objection based on a special ground removed, a bankrupt may have to show that the circumstances do not justify the objection in the first instance.

Discharge and Annulment

Introduction

Normally, a person's bankruptcy ends with the bankrupt being discharged—called a 'discharge from bankruptcy'. Unless an 'objection to discharge' is lodged, discharge occurs automatically three years after the bankrupt's Statement of Affairs is filed with the Australian Financial Security Authority (AFSA). Discharge releases the bankrupt from the bankruptcy; however, the bankrupt estate (property, assets etc.) continues until all matters are satisfactorily concluded. This means the discharged bankrupt is still obligated to cooperate with the bankruptcy trustee.

WHAT IS THE DIFFERENCE BETWEEN DISCHARGE AND ANNULMENT?

Alternatively, a bankruptcy can be annulled. Discharge and annulment do not have the same legal result.

A discharge concludes the legal status of a person being a 'bankrupt', while the bankruptcy trustee completes their duties to the bankrupt estate. Whereas an annulment reverses the bankruptcy entirely—to be as if it never happened, thereby removing the person from bankruptcy and ending the bankrupt estate completely.

The Bankruptcy Act 1966 allows a bankruptcy to be extended for a total of five or eight years when a bankrupt has not cooperated with their bankruptcy trustee, or when an offence has been committed. If an objection to discharge is lodged against a bankrupt, the discharge date occurs at the end of the granted extended period.

DISCHARGE FROM BANKRUPTCY

Commonly, a person's bankruptcy automatically ends three years after their Statement of Affairs is filed with AFSA, under section 149 of the Bankruptcy Act. If the bankruptcy commenced via a debtor's petition (i.e. a person voluntarily goes bankrupt), the Statement of Affairs must have been filed at the same time. Therefore, without an objection to discharge being lodged, the bankruptcy ends three years after the debtor's petition was accepted.

If the bankruptcy commenced via a sequestration order (i.e. an order of the court), the Statement of Affairs would not have been filed at that time. The bankrupt must subsequently complete and lodge a Statement of Affairs with AFSA; the bankrupt is then discharged three years from this date.

The longer the delay in filing the Statement of Affairs, the longer the three-year bankruptcy period is protracted. If the Statement of Affairs is never filed, the bankruptcy will continue until the death of the bankrupt; however, the estate's conduct will continue until completed.

Discharge from bankruptcy is an automatic process of law, regardless of whether it ends at the standard three-year mark, or at the end of the extended period. Usually, a bankruptcy trustee will confirm in writing that the bankrupt has been discharged and ask for information to conduct a final income assessment.

BANKRUPT TO CONTINUE TO ASSIST TRUSTEE AFTER DISCHARGE

Even though the bankruptcy ends, the discharged bankrupt is obligated to assist the bankruptcy trustee under section 152 of the Bankruptcy Act, as the conduct of the bankrupt estate may continue. While the estate is commonly completed within the three-year period, there are exceptions. The administration of the estate does not end until the bankruptcy trustee has completed all the necessary tasks. Penalties apply to discharged bankrupts that do not reasonably cooperate with the bankruptcy trustee.

RELEASE FROM DEBTS

Discharge releases a bankrupt from their provable debts. These are debts that were outstanding at the date of bankruptcy—not the debts incurred after the bankruptcy commenced—and that can be proved for in the bankrupt estate for a dividend. Debts that are not provable in the estate are not released and some debts are only partially released.

Significantly, pursuant to section 153 of the Bankruptcy Act, a person's debts are only released upon their discharge from bankruptcy.

This allows creditors such as the Australian Taxation Office to offset monies payable to the bankrupt (after the date of bankruptcy) against debts payable by a person before their bankruptcy.

If a bankruptcy is annulled, a person's debts will still exist and must be satisfied in some other manner. These debts are usually satisfied in the process of getting the annulment, i.e. payment in full, or through a section 73 agreement.

Section 82 of the Bankruptcy Act sets out what debts are provable in the estate and will be released upon discharge. Frequently, all of a bankrupt's debts fall into this category and are discharged, but there are some significant exceptions including penalties or fines and some portion of a HECS and HELP debts (government student loans).

Only provable debts are released. Furthermore, some debts are provable in the estate for the amount owing, but by statute are not released in full at discharge (e.g. amounts under a maintenance agreement or order given before the bankruptcy date). An outstanding maintenance agreement amount at the time of the bankruptcy is released but amounts payable after the bankruptcy commenced are not released at discharge.

Section 82 of the Bankruptcy Act also outlines debts that are not provable and that will not be released on discharge. These are confirmed by section 153 of the Bankruptcy Act that provides that non-provable debts are not released upon discharge. These sections include a liability to pay an income contribution to the bankruptcy trustee, debts incurred by way of fraud, and liabilities under maintenance agreements or orders.

A bankrupt should be aware that non-provable debts will survive the bankruptcy process and will need to be paid by other means.

RIGHTS OF SECURED CREDITORS

A debt owed to a secured creditor is not released against the secured asset—only against the bankrupt. Valid securities in place at start of bankruptcy can be enforced against the secured asset at any time, even after the bankrupt is discharged. However, secured assets are generally sold in the three years prior to discharge from bankruptcy (although there are some exceptions).

Any shortfall after the secured asset's sale is released from the bankrupt upon their discharge. A secured creditor cannot recover any shortfall suffered after selling the secured asset from the discharged bankrupt. Most securities are exercised with the asset sold before the bankrupt's discharge and any shortfall is proved for in the estate, but not always. Sometimes these assets take longer than three years to realise. In this case, the secured creditor will not recover any shortfall.

If the secured asset has not been sold before discharge, any amount proved for (an estimated shortfall) in the estate is released at discharge. That debt therefore no longer exists and cannot be claimed against the secured asset. This affects creditors that make large shortfall estimates by underestimating the value of the secured asset.

The key point, under section 153(3) of the Bankruptcy Act, is that the secured part of a secured creditor's debt survives a discharge from bankruptcy and the deficiency is released.

OBLIGATIONS OF BUSINESS PARTNERS, GUARANTORS & JOINT DEBT HOLDERS

A business partner of a bankrupt must be aware that section 153(4) of the Bankruptcy Act provides that their liability for partnership debts incurred during the period they were in partnership with the bankrupt are not released by the bankrupt's discharge from bankruptcy. These debts normally hold a joint liability under the *Partnership Act 1892*. These provisions also apply to people who entered into contracts or other arrangements with the bankrupt, guaranteed a debt of the bankrupt, or simply have joint debts with the bankrupt. These people remain liable for those debts - or that portion of the debt they would have been liable for if the bankrupt had not become a bankrupt.

These joint debts are only released against the discharged bankrupt, not the other parties to the debt. Creditors can pursue the other parties to a debt, even after the discharge of the bankrupt, and their subsequent release from the debt from the bankrupt.

ANNULMENT OF BANKRUPTCY

An annulment is a reversal of a bankruptcy. However, the bankruptcy will appear indefinitely on the National Personal Insolvency Index (NPII) and on credit reference databases for two years from the annulment date, or five years from the date of bankruptcy, whichever is later. For an annulment to occur, a bankrupt must take one of the following three actions:

1. Annulment on payment of debts in full.
2. Gaining approval on a section 73 proposal.
3. Annulment by court order.

The first two actions require satisfaction of the bankrupt's debts, at least in part, and the last one requires an order of the court.

ANNULMENT ON PAYMENT OF DEBTS IN FULL

Under section 153A of the Bankruptcy Act, a bankruptcy is annulled if the estate has sufficient monies to pay all of the debts and the costs of the estate in full. This means that the bankrupt is now solvent and there is no need for the bankrupt estate, or a release from debts. Commonly, a bankruptcy is annulled when a bankrupt receives monies from a third party (usually a relative) or when a bankrupt's assets are sold or refinanced.

The debts include all those that have been proved for in the bankruptcy, but also any applicable interest accrued after the bankruptcy's commencement. The administration costs, charges and expenses of the bankrupt estate—including the bankruptcy trustee's remuneration and expenses and AFSA's realisation charge (currently seven percent)—are payable on the amount required to meet all the debts and costs. If the bankruptcy was commenced by a creditor's application, the petitioning creditor's costs also need to be paid.

Bankrupts must understand that the extra estate costs incurred may be significant and must be paid in full to obtain this type of annulment.

SECTION 73 PROPOSAL

A section 73 proposal is made under section 73 of the Bankruptcy Act. Section 73 gives bankrupts an alternative to their continued bankruptcy by allowing them to propose a formal arrangement to their creditors. This process is similar to proposing a Part X agreement to creditors (i.e. instead of bankruptcy); however, a section 73 proposal is initiated during a bankruptcy.

The process requires the creditors to accept the proposal and receive a benefit that was unavailable to them in the bankruptcy in exchange for agreeing to annul the bankruptcy. Upon acceptance, an annulment occurs, and the new agreement takes effect. The debts of the now ex-bankrupt are not released by discharge, but through the agreement terms being satisfied. Non-provable debts are covered in section 75 of the Bankruptcy Act.

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ANNULMENT BY COURT ORDER

Under section 153B of the Bankruptcy Act, a bankrupt can apply to the court for an order annulling (i.e. effectively overturning) the bankruptcy. The court will only consider an application if it believes that the bankruptcy should never have commenced in the first place. An application can be made against a sequestration order (i.e. a creditor's petition) or the acceptance of a debtor's petition by AFSA.

A bankrupt may apply for an annulment for numerous reasons not detailed here; the emphasis is on the bankrupt's rights.

PROTECTION OF THE TRUSTEE

Once a bankruptcy is annulled, the bankruptcy trustee gives the appropriate notices to AFSA to update the NPII.

Section 154 of the Bankruptcy Act protects a bankruptcy trustee's actions during their appointment. Any transactions or sales entered into during this period are not reversed or reviewed. The bankruptcy trustee can use assets in the annulled estate to pay any costs and remuneration that remain unpaid at the time of the annulment.

If the assets in the estate are insufficient to meet the bankruptcy trustee's costs and expenses, a bankruptcy trustee can collect the balance from the annulled bankrupt. This means that it is possible for a bankruptcy trustee to re-bankrupt the former bankrupt for costs incurred before the bankruptcy was annulled. However, this is a rare scenario.

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