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Proposed amendments make it harder for high-income earners to use bankruptcy law to their advantage

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Bankruptcy amendments target high-income earners

Partner Geoff Rankin and Law Graduate John Hedge review the recently proposed amendments to the *Bankruptcy Act 1966* (Cth) aimed at high-income earners who use bankruptcy to avoid paying their debts. If passed, the amendments will have far-reaching effects on professional and small-business people.

Background

The Bankruptcy Legislation Amendment (Anti-Avoidance and Other Measures) Bill 2004 (Cth) (the **Bill**) seeks to implement recommendations made in January 2002 by the *Joint Taskforce Report on the Use of Bankruptcy and Family Law Schemes to Avoid Payment of Tax*.

The proposed amendments are a response to the public outcry about barristers and company directors who have been declared bankrupt with large outstanding debts, but continue to live the 'high life', funded by assets held by their spouses or family trusts, and therefore protected from creditors. The Attorney-General initially announced the changes on 16 December 2003, and on 14 May 2004 an exposure draft of the Bill and Explanatory Memorandum was released.

Orders for recovery of property from third parties

The proposed amendments aim to prevent high-income earners from shielding their 'real assets' from creditors when they become bankrupt. This will be achieved by allowing the courts to make orders for recovery of 'tainted property' and 'tainted money' held by third parties (including the bankrupt's spouse or family trust).



Property held by a third party would be 'tainted property', and therefore recoverable, where:

- the property was acquired by the third party:
 - using funds or property provided by the bankrupt prior to bankruptcy;
 - by a transfer from the bankrupt prior to bankruptcy;
 - as a result of personal services supplied by the bankrupt to, or on behalf of, the third party; or
 - as a result of a scheme; and
- the bankrupt's main purpose in making the transfer was to ensure that the funds or property would not be available to pay creditors (a 'tainted purpose'); and
- the bankrupt has used or derived a benefit from the property now held by the third party (including any replacement property that can be traced to the original transfer).

This makes it far easier for trustees to challenge transfers than under the existing legislation, because the burden of showing that the transfer was for a legitimate purpose is placed on the bankrupt.

Money held by a third party would be 'tainted money', and therefore recoverable, where:

- prior to the date of bankruptcy the money was transferred by the bankrupt to the third party, and the bankrupt had a 'tainted purpose' in paying the money; or
- the money was the proceeds from the disposal of tainted property.

In addition to extending the circumstances under which property can be recovered from third parties, the amendments also create a presumption that the bankrupt had a 'tainted purpose' if the trustee of the bankrupt's estate alleges that they did.

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Property that cannot be recovered

The court would not be able to order recovery of property held by a third party where the third party provided market-value consideration in return for the original transfer, and either:

- the transfer occurred more than 10 years before bankruptcy; or
- the transferee was unaware of the bankrupt's purpose in making the transfer.

The amendments will jeopardise the sort of family arrangements that are currently very common among professionals and company directors.

Other amendments

The proposed amendments also:

- improve the ability of trustees in bankruptcy to collect income contributions from bankrupts; and
- allow trustees in bankruptcy to challenge transfers by the bankrupt in a financial agreement made under Part VIIIA of the Family Law Act 1975 (Cth).

Implications

The proposed amendments will apply to all bankruptcies current at the date the Bill receives the Governor's assent, and any bankruptcies occurring after that date. The amendments therefore apply to all previous transfers made by the bankrupt, including those carried out long before the amendments commence, in circumstances where the transfer was lawful at the time it was effected. This retrospective legislation obviously will affect more than just high-income earners.

These amendments significantly extend the circumstances in which trustees in bankruptcy can recover property from third parties, and will certainly improve creditors' access to the 'real assets' of the bankrupt. However, the amendments will jeopardise the sort of family arrangements that are currently very common among professionals and company directors. Indeed, the explanatory memorandum notes: 'the amendments... represent a fundamental shift away from the perceived legitimacy of these arrangements'.

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