Prosperity Accountants

Asset Protection

How personal assets are protected under common Australian business structures.

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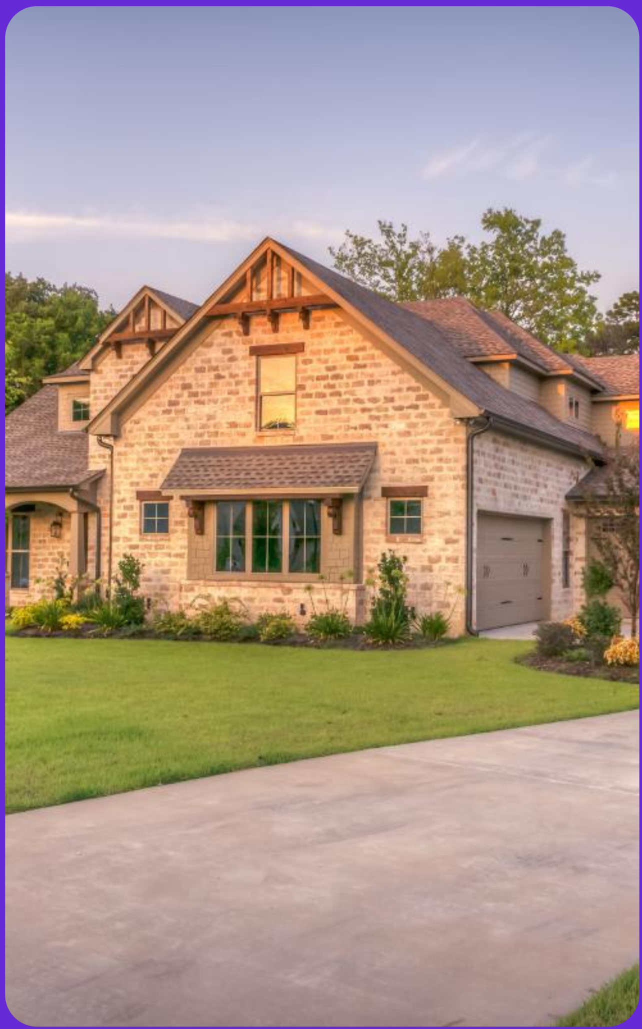
Asset protection features of common structures



Most clients understand that it is preferable to utilise a structure that offers a good level of asset protection in order to safeguard their assets should something go wrong. However, what is considered an adequate level of protection will vary from one client to the next (or even one venture to the next for the same client), depending on the client's personal risk profile, how much is at stake, and the assets they wish to protect.

The following guide provides an overview of the general asset protection features of some common structures.

1. Sole trader

There is **no asset protection** where a business is carried on in the individual's own name (leaving aside insuring against risk). Such individuals could potentially lose all of the business and private assets they own (i.e., all property owned would be exposed in the event of bankruptcy or a relationship breakdown).

2. Partnership

A partnership of *individuals* offers no **asset protection**. In fact, from an asset protection perspective, a partnership of individuals is inferior to operating as a sole trader because each partner is liable not only for their share of the partnership debt but also for the debts of the other partners (i.e., each partner is **'jointly and severally liable'**, even if the partner had no knowledge of, and was not responsible for, the debt).

However, a partnership of *discretionary trusts* can offer the same asset protection that a single discretionary trust offers (as discussed below). Note that, as for a partnership of individuals, each discretionary trust partner will still be jointly and severally liable for the debts of the partnership.

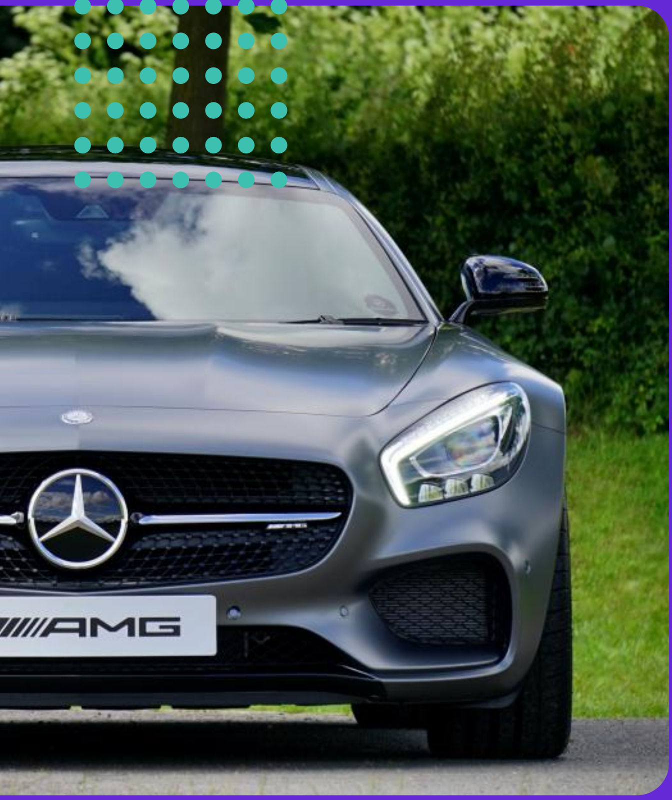
3. Company

A company structure offers a high level of asset protection where the objective of the client is to quarantine risk to the company (i.e., in circumstances where the company carries on a business that carries risk). This is because, in such a situation, whilst company creditors will have access to the company assets in the event of insolvency, the creditors will not be able to access the assets of shareholders (except to the extent the share subscription price remains unpaid). This important feature of a company is referred to as **'limited liability'**.

An exception to this rule is that company directors can be personally liable where the company has traded insolvent or where a **Director Penalty Notice** ('DPN') is enforced in respect of unpaid employee entitlements (PAYG withholding and/or super guarantee) and GST (and some other obligations) from 1 April 2020. Also be mindful of **personal guarantees** provided by directors, as this will reduce the level of asset protection offered by the company for those directors.

In contrast to the above, a company structure will not provide asset protection where the shareholder client is exposed to risk outside the company (e.g., where the shareholder is at risk of becoming bankrupt due to activities outside the company). This is because the shares are assets of the shareholders and, therefore, these shares are not protected in the event of either the shareholder's bankruptcy and/or divorce.

That said, the level of asset protection can be increased if the shares are held by a discretionary trust (the level of asset protection a **discretionary trust** can potentially provide is discussed below).



4. Discretionary trust

A discretionary trust has long been the 'go to' structure for asset protection for many years. Where the objective of the client is to quarantine risk to the trust (e.g., where the trust carries on a business that carries risk), a discretionary trust with a ***corporate trustee*** provides very effective asset protection. To maximise asset protection, it is important the corporate trustee only acts in its capacity as trustee of the trust (and does not, for example, carry on business or own assets in its own right).

In these circumstances, trust creditors generally have recourse against the corporate trustee in the first instance, and then against the assets of the trust (via the trustee's right of indemnity). Creditors generally have no claim against trust beneficiaries.

There are (somewhat limited) circumstances in which a director of the corporate trustee may be personally liable to creditors (refer to S.197 of the Corporations Act 2001), and regard must also be had to the ***director penalty regime*** and insolvent trading provisions. As a result of this risk, it is recommended that such a director refrain from owning assets in their own name (and not even hold assets as trustee of another trust).

More commonly, however, the objective of a client will be to shield the trust assets from third party attack, such as from a trustee in bankruptcy where a beneficiary of the trust goes bankrupt and/or from an ex-spouse or ex-partner in the event of a ***relationship breakdown.***

Unfortunately, the effectiveness of using a discretionary trust to protecting trust assets from a third party attack has been diluted in recent times, particularly in the context of divorce. The current 'state of play' in relation to discretionary trusts and asset protection can be summarised as follows:

(a) As a general proposition, notwithstanding some recent case law in this area, it appears that it remains possible to configure the control of a discretionary trust so that it can generally provide an effective level of asset protection in the event a beneficiary goes bankrupt.

However, particular care must be taken in choosing trustees and appointors etc. to increase their chance of successfully protecting trust assets in this regard. Further, there is also an element of uncertainty as to how future litigation in this area will 'play out'.

(b) Recent case law continues to illustrate how difficult it is to protect assets held in a 'typical' discretionary trust from the reach of the Family Court in the event a beneficiary of the trust experiences a relationship breakdown (note that a 'typical' discretionary trust refers to the scenario in which either or both spouses control the trust, whether directly or via a corporate trustee, and the assets of the trust have accumulated prior to, or during, the marriage).

However, if care is taken when establishing the trust (including in limiting the class of potential beneficiaries) and in managing the trust (including in choosing trustees and appointors etc.) the trust assets may be protected in this regard (although the trust may still be considered a 'financial resource'). It should also be remembered that there are other avenues that can be pursued, including the use of a Binding Financial Agreement.

5. Unit trust

In terms of asset protection, a unit trust (with a corporate trustee that does not carry on a business, nor hold assets, other than in its capacity as trustee of the trust) provides similar asset protection to a company.

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6. SMSF

An interest of a bankrupt in a super fund is, generally speaking, a ***protected asset*** under S.116(2)(d)(iii) of the Bankruptcy Act 1966. However, there can be consequences for the fund member and the fund under the contribution ‘claw-back’ provisions.

Furthermore, a super fund will not protect assets in the event the fund member divorces (as superannuation is treated as property under the Family Law Act 1975 that may be split on a relationship breakdown).

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Next Steps

Don't wait for business accidents, losses or risk to strike. Take proactive steps towards securing your assets before its too late.

Book a free discovery call

and start protecting your personal assets

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