

## **[340] Forcing spouses to sell family home to pay tax by Robin Speed, Speed and Stracey Lawyers**

Under the *Bankruptcy Legislation Amendment (Anti-avoidance) Bill 2005* (see 2005 WTB 51 [2044] and para [377] of this *Bulletin*), a bankrupt's spouse who owns the home where the spouse and the children live is required to pay creditors, including the Commissioner of Taxation, the value of the spouse's interest in the home which is attributed to financial contributions made by the bankrupt at any time within 4 years before bankruptcy.

The Bill extends the bankruptcy claw-back to any financial contribution made by the bankrupt, where the bankrupt received a benefit from the home no matter how small, eg by living there for one week - even if the bankrupt was solvent at the time of payment, had no intention to defeat creditors and no longer lived in the home at the time of getting into financial trouble.

Never before have unsecured creditors had this power. It is irrelevant whether the bankrupt's spouse guaranteed the amounts owed to the creditors, or even knew of their existence.

Given the tragic consequences to families in most bankruptcies, and the costs to the community which result, this article examines the circumstances in which the provision in the Bill operates, and asks why it is necessary.

### **Bankrupts**

It is first desirable to say something of persons who become bankrupt.

In the overwhelming number of cases, bankruptcy results from taking on excessive personal debt or business failure or accident. The chronic gambler, drug addict, alcoholic, manic depressive and sick also make up the sad list of bankrupts.

There is a small minority who seek to manipulate the bankruptcy system by avoiding payment of their debts, including tax, whilst enjoying the benefits of their assets. *The overwhelming number of persons made bankrupt do not fall into that category. For most, bankruptcy is a catastrophe.* The bankrupt's family are usually the innocent victims. One can only have sympathy for a spouse and children living with a chronic gambler, drug addict or alcoholic or person suffering from mental sickness. To then have to sell their home to pay the bankrupt's tax and other debts adds catastrophe on to catastrophe.

### **The amending Bill**

The Bill provides that if the Court is satisfied that:

- during the examinable period, the value of a person's interest in a property increased as a direct or indirect result of financial contributions made by the bankrupt during that period, eg the bankrupt assisted in meeting mortgage payments on the family home; and
- the bankrupt used or derived (whether directly or indirectly) a benefit from the property at a time or times during the examinable period, eg lived in the family home at some time during the period,

the Court may order the person concerned, eg the spouse, to pay the bankrupt's creditors an amount not exceeding the amount by which the value of the person's interest in the property increased as a result of the financial contributions made by the bankrupt: proposed s 139EA of the *Bankruptcy Act 1966*.

A similar provision exists where the person concerned, eg the spouse, acquired an interest in property as a direct or indirect result of financial contributions made by the bankrupt during the examinable period: proposed s 139DA.

The *examinable period* in relation to a related entity, eg the spouse, is 4 years prior to the commencement of bankruptcy or from the first point of insolvency in the year previous to that, if the bankrupt became insolvent during that year. For these purposes, related entity includes any relative of the bankrupt. In any other case, the examinable period is either 2 years prior to the commencement of bankruptcy, or from the first point of insolvency in the 3 years previous to that if the bankrupt became insolvent during that period.

The Bill introduces a rebuttable presumption of insolvency which arises if it is established that the bankrupt did not keep proper books, accounts and records in the relevant period or where having kept them the bankrupt failed to preserve them.

### **Additional provisions in the Bill**

The Bill also amends the Bankruptcy Act by:

- increasing the claw-back period in s 120 of the Bankruptcy Act from 2 to 4 years for transfers of property by a bankrupt or related entity for less than market value;
- introducing a rebuttable presumption of insolvency for the purposes of ss 120 and 121 of the Bankruptcy Act where a bankrupt has failed to keep proper books, accounts and records;
- providing that a transfer made to defeat creditors is void against the bankruptcy trustee under s 121 if it was reasonable for the transferee to infer that the bankrupt's main purpose in transferring the property was to defeat creditors.

Despite these substantial amendments, the Bill also contains the further claw-back provision the subject of this article.

### **The family home**

There were times when the husband was the sole bread-winner in the family. In those times, it might be claimed that any asset owned by a wife must necessarily result from a gift from the husband and then, to extrapolate that, the wife's assets should be available to his creditors. Even in those times, however, the Bankruptcy Act did not provide the provision presently contained in the Bankruptcy Amendment Bill.

Today, times are different, and the financial and social contributions of husband and wife make it frequently difficult to attribute one person's contribution to their single or joint assets. For example, where a spouse decides to stay at home and look after the children, is that spouse making a financial contribution to the family mortgage? Many would say they are.

It is also not possible today to assert that joint ownership of the family home by husband and wife, or sole ownership, is a ploy to defeat creditors. Family and personal considerations, and lenders' requirements, generally determine ownership.

### **Explanatory Memorandum**

In the Explanatory Memorandum to the amending Bill, the following statement appears as to the meaning of s 139EA:

"58. This proposed amendment will address the situation where, as a result of contributions supplied by the bankrupt, a person's net worth increases in the years immediately prior to bankruptcy, and the bankrupt derives a benefit from property directly connected to that increase in net worth. For example, in the 4 years prior to bankruptcy, a bankrupt may service the mortgage on a house property held in the name of his or her spouse, and the bankrupt may live in that property (thereby deriving a benefit from the property). Under these proposed provisions, the trustee may be able to recover the increase in the value of the property that can be attributed to the bankrupt's financial contributions."

This passage is confusing. It is stated that the section applies where the bankrupt derives a benefit from the property in question, eg family home, "directly connected to that increase in net worth". In the Bill, there is no correlation between the quantum of the benefit and the financial contribution. In other words, the section applies if the husband makes a financial contribution at any time 4 years prior to bankruptcy and only ever lives in the home thereafter for one week. The Explanatory Memorandum does not make this clear.

### **The prescribed circumstances**

The general position under the Bill is that if a bankrupt has made a financial contribution at any time within 4 years prior to their bankruptcy which increases the value of the spouse's interest in the family home, a court may order the spouse to pay to the bankrupt's creditors a specified amount not exceeding the amount by which the value of the spouse's interest in the family home increased as a result of the financial contributions. Accordingly, if at no time during the 4 year period the bankrupt ever lived in the family home or derived any benefit from it, the provision will not apply.

It is important in considering the above to note that the following are *not* relevant:

- That the bankrupt was solvent at the time of making the financial contribution.
- That the bankrupt had no intention to defeat or delay creditors.
- That the creditors were unaware that the spouse or the bankrupt owned an interest in the family home.
- That the creditors in providing credit did not rely upon the ownership by the bankrupt or spouse of the interest in the family home.
- That none of the creditors were misled by the bankrupt in becoming a creditor.
- That the spouse of the bankrupt and other family members made non-monetary contributions to the family's wellbeing.
- That the spouse was unaware that the bankrupt might be insolvent.
- That the benefit obtained by the bankrupt from the family home was fleeting and insubstantial.

### **The Court's discretion**

It might be said that a spouse has nothing to fear because creditors can only receive what a court determines should be paid by the spouse.

But in practice, a spouse will often be economically forced to compromise the creditors' claim before the matters get to court. The relative bargaining positions between the spouse and the creditors are

hardly evenly balanced. More importantly, however, is why a spouse should be put in the position of going through this process with ultimately a court deciding what payment it thinks on the evidence produced shall be made by the spouse.

### **The stated reason for the provision**

The reason given for the proposed new provisions is to attack "practices which undermine the integrity of the bankruptcy system". In particular, it is stated in the second reading speech:

"It is possible for bankrupts to deliberately avoid these provisions by, for instance, transferring assets to family members or close associates when insolvency is looming and then purposely delay the commencement of the bankruptcy. It is also possible for people approaching insolvency to build up wealth in the lead-up to bankruptcy in the name of a person who allows the bankrupt to enjoy assets acquired with that wealth."

It is not explained why the other provisions in the Bill will not address these concerns.

The justification given is all about intention to defeat creditors. In the provision under consideration, intention is irrelevant. The provision operates regardless of intent. Further, no evidence has been given publicly, that the writer is aware, of the number of bankrupts that fall within the category in question. In other words, is this a widespread problem or isolated to the few?

### **Conclusion**

The justification for the provision appears to be the intention to defeat creditors and a correlation between the financial contributions made by the bankrupt and the benefit obtained or to be obtained by the bankrupt from the property. But neither element is contained in the provision.

In the writer's view, the provision should be withdrawn and a tailored provision added for those instances where high income earners or others deliberately plan their affairs to avoid paying tax by becoming bankrupt.