articles

lifestyles of undiminished splendour - bankrupts on fringe benefits

Under Part VI, Division 4B of the *Bankruptcy Act 1966* bankrupts can now be required to make contributions from their income for the benefit of their bankrupt estates. This Division came into operation in July 1992 replacing section 131 of the Act which had given a bankrupt a *prima facie* right to retain income subject to any order to the contrary being sought by the trustee from the court. Now there is a positive statutory obligation on a bankrupt to make contributions from income earned above a threshold amount.

the Alan Bond case

An aspect of the income contribution provisions of the Division has been brought into focus by Mr Alan Bond's challenge to the decision of his trustee in bankruptcy to assess as income of Mr Bond the value of certain items gifted to him and hence to impose a contribution liability based on the receipt of that income. The challenge has produced a sharp division of opinion in a decision of the Administrative Appeals Tribunal and in majority and minority decisions of the Full Federal Court of Australia. As well, the case has provoked similarly diverse views in the press from the Minister responsible for administering the *Bankruptcy Act*, Mr Duncan Kerr, lawyers and trustees in bankruptcy.

The Bond case started when Mr Bond challenged an assessment of contribution made by his trustee in the AAT under section 139ZF of the *Bankruptcy Act*. The trustee, Mr Robert Ramsay, had assessed as "income" of Bond the value of free accommodation, office space, secretarial services and telephone facilities, and free travel and legal expenses provided to Bond by members of his family and by a business associate. By far the largest aspect of financial help to Bond was the payment of legal expenses totalling over $660,000 in respect of various criminal and civil proceedings in which Bond had been represented. The trustee treated these as fringe benefits in terms of subsection 139L(e) of the *Bankruptcy Act* which reads:

> *""**income**", in relation to a bankrupt, means any amount derived by the bankrupt that is income according to ordinary*

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usages and concepts, and includes:

(e) the value of a benefit that is, or if it were provided by an employer would be, a fringe benefit for the purposes of the Fringe Benefits Tax Assessment Act 1986 *(the FBT Act)".*

Fringe benefits under the FBT Act include the provision of the use of cars, the payment of expenses and the provision of low rental housing. Having treated the value of the benefits provided to Bond as income, the trustee then assessed the contribution which Bond became liable to pay under section 139P of the *Bankruptcy Act* at a figure of around $250,000.

At first instance, the AAT found in favour of the trustee[1] but on appeal the Full Federal Court by majority found in favour of Bond[2]. The majority judges held that the fringe benefits provided to a bankrupt must be provided in respect of the employment of the bankrupt before they could be assessed as "income" of the bankrupt on which contribution assessments would be levied. Fringe benefits provided outside the employment context were not to be regarded as income.

The trustee is to seek special leave from the High Court to appeal from the Federal Court's decision with funding provided by the Commonwealth pursuant to section 305 of the *Bankruptcy Act*. For those administering the *Bankruptcy Act*, if an appeal to the High Court does not succeed, and if the interpretation of Bond's trustee is sought to be maintained, then an amendment of subsection 139L(e) would need to be made.

The legal niceties of the interpretation of subsection 139L(e) having regard to the scheme of the *Bankruptcy Act*, to the purposes of Division 4B and to the *Acts Interpretation Act 1901* and principles of statutory interpretation will no doubt be the subject of detailed argument if the matter proceeds to the High Court. It is not proposed to go into these aspects here. What is queried is the result that Parliament was apparently trying to achieve in assessing a bankrupt as liable for income contributions in respect of the value of gifted fringe benefits from family or friends unrelated to employment. The division of opinion on this issue traverses matters involving the public perception of bankrupts' lifestyles, an apparent frustration with the difficulties of securing assets from sophisticated bankrupts and the merits of family support to those suffering in financially difficult times.

The AAT had not found any difficulties with the policy of the broad interpretation. On the question of taking into account the value of family assistance to a bankrupt in assessing income, the AAT said:

"The object set out in s 139J is to require a bankrupt to pay contributions to his creditors if he derives income as defined by the Act. Such an obligation cast upon him by a statute may, in some cases, cause a diminution in the bankrupt's resources or in those of his family. We see no objection to this result from a public policy point of view[3]".

In the Federal Court, each judge expressed his view on the propriety or otherwise of the construction of the subsection as asserted by the trustee. In considering whether gifts to the bankrupt in the non-employment context were income, Justice Cooper said:

"It is not an object within Section 139J of the Act to prevent bona fide acts of benefaction from family or friends of a bankrupt using their own money or property. Nor... to prevent a bankrupt accepting such benefaction unless the bankrupt has sufficient income to pay any contribution assessed... (nor) to require payment by the benefactor of any assessed contribution towards the bankrupt's estate as the price for providing the benefit[4]".

Carr J's opening words in his judgment were:

"In the case of an ordinary bankruptcy, there are doubtless many people who feel reassured when they see the family and friends of a *bankrupt rally around to help that person"*

and he espoused the "continuing importance of the family and friends in our rapidly changing society". He did go on to say:

"On the other hand, creditors, together with possibly most members of the community, might well resent the sight of a bankrupt continuing to enjoy the trappings of great wealth prior to discharge from bankruptcy. The suspicion arises that assets may have been secreted and placed out of reach of creditors only to re-emerge with the appearance of family support and benevolence.

Division 4B of Part VI of the Bankruptcy Act...was enacted by Parliament to deal with such concerns[5]".

He came to the same view as Justice Cooper on the interpretation of the subsection.

French J dissented, holding that fringe benefits did not have to be provided in an employment context before they could be assessed as income. He said:

"Division 4B is remedial of a public mischief which has allowed some bankrupts to enjoy lifestyles of undiminished splendour while their creditors, large and small, are left lamenting. It is to be construed broadly.[6]"

views on the decision

In a letter to the Australian Financial *Review* of 10 November 1994, the Minister for Justice Mr Duncan Kerr wrote:

> *"The Government believes that it is inappropriate for a bankrupt to be able to enjoy an extremely comfortable, if not luxurious, lifestyle because of gifts from relatives and friends without these gifts being taken into account as income for the purpose of providing some return to creditors.*
>
> *This was Parliament's clear intention[7] in enacting the relevant income contribution provisions which were the subject of the recent ruling by the Federal Court."*

This letter had been in response to a letter[8] from Mr R W Harmer, the Commissioner-in charge of the 1988 Law Reform Commission's general insolvency inquiry, who in agreeing with the decision of the majority described the policy behind the proposition "that if a person makes a payment of money from that person's own property to benefit a bankrupt person...the amount of any such payments is to be regarded as 'income' coming to the bankrupt" as "wrong, badly wrong". He was himself responding to a letter[9] from two registered trustees in bankruptcy, Messrs MW Prentice and S Denby, who severely criticised it as "an appalling decision running totally against the spirit, if not the letter, of the Act". They went on to say that entrepreneurs could conclude from the judgment

> *"that it is now possible to gift large sums of other people's money and assets to their family and friends against the day when creditors begin knocking at the door.*
>
> *This gifting is in many important respects very similar to the family trust relationship, a potential abuse which the legislation specifically sought to counter."*

In a subsequent letter[10] they referred to the "cosy financial relationships of the Gucci bankrupts". Similar views were expressed by counsel for the trustee, Mr Stephen Wright who said that:

> *It means a bankrupt can maintain a high lifestyle if his friends and family pay for his car, legal fees, travel and other expenses. So be nice to your children, because you never know...".[11]*

The range of strong views on the issue leads to an examination of the rationale for the policy pursued through subsection 139L(e) and the method of achieving this.

fringe benefits in the employment context

A primary aim of subsection 139L(e) is obviously to ensure that a bankrupt employee does not structure his or her employment package so as to receive minimal salary but substantial fringe benefits in order to avoid liability to pay income contributions to the bankrupt estate, in the same way that the fringe benefits tax was introduced to assess non-cash benefits as income in order to deter such structuring or at least to cause such benefits to be taxable. The difference with fringe benefits tax is that the tax is payable by the employer not by the employee-recipient of the benefit.

If an employee received $50,000 salary and $100,000 worth of fringe benefits, it would not necessarily be within the capacity of the employee to pay any such tax consequently assessed on a salary of $150,000. Fringe benefits tax is therefore levied on the employer either as a means of levying tax properly on income not payable as cash or to cause fringe benefits to be reduced and cash salary increased. However, under subsection 139L(e), the assessed contribution is payable by the recipient of the benefit, the bankrupt, and not the employer. This in itself is a difference in concept from fringe benefits tax. In addition, in the bankruptcy context, the recipient of the non-cash benefit from employer is, by definition as a bankrupt, unlikely to have a capacity to pay. This is so even in the employment situation to which subsection 139L(e) was obviously directed, so that in the example above, the bankrupt employee would be assessed for contributions on an income of $150,000. The disincentive for such an employment package is apparent.

In the employment context, the views expressed are consistent with the proposition that the provision should properly apply.

fringe benefits outside the employment context - the rationale

In the situation of fringe benefits provided in a non-employment context, the aim is not so clear. Any family support in the nature of a fringe benefit could be valued as such by the trustee as the income of the bankrupt and contribution levied accordingly. It is more difficult to see why this should be treated as income. Two reasons come from those in support of this interpretation: one, the view is held that a bankrupt should simply not be permitted to have an expensive lifestyle, and two, that there is a need to assess any such benefits as income on the suspicion that their sources were assets secreted away before bankruptcy.

lifestyle

The views expressed on this are that it is not thought appropriate for bankrupts to be able to maintain a high standard of living - "lifestyles of undiminished splendour" - whilst they are bankrupt. But this situation is only so because in some cases bankrupts do have family and friends of some means who can assist them. Not all or many bankrupts would have such assistance. The concern that this should not be so may be seen as moralistic [it is not right that the bankrupt should not suffer] or punitive [the bankrupt shall have a diminished lifestyle as punishment for causing losses to creditors[12]]. The reality is that bankruptcy does relieve a person from debts and that creditors are often unpaid, but this is of the nature of our insolvency laws. If it is the case that other persons have their own money and wish to provide it to the bankrupt to allow him or her to maintain a lifestyle or operate a business, the question is whether they should be effectively prevented from doing this. The operation of the subsection in the way contended by the trustee would have to be to deter friends and relatives "rally[ing] around", to quote Justice Carr, and offering support and assistance to a bankrupt.

secretion of assets

The view is also put that there is a need to avoid the possibility of a bankrupt divesting himself or herself of cash and other assets prior to bankruptcy, in anticipation of going bankrupt but with the expectation that his or her lifestyle would be maintained by the recipients of those benefits. The Explanatory Memorandum, after describing the deficiencies of the old section 131, then says:

> *"Further, some bankrupts manage to put their assets out of the reach of creditors, and to channel income away from themselves through the use of associated individuals, companies, partnerships or trusts, which are referred to in the Act as 'associated entities' of the bankrupt. These associated entities may, and usually do then provide the bankrupt with substantial non-cash benefits, such as free or low cost housing, motor vehicles, boats, and payment of expenses."*

If this is the real concern then a response might be that there are remedies available to a trustee under the *Bankruptcy Act* to deal with such cases, and if those remedies are thought to be inadequate, then they should be broadened. The recovery of property disposed of in anticipation of bankruptcy should be a proper object of any insolvency legislation but dealing with it in the context of income contributions could be seen as a contorted way of dealing with the issue. It disguises the limitations on a trustee in clawing back money and other assets divested before bankruptcy. If a trustee suspects that family of the bankrupt hold divisible property which is then being paid to the bankrupt in the way of financial assistance during bankruptcy, it clouds the issue to have him recover [only half of] the value of this assistance through Division 4B rather than for him to attempt to show that the assets were transferred prior to bankruptcy in circumstances where they are recoverable.[13]

broad brush approach

Nevertheless, the subsection may be seen as a broad brush attempt at deterring the secretion of assets or at retrieving them, the price for which is the effect on genuine benefaction from family or friends. The exemption of such benefaction may be, for the draughtsman of the subsection and those instructing, too difficult to attempt without providing some potential for misuse by unscrupulous bankrupts. This approach may be seen generally as representing a widening of the net to counter the range of schemes designed to keep assets out of the reach of a trustee.[14] It may also indicate some frustration with the inadequacies of traditional bankruptcy law in these areas.

perspective

Although a global approach to the issue is taken by subsection 139L(e), it might be said that one should keep the effect of the subsection in perspective. As Justice French pointed out[15], the contribution provisions of Division 4B apply only to half the difference between the assessed income and the actual income threshold amount and amounts up to that threshold (currently $24,406.20 for a person with no dependants, and higher with dependants) can be received without liability for contribution. Also, of the thousands of bankruptcies annually in Australia, the proportion of those that might be in the fortunate situation of having wealthy family or friends who were willing to assist them substantially would be very small. Mr Bond had not only incurred over $660,000 worth of legal expenses, but had had these paid for by family and friend. Whether a trustee would assess less overt assistance from family and friends than provided to Mr Bond as income would be another matter - it might be a strict trustee who would put a value on the parental accommodation provided to the bankrupt and his family and the loan of a cheap car for the purpose of assessing income contributions[16].

However, Justice Cooper considered that such a situation could occur and contemplated that a legally aided bankrupt, maybe not an unusual occurrence say in criminal proceedings, could be assessed as having received income to the value of that legal aid[17]. Also, Justice Carr referred to "numerous instances" where the consequences of the broad interpretation would "at the very least appear most unreasonable[18]".

The point is that the principle of pursuing family beneficence as income should not be lost sight of because only the "Gucci bankrupts" are said to be targeted.

after-acquired property

It could also be said that the broad interpretation of the subsection can be supported in the context of how after-acquired property is treated in bankruptcy. The law is that property obtained by a bankrupt during bankruptcy vests in the trustee pursuant to section 116 of the *Bankruptcy Act*; this principle now applies to income to the extent that Division 4B requires contributions to be paid. It is therefore not necessarily inconsistent with the scheme of the Act that the bankrupt should be assessed on benefits from family and friends when gifts of property from such sources vest in the trustee. But just as the reality is that no informed person would make a gift of property to a bankrupt during the period of bankruptcy (unless to genuinely assist the estate meet the claims of creditors, or to allow an annulment of the bankruptcy to be sought) so also the effect of subsection 139L(e) in the breadth argued by the trustee should also cause such benefaction to bankrupts to be withheld. It is this benefaction that was so valued by the majority judges[19].

Also, there is a fundamental difference between after-acquired property and the provision of fringe benefits. The bankrupt does not actually receive the asset or cash benefit involved, he or she merely has the use of the car or the house or has the cash applied to expenses incurred[20], and could thus be left with difficulty in meeting any contribution amount assessed.

contributions assessed on contributions

One effect of the trustee's interpretation of subsection 139L(e) which may not have been intended is that a bankrupt would only be able to pay any contributions assessed by a trustee, in a circumstance where the bankrupt has no cash income, out of funds again provided by third parties, which funds would then be further assessed as income of the bankrupt, and so on. However, as Justice French pointed out[21], this result also applies when the benefits are provided by an employer; it is only the more explicable in the employment context in that the bankrupt might at least have an income as well as the fringe benefits from which to be able to meet any contribution liabilities; although, as indicated above, employee recipients of fringe benefits are not themselves required to pay fringe benefits tax. In either context, there are logical difficulties in treating such further payments as income incurring further assessments by the trustee.

continuing debt

A final consequence of the present scheme is that if a bankrupt receives support from friends or relatives but is genuinely unable to pay the contributions subsequently assessed, then, under section 139R, this becomes a personal liability of the bankrupt that is not affected by the bankrupt's subsequent discharge from bankruptcy. Subsection 139ZG(3) says that unpaid contributions are recoverable by the trustee as a debt due to the estate and the trustee could further pursue these after bankruptcy in a civil court; and this could be after the trustee has objected to the bankrupt's discharge under paragraph 149D(1)(f) and extended the bankruptcy because of the bankrupt's failure to pay. And it would not be open to the Official Receiver, on application by a bankrupt, to use the hardship provisions in section 139T to ameliorate the bankrupt's position unless the bankrupt's situation comes within the particular categories of hardship described in that section.

conclusion

The High Court's ruling, if the matter proceeds that far, will be the final say on subsection 139L(e) as it presently stands. It may be that if the trustee does not succeed, Parliament will amend the provision to make clear its intention[22]. The ultimate effect of subsection 139L(e) in its broad interpretation will then be to prevent any substantial benefaction to bankrupts from family or friends. This would apply in the same way that Section 116 inhibits gifts of property to a bankrupt. To the extent that such benefaction ceases, Parliament would have achieved its apparent aim of remedying the potential reality of secreted funds being rechannelled to a bankrupt and would remedy the public perception of bankrupts being seen to live well even if only from the benefit of family or friends. However, the concern would remain that the policy behind this achievement is questionable.

footnotes

1. Re Bond and the Trustee of the Property of Alan Bond, a bankrupt, 30 ALD 232

2. Alan Bond v The Trustee of the Estate of the property of Alan Bond, a bankrupt, unreported, 20 October 1994

3. 30 ALD at 240

4. p.10

5. pp. 1-2

6. p.29

7. It is interesting to note the comment of the Minister as to Parliament's intention. Whilst this may be the expressed intention now, the Federal Court decision shows that it was not in fact clear whether such results were intended either from a reading of subsection 139L(e) or of the Explanatory Memorandum. The two majority Judges considered that their interpretation was available solely on a literal reading of the section without strictly having to go to the Explanatory Memorandum or Second Reading Speech for assistance.

8. Australian Financial Review, 7 November 1994

9. Australian Financial Review, 27 October 1994

10. Australian Financial Review, 22 November 1994

11. As reported in the Sydney Morning Herald, 21 October 1994

12. Even if this does not produce any gain for creditors. Note however the comments of Justice French: "...Division 4B is to be seen as legislation protective of the interests of creditors and not punitive of the bankrupt. The definition of 'income' in s.139L is not to be construed as though it were a penal provision" - p.29

13. Mr Bond's activities are no doubt the subject of continuing investigations by his trustee and others. In the Sydney Morning Herald of 24 November 1994 his trustee is reported as noting that "in the six years before his bankruptcy Bond earned \$2.5m according to his tax returns, but he managed to give \$32.5m to his family and friends" and that there is the possibility of Swiss bank accounts ultimately controlled by Bond and other assets within his control.

14. As another example, see subsection 139L(f) which treats as income of the bankrupt money received by another person as a result of work done by the bankrupt. This is an extension of the scope of Division 4A which allows a trustee to seek orders against those who benefit from services provided by the bankrupt at an undervalue but this Division appears to have been little used.

15. p.30

16. Such a strict approach was not considered proper in the AAT where the Tribunal said that "gifts given in an ordinary family setting which would have been a normal incident of a family relationship" would not be regarded as fringe benefits - 30 ALD at 239.

17. p.11. This example was also raised in a subsequent letter in the Australian Financial review of 23 November 1994 from Mr Harmer, who said "[i]t surely cannot be suggested that [legal aid] is consumed by the bankrupt as part of a "lifestyle".

18. p.13

19. At least in the sense of the bankrupt being provided with on-going maintenance and support rather than gifts of property, which would pass to the trustee as after-acquired property.

20. In the words of Mr Harmer in his letter cited at footnote 17, "the bankrupt has not got it [the 'income']. He never had it".

21. p.29

22. Whether Parliament would make any amendments retrospective, as suggested by Messrs Prentice and Denby [in their letter at footnote 9.] but which prospect was described as "draconian" by Mr Harmer [in his letter at footnote 8], remains to be seen