The Tax Man and a Family Law Matter
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Introduction

Companies, trusts and superannuation funds are very commonly used by Australians for either the conduct of their business activities or the holding of investments.

Asset protection may be the driver behind the holding of risky assets in a corporate structure. Similarly, investment assets may be held in a trust environment to minimise their accessibility to interested others.

However, more often than not the driver behind the chosen structure is **legitimate tax minimisation**. The income tax rate for companies remains materially lower than the highest individual marginal rate, and consequently companies remain an attractive vehicle for the conduct of a business. Trusts allow for the distribution of income, often across a broad group of beneficiaries, which again can be attractive from a taxation perspective. Superannuation funds continue to offer tremendous tax concessions to retirees.

The taxation and asset protection advantages offered by these structures are great while the family relationship remains intact. However, when the wealth of the marriage is tied up in a company, trust or superannuation fund, the unravelling required at the time of property settlement can cause all sorts of headaches from a tax perspective. The benefits achieved over the years of a happy marriage can be quickly forgotten when certain tax liabilities crystallise when the structure is pulled apart.

Compulsory marriage breakdown roll over relief from capital gains tax lulls many into the false sense of security that there will be no tax burden associated with asset transfers as part of a property settlement. Unfortunately this erroneous conclusion is held by as many small accountants as family law practitioners, and there must be many tax time bombs waiting to be revealed by an ATO audit.

The principles set down in ***Rosati*** [i] may also result in little attention being given to tax liabilities on the expectation that the Family Court may not take them into account when assessing the pool under section 79 of the Family Law Act.

However, it never ceases to amaze us that tax liabilities seem to be overlooked more often than not, with evidence of the consequences of the orders sought rarely obtained.

Regardless of the level of attention that may be paid to the tax traps by the Court, an essential step in the conduct of all property proceedings must be a thorough review of the taxation consequences of the orders sought, whether by consent or via application to the Court.

The identification of both current and future tax liabilities is equally as important as the identification and valuation of the property and resources of the parties, and this is amplified when a family entity is involved.

Brief review of case law

Before getting into the mechanics of the tax dramas that may arise when splitting a pool of assets on marriage breakdown, a brief review of the Court's approach to taxation may be of benefit.

Carruthers v Carruthers (1996) FLC 92-707

In this case, the husband sought to bring into account as a liability the capital gains tax and selling expenses on the notional disposal of various parcels of real property.

The approach was based on the husband's proposal that an Order should be made that the wife transfer a number properties to the husband and upon his proposition, it would be necessary to sell these properties in order to finance a new purchase that he was committed to make.

It was reported, that at the time of the trial, title for the husband's new purchase had not issued but was expected to issue in the near future.

In considering whether an allowance for tax and other realisation costs should be made, the trial judge considered the following:

1) "…tax law is not a constant, and differing views have been taken in this country to rates and the incidence of capital gains tax from time to time. The longer the likelihood of a particular property being retained, then in my view the less it is justifiable to treat the property as being subject to a present notional liability";

2) "… the person who holds the property may, over a period be able to so arrange his or her affairs as to heavily reduce, if not completely eliminate the liability…"; and

3) “…the extent of the liability will fluctuate with the market and as it is not a present liability, if the person who holds the property does not propose to realise it, the incidence of the tax might be quite different at the time of sale.”

Nicolson CJ concluded that “the husband should be allowed a substantial proportion of these costs, but I do not think that he should have all of them and I propose therefore to allow him the realisation costs and capital gains tax effects in relation to the relevant properties other than Balfe Street”

Accordingly, it has become a widely adopted practice to make an allowance for tax and other realisation costs where the asset is likely to be disposed of, or the Orders of the Court will cause a disposal.

Rosati v Rosati (1998) FamCA 38

The husband in this case was a real estate agent, operating a real estate agency, “LJ Hooker Crows Nest” through a trust known as the “LJ Hooker Trading Trust”. The husband asserted that he was suffering mental health issues and accordingly wished to sell his business and find alternative employment, but the trial Judge opined that the husband’s health problem did not necessitate that course of action occurring.

Accordingly, the trial Judge considered that it was “appropriate to take into account his capacity to continue to carry on business at the present for the purpose of these proceedings”. However, he also took into account the fact that if the business were to be sold, the husband could be liable for capital gains tax with the amount of tax dependent upon factors including the timing of the sale and the sale price.

The decision of the Full Court in Rosati v Rosati (1998) FamCA 38 affirmed the trial Judge’s approach of not making a specific allowance for capital gains tax when determining the value of the property pool, rather the possibility of CGT arising was taken into account as a s 75(2) factor, at para 6.44:

> “this is not a case in which we think the evidence was so clear, and the prospects of a sale of the entire business in the short term so likely, that in the absence of an order for its sale it was an error not to make such an allowance. Rather we think that it was within the proper exercise of His Honour's discretion to take the prospect of such a tax being incurred by the husband into account as a relevant Section 75(2) factor, as His Honour said that he did, and as we have no doubt that in fact he did.”

The judgment in Rosati (para 6.36) contains a succinct analysis of the reported decisions prior to that case:

"It appears to us that although there is a degree of confusion, and possibly conflict, in the reported cases as to the proper approach to be adopted by a Court in proceedings under s 79 of the Act in relation to the effect of potential capital gains tax, which would be payable upon the sale of an asset, the following general principles may be said to emerge from those cases:--

(1) Whether the incidence of capital gains tax should be taken into account in valuing a particular asset varies according to the circumstances of the case, including the method of valuation applied to the particular asset, the likelihood or otherwise of that asset being realised in the foreseeable future, the circumstances of its acquisition and the evidence of the parties as to their intentions in relation to that asset.

(2) If the Court orders the sale of an asset, or is satisfied that a sale of it is inevitable, or would probably occur in the near future, or if the asset is one which was acquired solely as an investment and with a view to its ultimate sale for profit, then, generally, allowance should be made for any capital gains tax payable upon such a sale in determining the value of that asset for the purpose of the proceedings.

(3) If none of the circumstances referred to in (2) applies to a particular asset, but the Court is satisfied that there is a significant risk that the asset will have to be sold in the short to mid term, then the Court, whilst not making allowance for the capital gains tax payable on such a sale in determining the value of the asset, may take that risk into account as a relevant s 75(2) factor, the weight to be attributed to that factor varying according to the degree of the risk and the length of the period within which the sale may occur.

There may be special circumstances in a particular case which, despite the absence of any certainty or even likelihood of a sale of an asset in the foreseeable future, make it appropriate to take the incidence of capital gains tax into account in valuing that asset. In such a case, it may be appropriate to take the capital gains tax into account at its full rate, or at some discounted rate, having regard to the degree of risk of a sale occurring and/or the length of time which is likely to elapse before that occurs.

JEL V DDF (2001) FLC 93-075

This was an 18 year marriage which produced three children. The wife's son from her previous marriage also lived with the parties. In the course of the marriage the husband (a geologist) literally struck gold, through a management buy-out of his employer's Australian mineral assets, and created the largest gold mine in Queensland. He subsequently sold his interests and went into other investments.

By the time of the trial the assets stood at $44 million.

In considering the application of realisation costs and capital gains tax, the trial Judge, May J., identified the issues as being whether the realisation costs should be deducted from the whole of the pool or from only those assets to be distributed. Her Honour concluded that the realisation costs:

> "should only be taken into account in respect of any assets which are actually to be sold or transferred pursuant to the orders of this Court or which must inevitably be sold to enable the husband to comply with such orders."

She later also stated:

> "While, of course, it is correct the assets have been acquired with a view to making a profit, the husband cannot fairly be allowed to assert that the wife should contribute to capital gains liability and other potential tax liabilities when it is far from clear when and if these liabilities will ever arise".

The husband appealed that realisation costs should have been fully taken into account, not just partially applied, noting:

(a) the fact that the net assets were contained within a trust structure and the only way for the husband or wife to access the assets was to transfer them to themselves and/or convert them to cash which would attract realisation costs;

(b) that the net realisable method of valuation had been adopted by both accountants; and

(c) the fact that each and every asset of the parties and the Trust had been acquired for an investment with a view to ultimate sale at a profit.

The appeal was unsuccessful.

I note that this appears to be an overly onerous application of the second limb of the Rosati principles, regarding the nexus between the purpose of the asset holding and an allowance for tax. While it was clear that certain assets had been acquired with a view to making a profit, and all of the assets were valued on a net assets basis, the uncertainty about the timing of such liabilities crystallising led to only a partial allowance being made.

Jarrott & Jarrott (2012) FamCAFC 29

This case involved an appeal from a decision of Cleary J to the Full Court of the Family Court of Australia. Relevant for the current purposes, the Full Court considered the correct expression of an order for the realisation of assets and the proper way in which to consider Capital Gains Tax (CGT) liabilities that "could" occur as a consequence of compliance with property settlement orders.

In the primary decision, the trial judge determined the parties' contributions to be 75% by the husband and 25% by the wife. This was adjusted by increasing the wife's entitlement by 10% pursuant to section 75(2) factors such that the assets were to be split 65/35 in favour of the husband. Such a conclusion resulted in an order that the wife receive a lump sum payment of $765,000.

As part of the property division, the trial judge also ordered that the former matrimonial home be sold. While it was not expected that there would be any net proceeds of sale after amounts for the cost of sale and mortgage were deducted, the balance, if there was any, was to be paid to the wife.

In reviewing this decision, the Full Court noted the authorities which confirm that, where orders require the realisation of assets, those orders should be expressed in percentage terms. This is necessary because, if the orders are not expressed this way and an asset is realised for significantly more or less than the values relied on at trial, then the overall percentage entitlements of the parties will be altered.

In this regard, the Full Court considered that, if the sale of the matrimonial home generated a surplus after the payment of agent's commission, legal fees and the mortgage, the wife would be entitled to that surplus as well as retaining her entitlement to receive $765,000. Such an outcome would increase the wife's entitlement above 35% and cause a corresponding decrease in the husband's percentage entitlement.

It was therefore, held that the trial judge had failed, when making her orders, to express those orders in percentage terms which was potentially to the detriment of the husband and contrary to the authorities.

The husband also submitted that in order to meet the wife's entitlement pursuant to the trial judge's orders, he would have to either borrow from or through the company in which he held a majority shareholder (the D company) or sell some shares in it. It was submitted that if the husband had to sell shares then this would, on balance, give rise to a Capital Gains Tax liability of $80,000 - $90,000. Further, a loan through the D Company which was not repaid within 12 months would also attract a tax liability. It was the husband's position that the trial judge had failed to take into account this cost.

The Full Court found that the trial judge had correctly accepted that a tax debt "could" arise in complying with the orders. However, the Court went on to note that failing to include that possibility in the balance sheet was not erroneous but, that having not done so, it was necessary to have regard to it in the context of the consideration of the section 75(2) factors.

The Full Court considered that the trial judge had accounted for the possible CGT event in making her percentage adjustment. However, it was not clear exactly how this had been done.

The Full Court noted that an "all or nothing" approach of either including CGT or not, but trying to take it into account under s 75(2) had the potential to visit an injustice upon one of the parties. If an allowance was made on the balance sheet, or pursuant to s75(2), and no CGT liability materialised, the wife would be disadvantaged. Alternatively, the husband could be disadvantaged if CGT did materialise and the trial judge had discounted that figure significantly in respect to s75(2) because its incidence was only a possibility.

The Full Court held that a CGT event was not inevitable and therefore, pursuant to Rosati v Rosati, the appropriate course in this situation would have been to have made a contingent order, which would operate if and when a CGT liability arose.

Lovine & Connor and Anor (2012) FamCAFC 168

Again, the key relevant issue in this case related to an anticipated CGT liability, with the wife making a cross-appeal in relation to an allowance of $300,000 made by the trial judge. The CGT liability was associated with the potential sale of shares by the husband in order to fulfil his obligations under the orders made by the court, and had been taken into account by the trial judge when calculating the divisible pool.

The trial judge had calculated an overall division of 60%/40% in favour of the husband. In giving effect to these orders the wife was to receive, amongst other assets, cash payments from the husband.

The trial judge in this case had concluded that, in order to fulfil his obligations under the orders, the husband had three possible options. Those were:

(a) To sell shares and other property, which would be subject to CGT;

(b) To borrow the money, which would require the payment of interest from income as well as ultimately having to pay the principal amount; or

(c) To sell the property that was the primary residence, which would not be subject to CGT. However, the trial judge considered that the costs of the sale and of the purchase of another residence would not be dissimilar to the amount claimed by way of CGT.

The only evidence before the trial judge was the husband's own calculations (which were not accepted) as to the CGT liability that would be incurred if the whole of his share portfolio was sold. There was therefore no evidence as to the CGT liability if other property was sold, nor evidence of the cost of any borrowing, or the likely cost of realising the sale of the principal residence.

It was argued by the husband that there was a significant risk of the assets being sold in the short to mid-term and, in these circumstances, the court could take that risk into account as a relevant section 75(2) factor as per Rosati & Rosati. However, the Full Court held that the fundamental difficulty with this proposition was that such an approach was referrable to the incidence of capital gains tax, upon the sale of a particular or specified asset . In this case, the judge had identified a number of possible alternatives, none of which were elevated as more likely than another, and which may incur costs other than the CGT or costs of asset realisation.

The Full Court considered that, as the husband had not established the quantum of his claim for realisation costs, there was no evidentiary basis for the learned trial judge's determination to allow a liability in the determined amount of $300,000. The Full Court, following Jarrott & Jarrott, held that the trial Judge should have made orders such that, if the husband did incur a liability or legitimate realisation cost in selling assets to meet his liability under the Orders, then the parties should share in that liability in proportion to their beneficial entitlements as determined (i.e. in their percentage shares).

It is therefore essential to have an understanding of the tax consequences in order to persuade the Court that any order should be made in respect of taxation.

Capital Gains Tax (CGT) consequences of a property settlement

Capital gains tax is normally payable on the differential between the capital proceeds from disposal (or deemed market value when the transaction is not arm's length) and the "cost base" of an asset. The cost base includes the original purchase price as well as other purchase and disposal costs relating to the asset. Depending on whether the owner of the asset is an individual or an entity, the effective rate of capital gains tax will vary.

The transfer of assets between spouses, from an entity to a spouse, or between entities will constitute "a CGT event". In the absence of any roll over relief, the transfer would ordinarily result in a capital gain being realised by the transferor.

In order to determine the capital gains tax consequences of a property settlement it is necessary to consider whether the asset being transferred is subject to CGT and whether there are any roll-over provisions available to reduce or eliminate the CGT.

Is the asset being transferred subject to CGT?

Assets for CGT purposes include tangible assets such as real estate or shares as well as intangible assets such as the goodwill of a business. As a general rule, the following assets are normally **exempt** from CGT:

- Assets acquired prior to 20 September 1985 ("Pre-CGT assets")
- Cars and motor cycles
- Collectables (eg artworks or jewellery) costing less than $500
- Certain personal use assets costing less than $10,000
- Assets used to produce exempt income
- The main residence of the party/parties

It is also of interest to note that there may be other CGT exemptions available on the sale of a small business or business asset, which may eliminate or reduce the owner's capital gains tax liability. The small business CGT concessions include the small business asset rollover, the small business 50% active asset reduction, the 15 year exemption and the retirement exemption. There are various eligibility criteria that must be met for a tax payer to achieve these exemptions, however they are worth exploring as in some instances the CGT otherwise payable may be reduced to $Nil.

Will there be roll-over relief on transfer of assets to a party?

(a) Transfers between spouses

Any capital gain or loss arising to the spouse on the notional disposal by them of their interest in an asset to the other spouse will be disregarded under the compulsory marriage breakdown rollover relief pursuant to s126-5 of the Income Tax Assessment Act 1997 ("ITAA 1997").

The marriage breakdown rollover relief is compulsory where an individual disposes of an asset to his/her spouse (including same sex spouse) as a consequence of:

- A court order under the Family Law Act 1975 or a corresponding foreign law;
- A court order under a state, territory or foreign law relating to de facto marriage breakdowns.
- A binding financial agreement made under the Family Law Act 1975 or a corresponding foreign law;
- An arbitral award made under the Family Law Act 1975 or a corresponding foreign law; or
- A binding written agreement that is made under a State law, Territory law or foreign law relating to de facto marriage breakdowns and that, because of such law, cannot be overridden by an order of a court (except to avoid an injustice).

(b) Companies and trusts

The rollover relief also applies where a CGT asset is transferred from a company or trust to an individual. The recipient of the asset must be an individual (being one of the parties to the marriage), unfortunately the relief does not work in the reverse.

Where the marriage breakdown rollover relief is applied, any gain or loss to the company or trust is disregarded (s126-15 ITAA 1997).

On receipt of the asset, there will be no CGT implications for the transferee spouse. There **may** be CGT on eventual disposal of the asset by the transferee spouse. This will depend on the differential at the time of sale between the sale price and the cost base of the asset.

As the transferee spouse did not originally pay for the asset, the legislation provides a deemed cost base for the asset, based on whether the asset is a pre-CGT asset (originally purchased prior to 20 September 1985) or a post-CGT asset (originally purchased subsequent to 20 September 1985) as follows:

- for post-CGT assets transferred between the parties, the cost base of the asset will be the asset's cost base to the transferor spouse at the time the transferee spouse acquired the asset.
- for pre-CGT assets transferred between the parties, the asset retains its pre-CGT status in the hands of the transferee spouse – ie there will be no capital gains tax on ultimate disposal of the asset.

Non-deductible holding costs may be able to be added to the cost base when calculating any capital gain in the event of a future sale. Such costs would include for example, interest on borrowings, rates and repairs, where these costs have not already been claimed as a tax deduction.

Example:

Mandy and John are the shareholders in an investment company, Colorado Investments Pty Limited, which owns a residential investment property that is to be transferred to Mandy as part of their property settlement.

The investment property was purchased in 1998 for $300,000 and is now worth $650,000. The company will transfer this property to Mandy pursuant to a consent order made under the Family Law Act.

At the time of transfer, there is no capital gains tax implication for either Mandy or Colorado Investments Pty Limited. The cost base to Mandy will be $300,000.

However, in the event of future sale, Mandy will pay capital gains tax by reference to this cost base, not the value of the property at the time of transfer. She should be informed of this at the time of agreeing to take the property as part of the settlement. This is not the only adverse implication for Mandy, as there may be a taxable deemed dividend implication, as discussed in detail below.

The consequences of the roll over relief may also result in a reduction in the cost base of shares or units in the entity held by other shareholders, ultimately leading to higher capital gains tax on the eventual sale.

It is critical to note that this is not the end of the tax consequences for Mandy. While the transfer of the property is free from an immediate CGT consequence, there is an income tax problem, via Division 7A, that must be taken into account. We will deal with that shortly, along with the "double tax" drama.

(c) Superannuation Splitting – CGT consequences

Where CGT assets are transferred in specie (eg off-market share transfers, property transfer) between superannuation funds, there will normally be CGT payable. However, roll-over relief is available in a marriage or relationship breakdown if the transfer occurs as a consequence of an award, court order or agreement, as detailed above.

Roll-over relief is available in a marriage breakdown, which will permit one spouse to transfer their entire in specie interest in a small superannuation fund[ii] to another complying superannuation fund[iii] without there being an immediate CGT taxing point (s126-140 of ITAA 1997). The transferee superannuation fund will be deemed to acquire the CGT assets at the same cost base and at the same time as the original acquisition by the transferor fund.

Main residence exemption

Generally, the main residence exemption allows a taxpayer to disregard a capital gain or loss that is made from a CGT event happening to a dwelling that is the taxpayer's main residence (e.g. the matrimonial home). The key points of how the exemption operates are summarised below:

For a taxpayer to qualify for full exemption:

- the taxpayer must be an individual;
- the dwelling must have been the taxpayer's home (generally the disposal relates to a dwelling or an ownership interest in a dwelling);
- the dwelling was the taxpayer's main residence for the entire ownership period;
- the disposal resulted from one of a number of specified CGT events (s118-110).

A partial exemption may be available if:

- the dwelling was the taxpayer's main residence during only part of the period that the taxpayer owned it (s118-185); or
- the taxpayer used the dwelling to produce assessable income (e.g. to derive rental income), noting the exemption is reduced in certain circumstances (s118-190).

Where a transferor spouse acquires an ownership interest in a dwelling after 19 September 1985 and marriage breakdown rollover is available to the transferor spouse, the main residence exemption rules take into account the way in which **both** the transferor and transferee spouses used the dwelling when determining the transferee spouse's eligibility for the main residence exemption (s 118-178)[iv].

If marriage breakdown rollover relief applies to the transferee spouse, the following applies to the transferee spouse with respect to the interest in the home transferred from the transferor spouse:

- the transferee spouse is taken to have acquired their ownership interest at the time that the transferor spouse acquired their ownership interest;
- from the date of acquisition until the time of transfer to the transferee spouse:
    - the transferee spouse is taken to use the dwelling in the same way as the transferor spouse; and

- the dwelling had been the main residence of the transferee spouse for the same number of days as it was the main residence of the transferor spouse.

This rule applies to CGT events that are trigger events for the rollover on or after 13 December 2006. Prior to 13 December 2006, only the use of the dwelling by the party who retained the former matrimonial home was considered when determining their eligibility for the main residence exemption when the home was ultimately sold. *It cannot be assumed that the former matrimonial home is free of CGT consequences where it has always been used as a family home.*

The CGT implications may be substantial where a new property has been acquired by the spouse no longer residing in the former matrimonial home and:

- the home was owned for a relatively short period of time prior to separation; and/or
- the home is located in a high growth property market; and/or
- there is a long period between separation and property settlement.

Under the current regime, there may be a favourable impact for a spouse who acquires an investment property that was previously a main residence of the other spouse, as the main residence use by the transferor spouse may be taken into account to reduce the capital gain on future disposal by the transferee spouse.

If a dwelling that was a taxpayer's main residence stops being their main residence, the taxpayer may choose to continue to treat it as a main residence. The maximum period that the dwelling can be treated as a main residence is:

- six years, if the dwelling is used for income-producing purposes while the taxpayer is absent; and
- indefinitely, if the dwelling is not used for income-producing purposes.

A person cannot use the main residence exemption on more than one property concurrently. If the taxpayer owns more than one dwelling during a particular period, only one dwelling can be the main residence at any one time. An exception to this rule can arise where the taxpayer acquires a new residence while they continue to hold their former residence (because they are in the process of selling their former residence). Both properties will be treated as main residences for either six months or when the former residence is sold (whichever is shorter) (s118-140).

Where the spouse no longer residing in the former matrimonial home acquires a new main residence, their main residence election should be clearly set out as a notation in the orders.

An example of such an election can be obtained from the Delbridge Forensic Accounting website. See **www.delbridgeforensic.com.au/support-documents.**

Income tax consequences of private company payments and asset transfers - "Deemed dividends"

In some circumstances, the transfer of an asset, the payment of cash or the forgiveness of loan advanced from a private company to a party will result in the party being deemed to receive a taxable dividend. This may be the case regardless of whether there is a Court order to transfer the asset, pay the cash or forgive the loan. The relevant area of legislation is Division 7A of the Income Tax Assessment Act 1936 ("Div 7A" "ITAA 1936").

Unfortunately there is a misconception that because there is relief from CGT there is nothing else to worry about, hence the Div 7A trap that many unsuspecting parties fall into. Often this is the "non-business" spouse, who has a limited understanding of both the structure and the consequences of receiving assets from a company or trust structure.

General overview of Division 7A

A deemed dividend[v] may occur when a private company pays an amount to a shareholder or associate, or forgives a shareholder (or associate) loan. A "payment" includes the transfer of property or the granting of guarantees and meeting of guarantee obligations.

An "associate" of a shareholder is broadly defined in s318 ITAA 1936 as a relative, partner, trust controlled by the shareholder or company controlled by the shareholder.

Importantly, it is the person who receives the benefit who is taxed, not the shareholder. The risk may therefore lie with the non-suspecting ex-spouse who receives an asset or payment from a company, not the shareholder spouse.

The payment, if deemed to be a dividend pursuant to Div 7A, is not frankable, resulting in the full amount being taxed at the marginal rate of tax of the individual without any credit for the tax already paid by the company. Div 7A is meant to be onerous, to encourage companies to properly declare dividends, taxable in the hands of shareholders.

Excluded Payments

Certain payments may qualify as excluded payments, ie Div 7A does not apply to the payment by the company. Two of the exclusions are:

- Loans made on commercial terms (s109N); and
- Payment of a genuine debt (s109J)

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Commercial Loans (‘the 109N exemption”)

A loan made on commercial terms is excluded from the application of Div 7A. The minimum loan requirements are contained in s109N of ITAA 1936, including:

- Loan must be made under a **written agreement**
- Maximum term of 25 years for secured loans and 7 years for unsecured
- Security must be real property
- Market value of security must be a least 110% of the loan advanced
- **Interest must be charged** at the minimum benchmark rate
- Minimum loan repayments must be made annually

Often the payments made by a company for the benefit of the shareholders and their associates are accumulated in a loan account balance owing back to the company (“a debit loan account”). Many parties, and their accountant, assert that a debit loan account is a complying loan pursuant to Division 7A s109N, yet they are unable to produce a copy of the written loan agreement and there is no interest income being declared in the company financial statements. The absence of both must lead to a reasonable suspicion that the debit loan account is not actually a complying commercial loan, and there is a heightened risk of the amount being a deemed dividend in the hands of the shareholder.

Care must also be taken when the security position changes as a consequence of the marriage breakdown, as the s109N requirements may be breached if the security is no longer available.

Payment of a genuine debt (“the 109J exemption”)

The 109J exemption has been utilised in the past to assist in the settlement of large property cases, where significant wealth has accumulated in a corporate structure. The exemption has been obtained by the company being joined as a party to the proceedings, and then being ordered to pay an amount to a spouse. While this exemption was probably always too good to be true, it has been utilised under the watch of the ATO, resulting in multi-millions in income tax being legitimately avoided.

On the basis of previous private rulings issued by the ATO, the apparent policy of the ATO has been that if the Family Court ordered a cash payment be made to an associate of a shareholder, prima facie the amount was considered a deemed dividend under Division 7A of the ITAA 1936. However, the payment was excluded from the provisions of Division 7A pursuant to the s109J exemption, which specifically excludes payments that discharge an obligation of the company to pay money.

The amount was required to be paid as cash, not an in specie distribution of property. The ATO had previously accepted that a court order made in respect of Family Law proceedings was an obligation of the company. Accordingly, the payment to a spouse on the basis of a court order was not considered a dividend for income tax purposes. The 109J exclusion enabled a very tax effective redistribution of wealth accumulated in a corporate structure, as amounts could be paid to a spouse without tax consequences crystallising.

However, **on 31 July 2014 the Australian Taxation Office issued a new taxation ruling, TR 2014/5** (having released a draft ruling in November 2013), reversing its position in respect of the taxation effect of orders made in Family Law proceedings that involve payments from companies.

The effect of the policy change is that there will be no relief from a Division 7A deemed dividend consequence via the "109J Payment of a Genuine Debt" exemption.

The ruling states that:

"Where a section 79 property order requires:

- *A private company, or*
- *A party to the matrimonial proceedings to cause the private company,*

to pay money or transfer property to a shareholder of the private company, the payment of money or transfer property in compliance with that order is an ordinary dividend to the extent paid out of the private company profits and is assessable income of the shareholder under section 44 of the ITAA 1936".

Similarly, a payment of money or transfer of property to an associate of a shareholder in compliance with such an order is a payment for the purposes of s 109C(3) of the ITAA 1936.

Specifically, section 109J does not prevent the payment from being treated as a dividend under subsection 109C(1). The dividend is frankable to the extent permissible under normal franking rules.

The effect of the ruling is that there is now a difference between a payment to a shareholder and a payment to an associate of the shareholder, with a shareholder taxed under section 44 and an associate taxed under 109C(3). While the ruling may be the subject of challenge by a taxpayer in the future, the policy of the ATO is clear.

All orders in Family Law proceedings made from 13 November 2013 have been subject to the terms of the draft ruling.

The ATO has acknowledged that the ruling differs from their previous position and numerous private rulings issued. The ATO has stated that they will not undertake active compliance activities in respect of the treatment of payments prior to 13 November 2013.

This effectively means that they are not going to actively search for and review payments of this nature.

However, should such a payment be brought to their attention via an audit or some other process, and it falls within the applicable amendment period, an amended assessment will be issued by the ATO with the settlement taxed as a deemed dividend. If the taxpayer had obtained a private ruling, the conclusions of the private ruling will apply for the specific transaction. Private rulings are only binding for the specific taxpayer who requested the ruling.

The reporting of the ATO stance on this has been irresponsibly reported in the media to date, with headlines such as "*property settlements will halve*". This loophole was used infrequently, in large property cases, and will not have a widespread effect on the resolution of the vast majority of property proceedings.

However, it is imperative to seek taxation advice prior to the making of orders involving a company to ensure all tax liabilities of the parties are quantified.

Forgiving a debt

As noted above, often the payments made by a company for the benefit of the shareholders and their associates are accumulated in a loan account balance owing back to the company ("a debit loan account"). Even if there is a complying loan agreement entered into that achieves an exclusion from Div 7A under 109N in the year the loan is advanced, the loan must be dealt with properly, not forgiven. It is essential to consider the tax consequences that will crystallise if a debit loan owing by one of the parties is simply "forgiven".

The forgiving of the loan may result in an unfrankable deemed dividend being assessed to the party benefiting from the forgiveness. An alternative course of action should be explored, such as the other spouse (who is retaining the company) taking responsibility for the loan. A further alternative might be the declaration of a franked dividend to clear the loan the account, which while taxable, is a better outcome than an unfranked dividend.

Division 7A and trusts

Care must also be taken when assets are transferred from a trust to one of the parties if there is an unpaid present entitlement owing by the trust to a corporate beneficiary. **Subdivision EA** of Div 7A may intervene to deem the payment by the trust to be a deemed dividend from the related company. It is erroneous to conclude that because the asset is coming from a trust that there is no potential for Div 7A to come into play.

Marriage breakdown concessions (s109RC)

Division 7A provides that deemed dividends arising from "payments" on or after 1 July 2006, in respect of marriage or relationship breakdowns, may be frankable[vi] by the private company taken to have paid the deemed dividend (see **s109RC of ITAA 1936**)[vii].

The dividend may be franked irrespective of whether it was made to a shareholder or associate of the shareholder (for example, a former spouse). Accordingly, while the transfer of property from a private company to a spouse who is a shareholder or associate will continue to be treated as a dividend, this deemed dividend may be franked by the transferor company. It is important to note that top up tax may be payable by the recipient of the dividend, even where it is franked.

It should be noted that the dividend may only be franked in the same circumstances that CGT roll-over relief applies in relation to marriage breakdowns.

Example:

Mandy is to receive the residential investment property valued at $650,000 from Colorado Investments Pty Limited, a company owned by herself and former spouse John.

The transfer of the property to Mandy will result in a deemed dividend to her under Div 7A. The company has a distributable surplus in excess of the amount of the deemed dividend, and sufficient franking credits such that the deemed dividend can be fully franked under s109RC.

The income tax that will be payable by Mandy, in the year ended 30 June 2015, is calculated as follows:

Tax payable on deemed dividend	***$***
Deemed dividend	*650,000*
Franking credits attached	*278,570*
Gross dividend	*928,570*
Income from other sources	*180,000*
Taxable income	*1,108,570*
Tax including Medicare of 2%	*513,146*
Less: Franking tax offset	*(278,570)*
Total Tax payable by Wife	***234,576***
Tax on other income	***(58,147)***
Tax on deemed dividend	***176,429***

In Mandy's situation, the size of the deemed dividend, together with her significant income from other sources, sees her paying top up tax on the deemed dividend of 27.14%[viii].

Delbridge forensic accounting

However, in certain situations, the use of the deemed dividend rules and the s109RC concession may actually facilitate a favourable tax outcome for the parties.

The use of the provisions may enable value to be unlocked from a corporate structure in favour of one of the shareholders, that might not have otherwise been possible where all shares are of the same class. Depending on the size of the deemed dividend and the other income derived by the recipient party, the top up tax may be minimal.

The "double tax" drama

One of the bigger dramas that may arise due to the application of Division 7A pertains to the interplay between those provisions and the compulsory CGT rollover relief on marriage breakdown.

Despite being taxed on the receipt of an asset pursuant to Division 7A, this does not override the cost base rollover. On the subsequent sale of the asset, the cost base will be the amount rolled over from the company, pursuant to s126-15 of the ITAA.

Working with the example of Mandy as set out above, should she need to sell the property within 12 months of acquiring it from Colorado Investments, she would pay capital gains tax of $171,500 (being proceeds of $650,000, less cost base of $300,000, taxed at 49% in the 2015 fiscal year). Add this tax to the top up tax of $176,000 calculated above on the deemed dividend, and her total tax exposure is $347,500. An asset that she thought was worth $650,000 nets out to be $302,500.

Goods and Services Tax (GST) consequences on asset transfers

There is no general relief from GST on transactions that are entered into as a consequence of marriage or relationship breakdown.

The views of the ATO regarding the GST consequences of the transfer of assets following marriage or relationship breakdown are set out in GSTR 2003/6, with the ATO making a distinction between "private assets" and "enterprise assets".

An **enterprise asset** means real property, tangible and intangible personal property that is owned by either or both spouses or a related entity and used or intended to be used in an "enterprise" of the entity that is registered or required to be registered for GST. Examples of enterprise assets include trading stock, plant, office equipment, motor vehicles and real property.

A **private asset** means any property that is not an enterprise asset.

GST is imposed on taxable supplies, being:

- A supply for consideration;
- Made in the course of furtherance of an enterprise;
- Connected with Australia;
- Made by a registered person or person required to be registered for GST.

The transfer of private assets between spouses who are not registered (or required to be registered) for GST have no GST consequences.

Where an enterprise asset is transferred to a spouse under a matrimonial property distribution, there is a **supply** for GST purposes. However, if the supply is made for no consideration, GST will not be paid on the supply. The GST provisions that may deem market value consideration will generally not be applied in respect of supplies made as a consequence of marriage breakdown.

Where consideration is paid for the supply, further consideration is required as to whether the supply is made in the course of furtherance of an enterprise. This will generally not be the case for asset transfers made on marriage breakdown as the supply is considered to be made for private reasons.

While GST may not be required to be paid in respect of the transfer of an enterprise asset to a spouse, there may be an adjustment to the input tax credit previously claimed on the original acquisition of the enterprise asset, due to the change in use of the asset by the enterprise. The result is that there may be GST “payable” by the transferor spouse.

Example

Michael is an architect and conducts a small practice in partnership with Steven. Michael and Sarah have divorced and as part of the property settlement, a motor vehicle owned by the partnership will be transferred to Sarah.

The transfer of the car to Sarah will be a taxable supply, as the partnership is registered for GST, however as there is no consideration paid by Sarah the transaction will not be subject to GST.

However, the car has been used in the business to date and the partnership has previously claimed an input tax credit in respect of the car. When the car is transferred to Sarah, it is considered to now be applied for a private or domestic use and no longer has a creditable purpose. An adjustment may be required to reverse the input tax credit previously claimed by the partnership. Section 129-40 of the GST Act contains the method for calculating this adjustment.

It is important to note that if the car was held in a corporate structure, the transfer of the car to Sarah would give rise to a **deemed dividend** problem as detailed above.

Stamp duty consequences on asset transfer

The often forgotten tax trap of an asset transfer from a company or trust structure is stamp duty.

In all states and territories, asset transfers from an entity to one of the parties must be reviewed on a case-by-case basis, with differing exemptions across each state and territory.

References

i ***Rosati v Rosati*** (1998) FLC 92-804

ii Small superannuation fund means a complying superannuation fund (see below) with four or fewer members. Self managed superannuation fund has the same meaning as in the Superannuation Industry (Supervision) Act 1993 and is a small superannuation fund.

iii Complying superannuation fund means a complying superannuation fund within the meaning of section 45 of the Superannuation Industry (Supervision) Act 1993.

iv Section 118-178 ITAA 1997 was inserted by Tax Laws Amendment (2006 Measures No 4) Act 2006 (Cth).

v While, notionally, the amount of a particular Div 7A dividend calculated under a payment of property is the arm's length value of the property, this is proportionately reduced if the total of all Div 7A dividends taken to be paid by the private company for the income year exceeds the "distributable surplus" of the company for that year as calculated by the formula at s 109Y ITAA 1936. In other words, the maximum deemed dividend payable in the year of income will be the amount of the distributable surplus and not the arm's length value of the property. Care needs to be taken in properly assessing the quantum of the distributable surplus.

vi It should be noted that whilst Div 7A allows the deemed dividend to be franked, the franking percentage will be dependent on the benchmark rate and whether the company has any franking credits available (see Part 3-6 of ITAA 1997).

vii Prior to 1 July 2006, the deemed dividend arising from "payments" in respect of marriage or relationship breakdown could not be franked. This was amended on 21 July 2006 in Tax Laws Amendment (2007 Measures No 3) Act 2007 and is retrospective back to 1 July 2006.

viii The tax payable in 2015 includes the 2% budget repair levy.