



Cutcher & Neale

FORENSIC ACCOUNTING

## TAKING THE PAIN OUT OF TAX AND FAMILY LAW

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## TAKING THE PAIN OUT OF TAX AND FAMILY LAW

There are two important times when tax should be considered in Family Law matters. Firstly, when the value of the matrimonial pool of assets is being determined and secondly, when the pool of assets is being divided.

When determining the value of the matrimonial pool of assets, should tax be taken into account? If so, how? For example, how should the future tax liability in relation to an unrealised capital gain be treated? Should it be deducted from the value of the asset? Should it be taken into account as a section 75(2) factor? Or should it be left out all together? Do the parties and the Courts want to treat the future tax liabilities differently?

When dividing the matrimonial pool of assets, are there any tax planning opportunities? Can effective tax planning increase the value of the pool of assets post settlement? If you do not consider the taxation implications of a settlement, could you end up triggering an unforeseen tax liability for your client?

The questions posed above are just some of the common tax issues that arise in many Family Law matters. This paper aims to take away some of the pain often associated with the taxation implications of Family Law matters. Before going through a number of examples of tax issues that often arise in Family Law matters, I have set out a summary of how individuals are treated for income and capital gains purposes and how this treatment differs in relation to entities such as companies, trusts and self managed superannuation funds.

### SUMMARY OF TAX TREATMENT OF INCOME AND CAPITAL GAINS

#### Tax payable by individuals

As most people would be aware, individuals are taxed on their income at marginal rates of tax, where higher incomes are taxed at higher rates. Below is a summary of the marginal rates of tax applicable for the year ended June 2011:

Taxable income	Tax on this income
0 – \$6,000	Nil
\$6,001 – \$37,000	15c for each \$1 over \$6,000
\$37,001 – \$80,000	\$4,650 plus 30c for each \$1 over \$37,000
\$80,001 – \$180,000	\$17,550 plus 37c for each \$1 over \$80,000
\$180,001 and over	\$54,550 plus 45c for each \$1 over \$180,000

In addition, the Medicare Levy of 1.5% is generally payable by individuals earning greater than \$21,750 per annum. Medicare Levy is increased to 2.5% for individuals who earn more than \$73,000 and families who earn more than \$146,000, unless they have private hospital insurance. Certain exemptions and reductions may also apply to Medicare.

A capital gain is usually calculated by deducting from the proceeds from sale of an asset (being the selling price less the costs related to the sale such as advertising or agent fees), the cost of acquiring the asset (being the purchase price plus related purchase costs such as stamp duty or legal fees).

For example, if a block of land was purchased for \$200,000 (including purchase costs) and was later sold for \$260,000 (net of selling costs) the capital gain would be \$60,000.

The capital gain of \$60,000 would be included in the individual's tax return as assessable income, unless they had held the asset for more than 12 months. Where the asset has been held for longer than 12 months, only one half of the capital gain would be included as assessable income.

For example, if the taxpayer had \$80,000 of other income, they would include \$30,000 of assessable capital gain in their tax return (assuming they held the asset for more than 12 months). The marginal rate of tax for incomes of between \$80,000 and \$180,000 is 37 cents per dollar. They would therefore pay tax of \$11,100 (37% of \$30,000) plus Medicare of \$450 (1.5% of \$30,000) on the capital gain arising on the sale of the asset<sup>1</sup>.

### Tax payable by companies

Unlike individuals, companies do not have a marginal rate of tax. Companies pay a flat rate of 30% tax on all their income, regardless of the amount.

Unlike individuals, in respect of capital gains, there is no discount of the gain if an asset is held for longer than 12 months. Using the above example of the capital gain of \$60,000 on the sale of land, a company would pay tax of \$12,000 (30% of \$60,000). Where the asset was acquired prior to 21 September 1999, the cost of the asset may be indexed up to September 1999 and therefore the capital gain may be less.

When a company pays a dividend, its shareholders also receive what is called a franking credit or imputation credit. This is a credit for the tax already paid by the company on the profits it is distributing by dividend. For example, if a company with only one shareholder made \$10,000 profit, it would pay \$3,000 in income tax (30% of \$10,000). It would then have \$7,000 left, being its profit after tax. If the company paid out the \$7,000 as a dividend to its shareholder, the shareholder would need to include a total of \$10,000 as income in their tax return, comprising the \$7,000 in cash dividend plus the \$3,000 franking credit. Whilst the shareholder would pay tax on the \$10,000 they would also receive a credit for the \$3,000 tax already paid by the company— which is a little bit like an employee being taxed on their gross income and then receiving a credit for the tax that their employer has paid on their behalf directly to the tax office.

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<sup>1</sup> Where the asset was purchased prior to 1999, an alternative method of calculating the assessable capital gain may be used which involves indexing the cost of the asset. However, the outcome of this method is rarely favourable in comparison to the 50% discount method.

## Tax payable by trusts

Trusts generally do not pay tax. The income that is earned by a trust is generally distributed by the trust to the beneficiaries (in the case of a family/discretionary trust) or to the unit holders (in the case of a unit trust). If the trust distributes some of its income to an individual, the individual must pay tax on that income at his or her marginal rate of tax. If the trust distributes some of its income to a company, then the company will pay tax at 30%.

## Tax payable by superannuation funds

Like companies, superannuation funds pay a flat rate of tax, but instead of 30%, the tax rate payable by superannuation funds is 15%. However, where a superannuation fund makes a capital gain on an asset that was held longer than 12 months, the amount of that gain is discounted in a similar way to that for individuals – except that the discount is one third of the capital gain in comparison to one half of the capital gain for individuals. For example, returning to our example above, if the block of land was held by a superannuation fund for a capital gain of \$60,000, then only \$40,000 (\$60,000 less one third) would need to be included as assessable income and the superannuation fund would pay tax of \$6,000 (\$40,000 times 15%).

It should also be noted that superannuation funds do not pay tax on income that is earned from assets held specifically to pay a pension. For example, if a self managed superannuation fund had only one member and the member was in receipt of a pension, then the rate of tax payable by the superannuation fund would be nil and not 15%.

Further, if the recipient of the pension was over the age of 60, they too would not need to pay tax on the pension received by them.

Having briefly explained how income and capital gains are taxed, let's now have a look at some examples that might arise in Family Law matters

### Example 1: Future capital gains tax on an investment property

With increases in the property values over the years, investment properties held by the parties could have increased in value from the time that they were purchased.

To recap, Capital Gains Tax ("CGT") is normally payable on the difference between the capital proceeds (i.e. the amount the property was sold for less agents fees and other selling costs) and the "cost base" (i.e. usually the purchase price including stamp duty and other costs associated with the purchase).

The amount of tax payable will depend on whether the asset is held by an individual or an entity. It should be noted that CGT will only be payable when a "CGT Event" as defined in the Income Tax Assessment Act is triggered. The most common CGT Event is the disposal/sale of an asset.

The following table is a brief summary of some common tax rates on capital gains:-

Entity	Asset held for less than 12 months	Asset held for more than 12 months
Individual	100% of the gain taxed at the marginal tax rate of the tax payer (maximum rate of 46.5% including Medicare)	50% of the gain taxed at the marginal rate of the taxpayer (maximum rate of 46.5% including Medicare), effectively taxed at 23.25% of the total gross gain.
Company	100% of the gain taxed at 30%.	100% of the gain taxed at 30%.
Superannuation fund	100% of the gain taxed at 15%.	Two thirds of the gain taxed at 15%, effectively taxed at 10% of the total gain.
Trust	Gain distributed to the beneficiary/ies and tax payable by the beneficiary at the rates set out above.	

It should be noted, like in many areas of law, there are exceptions to the above table and therefore it should only be used as a general guide.

As a “general rule” assets that are normally exempt from CGT include:

- Assets acquired prior to 20 September 1985 (“Pre CGT assets”);
- Cars and motor cycles;
- Collectables (e.g. artworks or jewellery) costing less than \$500; and,
- The principal place of residence of the parties.

The following example sets out a practical example to highlight some of the issues and application of capital gains tax.

Assume that the Husband purchased a residential unit in Newcastle in 1999 for \$150,000 as an investment property which was leased via a local real estate agent. The property has a current value of \$300,000.

Ignoring the costs associated with the purchase and sale of the property, there is an unrealised capital gain on the property of \$150,000. Assuming that the Husband is on the highest marginal tax rate, he would pay \$34,875 in CGT on the disposal of the property (being 50% of \$150,000 at a tax rate of 46.5%). However, this tax will only be required to be paid if the property is sold. Therefore, this raises the question of how the notional tax should be treated when valuing the pool of assets held by the parties.

From the Court’s perspective following the decision of Nicholson CJ in ***Carruthers v Carruthers (1996) FLC 92-707***, the widely adopted practice has been 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.

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 CGT when determining the value of the property pool, rather the possibility of CGT arising was taken into account under section 75(2), stating 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 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 judgement in *Rosati* (para 6.36) contains 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 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 that 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 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.*
- 4. 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.*

It appears important, from the Court's perspective, that the likelihood of a possible future sale is a key element in determining whether the potential CGT liability should be taken into account and in what manner. In our example about the investment property in Newcastle, if there is no intention or likely need for the Husband to sell the property, it is my understanding that the Court would often place little or no weight on the future CGT liability.

However, the Court's treatment is often different from that of the parties in settlement negotiations. This is especially so where there are other assets without a CGT liability or possible future CGT liability. Assume that included in the pool of assets is bank account with a balance of \$300,000. Excluding any emotional attachment, most people, including the Husband and the Wife would prefer to have bank account rather than the property with the same gross value. This is because there is no future tax liability associated with the bank account.

The parties tend to place a much greater weight on possible future CGT liabilities than the Court. In negotiations, it seems as though a future CGT liability is more likely to be accepted by the opposing party as something that should be taken into account either by reducing the value of the asset or as a section 75(2) type adjustment. This may be because, considering the example above, both parties would prefer to have assets without any potential future liability and it is logical that when the asset is sold, the tax will be payable.

Therefore, when in negotiations, it is often worthwhile determining the amount of the notional CGT assuming that the asset is disposed of at the value at which it is included in the asset pool. However, the parties should be advised that the Court might consider the future CGT liability in a significantly different manner to how they may have taken it into account. In the event that the CGT on investment assets is not determined, the parties retaining those assets should at least be advised that there may be a future CGT liability on the ultimate sale of the asset.

Should the matter not settle, the future CGT liability should be put before the Court in order to allow the Court to make an informed decision. CGT and realisation costs were also considered in ***JEL and DDF (2000) FamCA 1353*** where CGT on properties required to be realised as a result of the orders were allowed as a liability. The CGT on other assets with unrealised gains, where the Court was not satisfied that there was significant risk that the asset would have to be sold in the short to mid-term, were not taken into account. The discussion on whether or not CGT should be taken into account followed the principles set down in Rosati, however there is one particular issue, while touched on in *JEL and DDF*, does not appear to have been fully explored.

In paragraph (2) of the quote from Rosati above, it is stated that "*...if the asset is one which was acquired solely as an investment and with a view to 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". In considering this issue, the decision in *JEL and DDF* includes the following:

*96. Her Honour's statement that the assets "have been acquired with a view to making a profit" is not a finding that all of the assets were acquired **solely as an investment** and with a view to ultimate sale for profit. To the contrary, it is clear that all of the assets were not acquired solely as an investment. As much as is conceded in the husband's written submissions where it is stated:*

*"The trial Judge ought to have had no doubt that each and every significant asset within the pool (save for the parties' homes and perhaps the Mermaid Beach properties) were acquired for investment purposes with a view to ultimate sale."*

The emphasis on "solely as an investment" is included in the judgement. The submissions by the Husband only state "for investment purposes". Therefore, is there an argument that the potential future CGT on an asset that was **acquired solely as an investment and with a view to ultimate sale for profit** should be taken into account, even if there is no intention or need to sell the asset in the short to mid-term?

Such an argument requires consideration of the differences between acquiring an asset "for investment purposes" versus "solely as an investment". For example, the purchase of an artwork may be for investment purposes but would also provide personal enjoyment and therefore would probably not fit the definition of "solely as an investment". However, there would appear reasonable grounds that the purchase of a share portfolio or an investment property rented out to third parties (excluding a holiday home) was purchased solely as an investment and with a view to ultimate sale for profit.

If such an argument were to be accepted, this would allow the approach of the Court to become more aligned with the attitudes of the parties in their settlement negotiations. It would also align the Court's "value to the owner" valuation objective to the treatment of notional realisation costs. In many instances, the value ascribed to an asset can only be achieved if the asset is realised, hence the inequity if no allowance is made for realisation costs.

However, in order for the Court to take the future CGT liability into account when determining the value of the asset to the party, the Court would need to be satisfied as to the quantum of the liability. If the ultimate sale of the asset is not contemplated in the near future, there would be a number of uncertainties that could impact on the amount of tax payable including the amount of the future sale proceeds, the circumstances of the individual/entity holding the asset and the prevailing tax laws at the time of the sale.

For example, if an individual holds the asset, they may currently be earning an income that places them on the highest marginal tax rate. However, they may choose to hold the asset until such point in time when they are earning less and will therefore pay less tax on the future capital gain due to a reduction in their marginal tax rate. If the asset was held by a discretionary

trust, it may be difficult to determine the tax position because there could be a number of beneficiaries to which the gain could be distributed to.

The difficulties in quantifying the tax with any reasonable level of certainty may result in the Court being unable to take into account the future CGT liability in determining the value of the asset to the party. However, it may be possible to perform CGT calculations under alternative scenarios, thereby providing the minimum and maximum amounts of tax that could be payable but for any changes to the taxation legislation.

This approach may result in the minimum amount of capital gains tax being taken into account in determining the value of an asset acquired solely as an investment and with a view to ultimate sale for profit. Alternatively, it may result in a greater consideration being given to future CGT liabilities when determining the section 75(2) adjustments, whereby the Court would place a similar weight to future CGT liabilities as that placed on them by the parties when they undertake settlement negotiations.

### **Example 2: Transfer of CGT assets on marriage breakdown**

Having considered how any tax costs on realisation should be taken into account in valuing the assets, it is then necessary to consider how the assets will be divided between the parties. While CGT is ordinarily payable on the disposal of an asset, section 126 A of the Income Tax Assessment Act 1997 provides **compulsory** “rollover relief” on marriage breakdown whereby the CGT characteristics of an asset are transferred along with its legal ownership. This effectively defers the payment of any CGT liability until the new owner disposes of the asset.

In order for the rollover to apply, the asset must be transferred from spouse to spouse or from a company or trust to a spouse as a result of a Court order (including a consent order), a binding financial agreement, an arbitral award or a binding agreement or award used by a de facto couple. Rollover relief is also available where assets of a self managed superannuation fund are transferred to another self managed superannuation fund.

From 1 July 2009, the marriage breakdown rollover relief has been extended to same sex couples.

The effect of the rollover relief to the spouse or the entity disposing of the asset is that they will not incur a CGT liability on transferring the asset.

For the spouse acquiring the asset, there will be no immediate CGT liability. However, there may be CGT on eventual disposal of the asset. This will depend on whether the asset was originally acquired prior to 20 September 1985 - these assets are referred to as “pre-CGT assets”. There is no capital gains tax payable on the disposal of a pre-CGT asset. A pre-CGT that is transferred to a spouse will retain its pre-CGT characteristics and therefore there will be no CGT payable on the ultimate disposal by the acquiring spouse.

In contrast, there will be CGT payable on the ultimate disposal by the acquiring spouse where the asset was originally acquired after 20 September 1985, being a post-CGT asset. The CGT will be payable on the difference between the sale price and the deemed cost base at the time of sale. As the acquiring spouse did not originally pay for the asset (or part thereof), the legislation provides that the acquiring spouse inherits the cost base of the transferring spouse or entity. It is important to note that the acquiring spouse also inherits the history of use of the asset.

To use an example, assume that David and Joanne are separating. In 1989, they purchased a unit in South Melbourne for \$150,000 with monies from Joanne's parents' estate. The unit was purchased in Joanne's name and rented to a third party. As part of the settlement, it has been agreed that Joanne will receive the matrimonial home and David will move into the unit. The unit currently has a value of \$600,000.

Normally, if Joanne were to dispose of the unit, she would be required to pay CGT on the gain of \$450,000. However, as she will be transferring the unit to David pursuant to an order under the Family Law Act, the capital gain will be rolled over. Under the current legislation, David is deemed to have acquired the asset for a cost of \$150,000 and also the history of use of the property. This means that as the property was held since 1989 as an investment property, even if David moves into the property and claims it as his principal place of residence, he will be liable for CGT on a portion of the gain when he subsequently sells the property. The gain will be apportioned over the period it was held as an investment property and as David's principal place of residence.

In contrast, the matrimonial home was purchased solely in David's name and has always been the parties' principal place of residence. When this property is transferred to Joanne, she will inherit the cost base and the history of use. Therefore, provided that Joanne continues to use the property as her principal place of residence there will be no CGT payable. This is because the house was used as a principal place of residence from its original purchase date until its transfer to Joanne (being the history of use inherited by Joanne) and Joanne continues to use the property as the principal place of residence. Therefore, it is deemed to have always been used as a principal place of residence.

It is important to note that the above CGT rollover provision specifically excludes assets held as trading stock. While for most businesses, the assets held as trading stock will be fairly obvious (and not usually transferred for Family Law purposes), caution should be exercised when dealing with entities involved in land development and construction. Entities involved in land construction and development may transfer property to a spouse as part of a marital settlement. If such property was held by the entity as trading stock, such as land for sale, the above rollover provisions would not apply.

It is also important to note that the CGT rollover should not be considered in isolation from other taxation consequences, for example, the possible impact of stamp duty and the extent of any exemptions that may be available to either spouse. Consideration also needs to be given to whether the proposed transaction could trigger other transaction consequences. One of the more common taxation issues that can be triggered by transferring an asset from a company to

a spouse is the possible impact of Division 7A of the Income Tax Assessment Act. This is discussed in more detail later in the paper.

### **Example 3: The need to sell an asset to fund settlement**

In many matters there will be the need to sell an asset in order to fund an equitable settlement between the parties. Consideration should be given to how the asset should be sold in order to minimise the taxation consequences.

A common scenario will be that an investment property has been purchased in the name of the higher income earning spouse in order to maximise the benefit of negative gearing. If that asset was sold in the name of the higher income earning spouse, then that capital gain will also be taxed at the higher marginal rate.

Consideration should be given to transferring the investment property to the lower income spouse prior to sale. If the transfer is pursuant to Court Orders or a binding agreement, then CGT rollover relief would apply on the transfer between spouses. The sale of the investment property by the lower income spouse would then result in less tax being paid on the capital gain. Consideration should also be given to any other costs that may be incurred, such as GST on the sale of commercial properties or stamp duty (for which the rate and transfer exemptions may differ between states).

### **Example 4: Hidden tax issues with loan accounts**

Where the parties' assets include a company or a trust, it will be common for there to be loans payable between the parties and the entity. Depending on how these loans have been dealt with in the past and/or how they are dealt with for the purpose of the Family Law settlement, it is possible either to trigger tax liabilities or for tax liabilities previously triggered to go undetected. The relevant legislation governing shareholder loans from a company is Division 7A of the Income Tax Assessment Act 1936 ("Division 7A"). Division 7A treats three kinds of payments by a private company as dividends, if paid on or after 4 December 1997, being:

- Amounts paid by the company to a shareholder or shareholder's associate (which includes a spouse);
- Amounts lent by the company to a shareholder or a shareholder's associate; and,
- Amounts of debt owed by a shareholder or shareholder's associate to the company that are forgiven by the company.

In order for a loan from a company to the shareholder not to be considered a dividend, the loan must be made under a written loan agreement which includes an interest charge and minimum repayment period as specified in Division 7A.

If the loan is not made under a loan agreement, or the payment or loan forgiven is deemed to be a dividend under Division 7A, the dividends will constitute assessable income in the hands of the shareholder or associate (with “associate” being a very broad catch all term). The deemed dividends are not frankable. The impact of this is that the recipient will be liable for tax on the full amount of the dividend at their marginal rate without the usual benefits of franking credits which are generally attached to a dividend.

This area is particularly complex with the tax implications further complicated by the ownership of the company, the remaining assets in the company subsequent to the transfer of the asset and loans made between entities, trusts and individuals. The following is an example of the potential effect of Division 7A:

Andrew owns all of the shares in Andy’s Investments Pty Limited, a company owning some shares listed on the ASX and residential investment properties. Andy’s Investment Pty Limited lent \$25,000 to Andrew’s wife, Jill, so that she could visit her mother in England during December 2008. There was no loan agreement drawn up, no repayments have been made and interest has not been charged on the loan. As Jill is an associate of the shareholder, the loan is deemed to be a dividend in the hands of Jill and should have been included in her assessable income in the year in which the loan was made. As there are no franking credits attached to the deemed dividend, the tax payable by Jill could be up to \$11,625 (being \$25,000 x 46.5%) depending on Jill’s marginal tax rate.

From a Family Law perspective, caution should be exercised whenever a company in which either party has an interest and the company has lent money to either party, i.e. where the parties owe money to their company. If there is no loan agreement with respect to the loan, there may be a tax liability of which either of both parties are unaware. If there is a loan agreement, care should be taken as to how the loan is dealt with so as to not trigger the deemed dividend provisions of Division 7A.

Assume in the above example, Jill borrowed the money from the company and there was a proper loan agreement covering the loan such that the initial loan did not trigger the deemed dividend provisions. The three options in a Family Law matter available are:

- The debt may be repaid as part of the settlement;
- The other spouse may assume responsibility for the debt; or
- The debt may be forgiven.

If the debt is repaid or Andrew assumes responsibility for the debt (in which case there should be a new loan agreement), the deemed dividend provisions will not be triggered and no other unforeseen taxation issues would generally arise. However, if the orders state that “The Husband in his capacity as shareholder and director of Andy’s Investments Pty Limited will cause the company to forgive the amount owed to it by the Wife”, this would be deemed to be a dividend by Division 7A and the loan value of \$25,000 would be included as assessable income in the hands of Jill on which tax of up to \$11,625 would be payable by her depending on Jill’s

marginal tax rate. Therefore, orders resulting in the forgiveness of debt should generally be avoided so as to not cause the debt forgiven to be treated as a deemed dividend.

### **Example 5: Transferring assets from a company/trust to a spouse**

Many parties who own a company, or have a beneficial interest in a trust often treat the assets held by the company or trust as their own personal assets. In the case of companies, when it comes to dividing the pool of assets, it is not uncommon for the corporate veil to be lifted and the distribution of assets to be performed without regard for the legal ownership and corporate structure. Caution should be exercised in such situations as transferring assets (including money) from a company can trigger the deemed dividend provisions referred to above and leave the recipient of the asset with an unexpected tax liability.

For example, continuing with our above example, assume that Andrew agrees to transfer \$200,000 of the publicly listed shares held by Andy's Investments Pty Limited to Jill as part of the property settlement. While there is no CGT triggered by this transfer because of the CGT rollover on marriage breakdown, it does fulfil the definition of an amount paid by a company to a shareholder or an associate of a shareholder. Therefore, the arm's length value of the shares, being \$200,000 (less any paid consideration by Jill for the shares) will be included as assessable income to Jill on which tax of up to \$93,000 (being 46.5% of \$200,000) will be payable depending on Jill's marginal tax rate. It should be noted that as the transfer would be a deemed dividend under Division 7A, the dividend would not normally be franked. However, given that the transfer is as a result of a Family Law obligation, the deemed dividend may be franked by the company – effectively utilising some of the company's franking credits (tax already paid by the company) to reduce the tax that would otherwise be payable by Jill.

Therefore, in order to avoid triggering the deemed dividend provisions when transferring an asset from company, there should be an amount equal to the arm's length value of the asset provided to the company as consideration. Alternatively, the value of the asset could be "paid for" by a properly executed loan agreement between Andrew and the company. By carefully structuring the transactions and the orders, the shares could be transferred to Jill and a loan agreement executed such that Andrew would need to repay the \$200,000 with interest over the coming years.

If Andy is to be responsible for a new loan as consideration for the shares transferred to Jill, thought should be given as to how Andrew will be able to fund the repayment. It may be that in order to make the repayment, he will need to cause the company to declare a dividend equal to his loan repayment on which Andrew may pay additional income tax. The question then is whether the tax should be taken into account, and if so, how?

Another alternative would be to cause the company to pay a dividend to the shareholder for an amount equal to the value of the asset being transferred. While this would trigger a tax liability for any additional tax that may be payable on the dividend, it would ensure that the dividend is franked. By comparison, assuming top marginal rates, the tax on a \$200,000 dividend would be

\$45,857 if the dividend was fully franked and up to \$93,000 if the asset transfer was deemed to be a dividend by Division 7A and therefore the dividend unfranked.

Where both parties are currently shareholders in a company that will ultimately be transferred to one party only, and a dividend from the company is proposed to provide sufficient value outside of the company to fund the settlement, consideration should be given to the parties marginal tax rates and whether it would be more effective to pay a dividend before or after transferring the shares in the company. For example, if one party has a lower marginal tax rate, then it may be more tax effective to ensure they receive as much of the dividend as possible prior to the shares being transferred. In considering such transactions, thought should also be given to any effect on Centrelink, Family Tax Benefits and child maintenance payments that can be impacted by an individual's taxable income.

### **Example 6: Dissolution of a Husband and Wife partnership**

Within a partnership, each partner owns part of each asset. A change in the partnership interests through adding or removing a partner results in a partial disposal and reacquisition of each partnership asset. The partial disposal of partnership assets may trigger CGT or income tax.

For example, a partnership between John and Sarah operates a nursery. Unfortunately their marriage was not as successful as their nursery and they are now getting divorced. John has agreed that Sarah will carry on running the nursery and he will transfer his interest in the partnership to her. The assets of the partnership include trading stock which has a cost of \$20,000 and a market value of \$80,000.

As John and Sarah each own part of each asset, where the transfer of John's interest in the assets of the partnership to Sarah would ordinarily trigger CGT, the CGT rollover provisions discussed at Example 2 would apply, as it is a spouse to spouse transfer. However, the CGT rollover provisions specifically exclude trading stock. This is because any profit on the disposal of trading stock would be subject to income tax rather than CGT. The transfer of John's interest in the trading stock to Sarah is deemed to be at market value and would therefore crystallise \$60,000 of profit. John and Sarah would each need to include \$30,000 as income in their income tax returns and pay tax on this income at their marginal rates.

In order to avoid triggering this tax, the provisions of section 70-100 of the 1997 Income Tax Assessment Act can be utilised. This section is designed for a change in ownership interests in a partnership. Provided that the old and new partners agree that the trading stock is to be taken to have been disposed of at its tax (cost) value, not at its market value, the trading stock will not be deemed to have been disposed at market value.

The effect of this is that John will transfer his interest to Sarah without triggering any income tax on the trading stock. Sarah will continue running the business and adopt \$20,000 as the cost of

the trading stock. Any profit realised on the sale of the stock will be assessable to Sarah when the stock is subsequently sold.

It is important to note that unlike the CGT rollover relief which is automatic and compulsory, the rollover of the trading stock is not and such an agreement must be made in writing. Therefore, it is important to include the agreement in the Court orders or alternatively ensure that the parties enter into a written agreement dealing with the transfer of trading stock...

### **Example 7: Tax on superannuation interests**

The methods of valuing superannuation interests prescribed by the Family Law (Superannuation) Regulations value superannuation interests on a before tax basis.

As a result of the “Simpler Super” changes introduced in the 2007 Federal government budget, amounts withdrawn from superannuation after age 60 are generally tax free.

Prior to the Simpler Super changes, the tax payable on the ultimate withdrawal of superannuation interests was an important consideration. However, that does not mean that the tax payable on the withdrawal of balances from superannuation should be ignored completely.

This is because there will be circumstances when a party may be able to access part or all of their superannuation interests prior to age 60<sup>2</sup>. When withdrawing funds from superannuation prior to age 60, the amount of tax payable, if any, will depend on many factors including the taxation components of the superannuation, the age of the member and the extent to which they may have used certain concessional tax limits. It is strongly recommended that you advise your clients to obtain specialist tax advice where there is a significant amount of superannuation being withdrawn in order to fund a settlement or such a withdrawal will be needed following settlement (such as to fund housing or legal expenses!).

It should also be noted that not all payments from a superannuation interest will be tax free after age 60. For example, tax may be payable by a member older than 60 where the pension is being paid in respect of interests held with many of the Commonwealth Government superannuation schemes<sup>3</sup>. By contrast, there will be no tax payable after age 60 for pensions paid by NSW State Super.

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<sup>2</sup> For further details of access to superannuation, refer to Nick Gaudion’s paper titled “Super isn’t Super”.

<sup>3</sup> These include the Commonwealth Superannuation Scheme (CSS), the Public Sector Super Scheme (PSS), the Defence Force Retirement and Death Benefits Scheme (DFRDB) and the Military Super Benefits Scheme (MSBS or Military Super).

### **Example 8: Splitting of superannuation interests to achieve access to and/or reduce tax payable**

Where there is not currently enough funds outside of superannuation in order to effect the settlement that the parties wish to achieve, consideration should be given to whether or not it is possible to access any of the parties superannuation. This may be by the member withdrawing their superannuation. Where the member cannot withdraw their superannuation, it may be possible to split the superannuation to the spouse and due to their age and work status, the spouse may be able to access this split superannuation.

Where either party can access the superannuation, consideration should be given to whether one party will pay less tax than the other. It may be possible to split the superannuation interests and pay less tax on the withdrawal of the superannuation than if it was withdrawn by the original member.

For example, assume that David has \$800,000 in superannuation and Kylie has none, having withdrawn her super on retirement to pay out the parties' mortgage. David is currently aged 58 and working full time whereas Kylie is aged 61 and is no longer working. Let's assume that both parties wish to own a house following separation but they need another \$400,000 outside of superannuation in order to achieve this. The components of David's superannuation interest would allow him to withdraw up to \$50,000 until he retires or reaches age 65.

As Kylie has reached her preservation age and has permanently retired, she is able to access any superannuation in her name. Further, because she is over 60, she will also be able to access superannuation from most funds on a tax free basis. Therefore, it would be possible in this situation to split \$400,000 of David's super to Kylie, and Kylie could then withdraw these funds tax free. In the event that the parties agree that Kylie retains the matrimonial home, the orders could provide that Kylie makes a cash payment of \$400,000 to David.

The dominant purpose of the above is to achieve a settlement between the parties which required that both parties had sufficient funds to acquire a house. However, this did indirectly result in the parties being able to access some of David's superannuation earlier than otherwise allowed. Care should be given to situations where the dominant purpose of the transaction is early access to superannuation funds, rather than the achieving a settlement of Family Law proceedings which is acceptable to both parties.

### **Example 9: Splitting of Superannuation Interests to achieve more tax effective retirement income**

Whilst this example is more relevant for higher net worth parties, it is important to highlight since I see this as an important tax planning opportunity which I suspect is overlooked in many matters where it could be applied.

Prior to the introduction of the Simpler Super changes in 2007, many practitioners were aware of how splitting a superannuation interest could spread the superannuation across the Reasonable Benefit Limits ("RBL") of each the Husband and the Wife resulting in a significant tax saving. However, the Simpler Super changes removed RBL issues post age 60 by allowing payments from superannuation post age 60 to be tax free. Therefore, where one party has significant super and the other party has little or no super, there does not appear to be the need to split the super to obtain a tax benefit.

While the RBL issues have been removed for access to superannuation post age 60, there are now limits on the amount that can be contributed to a superannuation interest. Therefore, an appropriate tax planning approach for many high net worth individuals is to maximise the amount that they have invested in superannuation as this will provide a more tax effective retirement income.

In most matters, the parties do not have significant assets and therefore there is often a preference to have assets outside of superannuation and take a lesser percentage of the assets within superannuation.

My concern is that this attitude should not carry across in high net worth matters where there are ample assets outside of superannuation to meet both parties living expenses and lifestyle. In such matters, it will be common for one party to have significantly greater superannuation entitlements than the other. The more financially astute spouse will generally appreciate the future benefits that a large superannuation interest will provide in the form of tax free income post age 60.

However, the non-financial spouse may not be aware of such benefits. Therefore, it would often be appropriate to suggest that the non-financially astute spouse seek financial planning advice to ensure that the outcome of the Family Law proceedings will place them in the best position for tax effective income on retirement.

## CONCLUSION

As can be seen from the above examples, the taxation issues in Family Law matters can be complex. Taxation should be considered both when determining the value of the pool of matrimonial assets as well as when the assets are being divided between the parties. There are opportunities to minimise the taxation impacts for the parties on settlement and more importantly, the risk that the settlement could trigger unforeseen taxation liabilities for the parties. This paper covers only some of the more common issues and should only be used as a general guide. Specific advice should be obtained where appropriate and the benefits of having any proposed orders reviewed by an appropriately qualified specialist prior to finalisation should also be considered.

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