



**A PRACTICAL GUIDE TO CALCULATING  
TAX ON YOUR FAMILY LAW SETTLEMENT**

*by*

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© The Argyle Partnership 2006 This paper is intended as a guide only as to when expert tax or accounting advice is needed. Every case is different and different fact situations can impact substantially on what otherwise may be a straightforward case. The paper is designed to prompt you to take care and identify tax issues when structuring a property settlement or giving advice during a divorce.

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## 1. INTRODUCTION

- 1.1 There are significant taxation, realisation costs and stamp duty issues that arise on relationship and marriage breakdown. These consequences follow because, of its nature, a family law settlement entails an enforced distribution of wealth. It is crucial that family lawyers be vigilant of the taxation, realisation costs and stamp duty consequences of any property orders made or likely to be made by the Court. Specifically care must be taken to ensure that the effect of property (and superannuation) orders take into account all taxation, realisation costs or stamp duty consequences that may follow.
- 1.2 The above will inevitably involve being proactive and consider each party's proposals at the very least and perhaps even go further and predict what a Court may do after a final hearing and take those consequences into account so as to ensure that **all** of the evidence is before the Court.
- 1.3 Taxation issues do not arise only in complex property settlements involving corporate structures, trusts or self manages superannuation funds but also can arise in simple cases where parties own investment properties, shares, or even a Partnership business owned and run by husband and wife.
- 1.4 There are also tax incentives or tax issues that also arise in respect of spouse maintenance and child support. With careful planning during the course of a Court case, spouse maintenance payments could be effectively paid to a former spouse. With appropriate tax planning, child support payments could be made from before tax dollars rather than after tax dollars!
- 1.5 It is also important to bear in mind tax consequences when drafting Financial Agreements and Superannuation Agreements (and for that matter Domestic Relationship Agreements or Termination Agreements under the *Property (Relationships) Act 1984 (NSW)*).
- 1.6 Failure to take tax and stamp duty consequences into account when negotiating a property settlement or when drafting a Financial Agreement could have disastrous consequences for your client and their future estate planning as well as expose you to a negligence claim.
- 1.7 The purpose of this paper is to outline some of the taxation and stamp duty consequences on marriage breakdown. Most of the issues raised will also apply to domestic relationships.

## 2. FAMILY COURT APPROACH TO TAXATION AND REALISATION COSTS

- 2.1 Unfortunately, the Court's approach to taxation and realisation costs over the years have been confusing and difficult to reconcile<sup>1</sup>. The Full Court in *Rosati*<sup>2</sup> finally set down principles in relation to the circumstances when the Court ought to take into account potential capital gains tax which would be payable upon the sale of an asset. The Full Court in *Rosati* held at paragraph 6.36:

*"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.*

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<sup>1</sup> See cases such as *Kelly and Kelly (No 2)* (1981) FLC 91-108; *Rothwell and Rothwell* (1994) FLC 92-511; *Harrison and Harrison* (1996) FLC 92-682; *Carruthers and Carruthers* (1996) FLC 92-707.

<sup>2</sup> (1998) FLC92-804

- (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.*
- (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.”*

2.2 Based on the principles or guidelines enunciated by the Full Court in Rosati above, the likelihood of a possible future sale is important in determining if and how the potential CGT liability should be taken into account. Accordingly if there is no intention or the evidence does not establish that a party has to sell a CGT asset then the Court generally would ignore any CGT liability.

2.3 On the other hand if the Court makes a finding that it would be inevitable to sell a property in the near future, then, CGT will be taken into account in the first step which has the result of reducing the property pool. Having said this, it should also be noted that the Court may still take the CGT liability as a section 75(2) factor if the Court is satisfied that there is a significant risk that the asset will have to be sold in the short to mid term.

2.4 It should be noted that because a property has been valued using a particular method it does not necessarily follow that the realisation costs or CGT liability will automatically be taken into account and therefore reduce the property pool. Certainly, the Court can still take the realisation costs and/or CGT in the third step under section 75(2) factor. In JEL v DDF<sup>3</sup>, certain assets of the parties were valued on a tangible asset or asset realisation approach, however, the Full Court noted that this is only one of the matters to be taken into account under the Rosati principles. The Full Court also noted the trial judge’s finding that whilst the assets had been “acquired with a view to making a profit” this did not equate to 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”. The Full Court referred to the parties former matrimonial home and their holiday home.

## 2.5 Tax Losses

- (a) There are cases where a company controlled by either of the parties or both of them may have significant tax losses and the question that will arise in the proceedings is whether or not such tax losses are property or financial resources.
- (b) This issue is significant because tax losses have the effect of reducing the tax that ultimately may be paid in respect of future profits earned by the company that would be retained by one of the spouses.

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<sup>3</sup> 2001 FLC 93-075

- (c) In *JEL v DDF* the trial judge found that the husband would retain the benefit of losses in a company with a tax benefit of \$1.866 million while the wife would retain a benefit in another company of approximately \$239,000. The trial judge found, on the evidence, that the tax losses did not constitute property as they had no immediate realisable value. However, Her Honour found that they constituted a financial resource of potentially significant benefit to the husband in the future. It appears that the trial judge thereafter omitted to return to this issue in the course of her judgment however on appeal to the Full Court the Full Court made an adjustment in the wife's favour under section 75(2) in the sum of \$200,000 by reason of the husband's significant tax losses for which he would retain the benefit.

## 2.6 Income Tax

In *SPG* and *BAG*<sup>4</sup> the Full Court held the following:

*“In the course of his oral submissions, senior counsel for the wife properly conceded that although the Court in Rosati was speaking specifically in relation to Capital Gains Tax, the principles therein stated would extend to ordinary (“mainstream”) income tax. We would perhaps go even further, and say that in our view, where property which is held by a party or the parties to proceedings under s79 of the Act was acquired as part of a business of acquiring, developing and the re-selling real property for profit (ie: essentially as trading stock of that business) then, in valuing that property for the purpose of the proceedings, the Court should ordinarily take into account both the estimated realisation costs and the tax (in that case) “mainstream” income tax which will ultimately be paid on its sale, even if the Court’s Orders leave the property in the hands of one party and the sale of it is not seen as an inevitable or even a likely consequence of those Orders. We think that statement falls within the purview of the principles stated in paragraph 2 of the above quoted extract from Rosati.”*

In *SPG* and *BAG*, the Full Court held that the trial judge ought to have made an allowance for realisation costs and tax payable on sale of the properties given that those properties were purchased for development and resale rather than for long term investment purposes. The Full Court went on to hold:

*“The acceptance by both parties of the fact that this property was **acquired as trading stock**, rather than for investment purposes, combined with the fact that efforts had been made to sell it prior to trial in the absence of any evidence to suggest that the husband, despite that, is likely to retain it indefinitely, leads us to the conclusion that a sale of it will probably occur in the near future. In that circumstance, whether or not the husband might have other tax losses which may be used to off-set the profit on the sale of this property is irrelevant, since he will still suffer the detriment of the tax liability in respect of this sale in the form of a corresponding reduction in the tax benefit which he will otherwise have received in respect of the loss set-off against this profit.”*

## 3. MARRIAGE BREAKDOWN CGT ROLLOVER BETWEEN SPOUSES

- 3.1 Under s. 126-5 of the Income Tax Assessment Act 1997, there is a compulsory or automatic same assets rollover if a CGT event involves an individual taxpayer disposing of an asset to, or creating an asset in, his or her spouse (or former spouse) because of:
- (a) a Court Order under the Family Law Act 1975 or a corresponding foreign law;
  - (b) a maintenance agreement under section 87 of the Family Law Act 1975 or a similar agreement under a foreign law; or

<sup>4</sup> Unreported, Full Court of the Family Court 20 December 2001

- (c) a Court Order under a State, Territory or foreign law relating to de facto marriage breakdowns.
- 3.2 Accordingly, any capital gain or capital loss from a CGT event is ignored if the marriage breakdown rollover happens.
- 3.3 If the asset is a post CGT asset and the transferor disposes of the asset to a transferee spouse and the marriage breakdown rollover happens, the first element of the cost base (or reduced cost base) for the transferee will be the same as the cost base of the transferor at the time the transferee acquires the asset. Therefore, any costs incurred by the transferor in effecting the transfer (such as conveyancing costs) pursuant to the court order will form part of the first element of the cost base (or reduced cost base).
- 3.4 In the 2005 Federal Budget, Mr Peter Costello announced that the Federal Government will extend CGT rollover relief to:
- (a) assets transferred to a spouse or former spouse under a Financial Agreement for married couples and Domestic Relationship Agreements and Termination Agreements for de facto couples or a similar agreement under a corresponding foreign law or an arbitral award under the Family Law Act or a corresponding award made under a corresponding State law, Territory law or foreign law; and
  - (b) changes to the CGT main residence exemption so that a spouse who receives a property pursuant to a Court order will inherit the history of the property

Unfortunately, to date the above measures have not been implemented.

- 3.5 In relation to the second measure announced in the 2005 Federal Budget referred to in paragraph 3.4(b), under the current CGT rollover relief, if a spouse receives an investment property owned by his or her former spouse pursuant to a Court order and immediately upon receiving that property the spouse commences to use the property as their main residence, then, the CGT main residence exemption applies and that spouse will not pay CGT when they sell the property in the future. Under the proposed amendments, the transferee spouse will inherit the property's history so that CGT will be apportioned between the periods when the property was held for investment purposes and when it was used as the main residence with CGT being payable on ultimate disposal for the period the property was used for investment purposes.
- 3.6 It should be noted that since 27 December 2000, section 87 Maintenance Agreements are no longer possible to be entered into and receive Court approval. Maintenance Agreements have been replaced by Financial Agreements, however, as indicated above, CGT rollover relief has not yet been extended to cover these Agreements.
- 3.7 For CGT rollover relief to apply pursuant to a Court Order, the transfer of a property must be to a spouse and **not** to a company or trust controlled by or associated with the spouse.
- 3.8 Whilst sections 126-5 and 126-15 of the 1997 Tax Act do not expressly require that there be marriage breakdown, this is implicitly required (see Tax Determination 49 of 1999).

#### **4. MARRIAGE BREAKDOWN CGT ROLLOVER ON TRANSFER FROM COMPANY/TRUST TO SPOUSE**

- 4.1 Section 126-15 of the 1997 Tax Act, extends the CGT rollover relief if the trigger event involves a company (the transferor) or a trustee (also the transferor) and a spouse or former spouse (the transferee) of another individual because of:
- (a) a Court order under the Family Law Act or a corresponding foreign law;

- (b) a Maintenance Agreement approved in accordance with section 87 of that Act or a corresponding agreement approved by a Court under a corresponding foreign law; or
  - (c) a Court order under a State law, Territory law or foreign law relating to de facto marriage breakdown.
- 4.2 Accordingly, there is also an automatic or compulsory marriage breakdown rollover if the marriage breakdown conditions between spouses are met, except that the transfer is from a company or trust associated with the parties to a spouse or former spouse.
- 4.3 **Warning:** Notwithstanding the above rollover relief, there are other significant consequences in respect of transfers of property owned by a company or trust to a spouse pursuant to Court orders which will be dealt with below under the heading “*Division 7A consequences*”.

## **5. MARRIAGE BREAKDOWN CGT ROLLOVER ON TRANSFER OF SHARES IN PRIVATE AND PUBLIC LISTED COMPANIES**

- 5.1 CGT rollover relief is also available on transfer of shares (in public and private companies) if made pursuant to Court orders.

## **6. TRADING STOCK AND MARRIAGE BREAKDOWN**

- 6.1 Trading stock applies generally to Partnerships. The disposal of trading stock on marriage breakdown is not in the ordinary course of business and is deemed a disposal at market value.

## **7. DEPRECIATION RULES AND MARRIAGE BREAKDOWN**

- 7.1 Assets that are depreciated such as plant and equipment or motor vehicles are not generally subject to CGT, however, income tax may be payable on any excess value over and above the written down value. If these assets remain with the controlling partner, CGT rollover relief is available.
- 7.2 However, the CGT rollover relief does not apply for trading stock of the transferor’s spouse’s interest in that trading stock.

## **8. CGT ROLLOVER NOT APPROPRIATE IN ALL INSTANCES**

- 8.1 There may be instances where it would be beneficial for the controlling spouse to buy out the exiting spouse rather than rely on the CGT rollover relief. For example, if the business was started by the parties and has increased in value over the years, it may be in the controlling spouse’s interest to crystallise the value of the business at marriage breakdown rather than take advantage of the CGT rollover provisions. This is especially in relation to business goodwill. As the business was started by the parties, goodwill cost base is nil.
- 8.2 If the controlling spouse buys the exiting spouse’s interest in the Partnership, the tax and superannuation rules in relation to capital gain, family business assets amounting to less than \$5 million (\$6 million from 1 July 2006) would apply and this may be for the benefit of not just the controlling spouse but also the exiting spouse.

## **9. EXEMPTIONS FROM CGT**

- 9.1 In general terms the following assets are exempt from CGT:
- (a) assets acquired before 20 September 1985;
  - (b) certain categories of motor vehicles and motor cycles;
  - (c) personal use assets with acquisition costs of less than \$10,000; and

(d) principal place of residence (subject to various restrictions).

## 10. CGT AND DE FACTO MATTERS

10.1 As indicated above, property transfers pursuant to Court orders under the *Property (Relationships) Act 1984 (NSW)* and other similar legislation in the various States, will also trigger CGT rollover relief under section 126-5 and 126-15.

10.2 Like Financial Agreements, transfers of property made pursuant to a Termination Agreement or a Domestic Relationship Agreement do not obtain the benefit of the rollover relief provisions.

## 11. DIVISION 7A CONSEQUENCES

11.1 Whilst capital gains tax rollover relief may apply to transfers of property from a company or a trust to a spouse associated with the company or trust (and for this matter stamp duty exemptions may apply as will be discussed below), there are significant tax consequences that will flow from a transfer of property owned by a company or trust to a spouse pursuant to Court orders.

11.2 Division 7A deals with three situations where a company will be deemed to have paid a dividend to an associate namely:

- (a) Payments made by the company to a shareholder or shareholder's associate (s. 109C);
- (b) Amounts lent by the company to a shareholder or shareholder's associate (ss. 109D and 109E); and
- (c) Amounts of debts owed by a shareholder or shareholder's associate to the company that the company forgives (s. 109F).

11.3 Section 109C of the Income Tax Assessment Act 1936 provides as follows:

***“When private companies taken to pay a dividend***

***109C***

(1) *A private company is taken to pay a dividend to an entity at the end of the private company's year of income if the private company pays an amount to the entity during the year and either:*

- (a) *the payment is made when the entity is a shareholder in the private company or an associate of such a shareholder; or*
- (b) *a reasonable person would conclude (having regard to all the circumstances) that the payment is made because the entity has been such a shareholder or associated at such time.*

(2) *The dividend is taken to equal the amount paid, subject to section 109Y.*

*Note: Section 109Y limits the total amount of dividends taken to have been paid by a private company under this division to the company's distributable surplus.*

(3) *...*

(4) *The amount of a payment consisting of a transfer of property is the amount that would have been paid for the transfers by the parties dealing at arms length less any consideration given by the transferee for the transfer. (The amount of a payment is nil if the consideration given by the transferee equals or exceeds the amount that would have been paid at arms length for the transfer.)”*

11.4 The effect of Division 7A is that if, for instance, a property owned by a private company is transferred to a spouse pursuant to a Court Order, then Division 7A deems that transfer as a dividend

payment upon which the company would have to pay tax at the current rate of 30%. The transferee spouse will also have to pay tax at their own marginal rate albeit that they will receive a franking dividend in relation to the tax already paid by the company in respect of the transfer.

## 12. COMPANY LOAN ACCOUNTS, SECTION 108 AND DIVISION 7A CONSEQUENCES

- 12.1 Loans to associated persons of a company may become the subject of the deemed dividend provisions. Associated persons include shareholders, their spouses and related entities.
- 12.2 Section 108 of the ITAA 1936 applies where a private company pays an amount to an associate as an advance or a loan or credits an amount to an associated person and the Commissioner forms the view that the amount represents a disguised distribution of profits. In those circumstances, the payment received will be deemed as an unfranked dividend paid by the company to the person and therefore assessable to income tax by the recipient.
- 12.3 Division 7A which came into operation on 4 December 1997, provides that where there is a loan from a company to an associated person then for the loan not to be deemed as a dividend, the loan must be repaid before the end of the financial year or there is a genuine commercial loan evidenced in writing on relevant terms and interest conditions and to be repaid by no later than seven years from the date that the loan was issued otherwise the loan will be deemed as dividends in the hands of the associated person.
- 12.4 When dealing with loan accounts the following should be taken into account and considered:
- (a) Forgiveness of the loan is not an effective way of dealing with the loan account as this will trigger the deeming dividend provisions.
  - (b) Consideration should be given as to whether loan accounts should be brought to nil by declaring a dividend payment in favour of the spouse in whose name the loan account is in however it should be noted that this would trigger income tax liability but such income tax will be less than if a section 108 operates.
  - (c) The loan could be assigned to the other spouse who will retain the company however it is important to obtain the relevant indemnities to ensure that the spouse exiting the company is protected from any tax liabilities that may flow on from such an assignment.

## 13. PART IVA CONSIDERATIONS

- 13.1 An important matter that must also be addressed in any family law matter which involves tax restructuring or tax advice is the potential impact of the general anti-avoidance provisions of Part IVA of the 1936 Act. Generally, these provisions can apply where there is:
- (a) A “tax benefit in connection with a scheme”; and
  - (b) The scheme is one to which Pt IVA applies, ie it bears the characteristics set out in section 177D of the 1936 Act.
- 13.2 Section 177D provides as follows:

*“This Part applies to any scheme that has been or is entered into after 27 May 1981, and to any scheme that has been or is carried out or commenced to be carried out after that date (other than a scheme that was entered into on or before that date), whether the scheme has been or is entered into or carried out in Australia or outside Australia or partly in Australia and partly outside Australia, where:*

- (a) *a taxpayer (in this section referred to as the **relevant taxpayer**) has obtained, or would but for section 177F obtain, a tax benefit in connection with the scheme; and*

- (b) *having regard to:*
- (i) *the manner in which the scheme was entered into or carried out;*
  - (ii) *the form and substance of the scheme;*
  - (iii) *the time at which the scheme was entered into and the length of the period during which the scheme was carried out;*
  - (iv) *the result in relation to the operation of this Act that, but for this Part, would be achieved by the scheme;*
  - (v) *any change in the financial position of the relevant taxpayer that has resulted, will result, or may reasonably be expected to result, from the scheme;*
  - (vi) *any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant taxpayer, being a change that has resulted, will result or may reasonably be expected to result, from the scheme;*
  - (vii) *any other consequence for the relevant taxpayer, or for any person referred to in subparagraph (vi), of the scheme having been entered into or carried out; and*
  - (viii) *the nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to in subparagraph (vi);*

*it would be concluded that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for the purpose of enabling the relevant taxpayer to obtain a tax benefit in connection with the scheme or of enabling the relevant taxpayer and another taxpayer or other taxpayers each to obtain a tax benefit in connection with the scheme (whether or not that person who entered into or carried out the scheme or any part of the scheme is the relevant taxpayer or is the other taxpayer or one of the other taxpayers).*

- 13.3 The most important requirement for Pt IVA to apply is that it would be concluded that a participant in the scheme had the sole or dominant purpose of obtaining a tax benefit for the taxpayer.
- 13.4 Matters (1) to (3) in section 177D relate to the type of the scheme, matters (4) to (6) relate mainly to financial aspects and matters (7) and (8) relate to other related aspects of the scheme.
- (a) Manner: this refers to the manner in which the scheme was entered into or carried out;
  - (b) Form and Substance of the scheme: this requires the Commissioner to look at the commercial reality as well as the legal or literal form of the scheme;
  - (c) Timing: this refers to the time at which the scheme was entered into and the length of the period during which it was carried out;
  - (d) Result achieved: this refers to the result that would have been achieved by the scheme if Pt IVA did not apply;
  - (e) Change in the financial position of the taxpayer that has resulted or may reasonably be expected to result from the scheme;
  - (f) Change in financial position of person connected with the taxpayer;
  - (g) Any other consequence for the taxpayer connected – ie non financial consequences; and
  - (h) Nature of connection between taxpayer and other person, the connection may be of a business, family or other nature.

## 14. STAMP DUTY EXEMPTIONS ON MARRIAGE BREAKDOWN

- 14.1 Stamp duty exemptions vary between each of the Australian States and therefore it is important to ascertain the stamp duty consequences as well as the stamp duty exemptions in the State where the property the subject of any property settlement is located.

## 15. RELEVANT LAW

### 15.1 Family Law Act 1975

Section 90 of the Family Law Act provides that there is exemption from stamp duty for transfers undertaken pursuant to

- (a) a deed or other instrument executed by a person for the purposes of, or in accordance with, an order made under this Part;
- (b) a relevant maintenance agreement that confers a benefit upon a party to, or a child of, the marriage to which the maintenance agreement relates, to the extent that the maintenance agreement confers that benefit;
- (c) a deed or other instrument executed by a person for the purposes of, or in accordance with, a relevant maintenance agreement, being a deed or other instrument that confers a benefit upon a party to, or a child of, the marriage to which the maintenance agreement relates, to the extent that the deed or other instrument confers that benefit.

- 15.2 Section 90L of the Family Law Act also provides that a financial agreement, a termination agreement or a deed or other instrument executed by a person for the purposes of, or in accordance with, an order made under this Part, is not subject to any duty or charge under any law of a State or Territory or any law of the commonwealth that applies only in relation to a territory.

### 15.3 Duties Act 1997 (NSW)

The relevant sections of the Duties Act (NSW) in respect of a stamp duty exemption are:

- (a) **Section 67:** exemptions on transfers of property between married couples or de facto partners as joint tenants or as tenants in common in equal shares in respect of their principal place of residence;
- (b) **Section 68:** exemptions from duty following breakdown of a marriage or de facto relationship;
- (c) **Section 267:** exemptions on transfers of motor vehicles following marriage breakdown or de facto relationship breakdown;
- (d) **Section 119:** exemptions on acquisition of interests in a private corporations following breakdown of marriage or a de facto relationship;

- 15.4 There are exemptions on stamp duty in relation to transfers pursuant to Financial Agreements under the Family Law Act.

- 15.5 In order to obtain the stamp duties exemption a declaration must be signed by at least one of the spouses to the effect that the marriage or the relationship has broken down irretrievably and that the parties are living separately and apart.

## 16. EXEMPTIONS FROM DUTY: PRINCIPAL PLACE OF RESIDENCE

- 16.1 There is an exemption from stamp duty under section 67 of the Duties Act in respect of a transfer by one spouse of one half of their interest in a property to their spouse or de facto partner. The transfer must be such that the property will be held as joint tenants or as tenants in common in equal shares. In respect of de facto partners, the Duties Act provides that the parties must have been living together in a de facto relationship for not less than two years, otherwise the exemption is not allowed.
- 16.2 The further pre condition in relation to the exemption is that the property must be held as the principal place of residence of the parties after the transfer is effected.
- 16.3 The exemption also extends to vacant land in circumstances where the married couple or de facto partners intend to use it as the site of a private dwelling house to be solely or principally used as their principal place of residence as well as to the transfer of shares that confer an entitlement to exclusive possession of a company title dwelling that was solely or principally used as at the date of the transfer as the principal place of residence of the married couple or de facto partners.
- 16.4 Care must be exercised when obtaining instructions from clients to effect the above transfer. Whilst the stamp duty exemption will apply regardless of whether the property was used by the spouse as an investment or principal of place of residence as long as the property will be used by the parties as their principal place of residence then the exemption will apply.
- 16.5 However, if the property had been used for investment purposes or not the spouse's principal of place of residence, CGT will become payable on the transfer of their half interest in the property to their spouse. CGT rollover will not apply as s.126-5 of the 1997 Act applies on marriage breakdown.

## 17. EXEMPTIONS FROM DUTY ON MARRIAGE BREAKDOWN

- 17.1 Section 68 of the Duties Act provides exemption from duty on transfer of matrimonial property following the breakdown of the marriage. (Similar provisions apply in respect of breakdown of domestic relationships).
- 17.2 For the exemption to apply, the property transferred must be 'matrimonial property'<sup>5</sup>, that is to say property of the parties to the marriage or of either of them. This has been interpreted widely by the Court in *Commissioner of Stamp Duties (NSW) v. Bryan*<sup>6</sup>. In that case, the property was transferred by the trustee of a family trust to one of the parties to the marriage. In *Bryan's* case, the trust was discretionary and provided for a gift over to parties to the marriage subject to the trustee's discretion. At the time, the only beneficiaries named were the husband and the wife, however, the trustee had the power to add new beneficiaries. At both first instance and on appeal to the Court of Appeal, it was held that the property transferred was matrimonial property and the exemption applied.
- 17.3 Where property is transferred by a company to a spouse, the property of the company is considered to be matrimonial property, if the only members of the company are the parties to the marriage. If only one party is a member of the company, the voting power of the spouse who owns the shares would be examined.
- (a) pursuant to section 68(1) of the Act no duty in chargeable in respect of a transfer of matrimonial property if:
- (b) the property is matrimonial property. Property includes real estate as well as shares in private companies;

<sup>5</sup> In de facto matters the property to be transferred must fall within the definition of 'partnership property', a definition in similar terms to the definition of 'matrimonial property'.

<sup>6</sup> (1989) 89 ATC 4529.

- (c) the transferee is a party to the marriage (and this includes a child or children);
  - (d) the marriage has either been dissolved or annulled or in the opinion of the Chief Commissioner, has broken down irretrievably;
  - (e) the transfer is affected by or in accordance with:
    - (i) a Financial Agreement under the Family Law Act;
    - (ii) a Court Order; or
    - (iii) an agreement that the Chief Commissioner is satisfied has been made for the purpose of dividing matrimonial property as a consequence of the dissolution, annulment or breakdown of the marriage; or
    - (iv) a purchase at public auction of the property that immediately before the auction was matrimonial property where the public auction is held to comply with any such agreement or order.
- 17.4 Section 68(4) provides for refunds to be made by the Chief Commissioner in respect of duty charged following breakdown of marriage (or pursuant to section 68(4A) in respect of the break up of domestic relationships). The circumstances where the Commissioner can reassess the transfer or the agreement and refund the duty paid after:
- (a) if duty was paid on the transfer of matrimonial property to the parties to a marriage or either of them, or to a child or children of either of them; and
  - (b) the transfer was effected as referred to in section 68(1)(b); and
  - (c) the marriage has been dissolved or annulled or has broken down irretrievably.
- 17.5 Refunds are also available in respect of financial agreements entered into and stamp duty paid in respect of transfers of property between spouses prior to the amendments made by the *State Revenue Legislation Further Amendments (No. 2) Act 2001*.
- 18. LAND TAX**
- 18.1 In NSW, Land tax is a tax levied on the owners of land situated in NSW as at midnight on 31 December of each year. In general, a principal place of residence or land used for primary production (a farm) is exempt from land tax. However, land tax may be levied on:
- (a) vacant land, including vacant rural land;
  - (b) a holiday home;
  - (c) investment properties;
  - (d) company title units, or
  - (e) residential, commercial or industrial units
- 18.2 For the 2006 land tax year a \$352,000 threshold will apply to owners of liable land. The land tax rate for 2006 will be 1.7 per cent (plus \$100) on the combined value of all taxable land in excess of \$352,000. If a land tax liability is less than \$100, no land tax will be payable.
- 18.3 There is no threshold in 2006 for non-concessional companies and special trusts. These entities will be taxed at the flat rate of 1.7 per cent on the total value of all the taxable land owned. This includes hybrid trusts.

- 18.4 It is important to consider the land tax implications of a property settlement as there is no land tax rollover on transfer of land pursuant to court orders. Thus, if a company is to transfer land to a spouse pursuant to a court order, then land tax may well be payable by the company and this need to be considered at the time of settlement. Similarly, the transfer of an investment property between spouses under a court order.

## **19. TRUSTS**

- 19.1 Where trusts are involved, certain provisions are generally included in agreements or orders for the spouse exiting from the trust to relinquish their rights as to income and/or capital from the trust. If that spouse is a co-appointor of the trust, provision is also made for them to relinquish their rights as appointor. Such relinquishment does not generally cause resettlement of the trust and therefore does not trigger any tax issues. However, it is crucial that the Trust Deeds are reviewed to ensure that no resettlement of the trust will occur.
- 19.2 A trust structure is a viable way for divorced spouses to still run a trust for the benefit of their children. More and more cases are being settled on the basis that certain assets owned by a trust are retained for the benefit of the parties' children. In those circumstances, there may be possibility for income distributions, for instance, to be made by the Trust to the exiting spouse. If this is agreed to by the exiting spouse, care must be taken to ensure that that spouse remains entitled to receive the income as some trust deeds provide that the beneficiaries are for instance the appointor and their spouse. On divorce (or even after separation) that spouse is no longer a spouse. This has significant tax ramifications as income distributions from a trust to a person who is not a beneficiary will trustee being liable to family trust distribution tax ("FTDT"). FTDT is charged at a rate equal to the top marginal rate plus the Medicare levy on the amount of income distributed to that beneficiary.

## **20. FAMILY TRUST ELECTIONS**

- 20.1 Generally, the trustee of a discretionary trust would consider making a family trust election in the following circumstances:
- (a) the discretionary trust has tax losses and would like to carry forward its losses. If the discretionary trust had made a family trust election, it only need to satisfy the income injection test to enable the losses to be carried forward;
  - (b) the discretionary trust is the shareholder of a company that has tax losses and the company would like to carry forward the losses. If a family trust election is made, the discretionary trust is deemed to hold the shares in the company in the capacity of an individual. This will assist the company in satisfying the various tests that must be met to carry forward its tax losses;
  - (c) the discretionary trust will be receiving franked dividends for shares that it acquired after 31 December 1997 and would like to pass on the franking credits that are attached to the dividends to its beneficiaries.
- 20.2 Although the making of a family trust election will ensure that the relevant tax benefits can be passed on to the beneficiaries and related entities, the election has the effect of narrowing the class of beneficiaries to whom distributions from a discretionary trust can be made tax-effectively. This narrower class of beneficiaries (called the "family group") is defined in the ITAA36 by reference to a "test individual." Any income distributions made by the trustee to a beneficiary that is not within the "family group" will result in the trustee being liable to family trust distribution tax ("FTDT"). FTDT is charged at a rate equal to the top marginal rate plus the medicare levy on the amount of income distributed to that beneficiary.
- 20.3 Section 272-90 of Sch 2F of the ITAA sets out the members of a "family group" as:

- (a) the parent, grandparent, brother, sister, nephew, niece, child, or child of a child of:
    - (i) the test individual or;
    - (ii) the test individual's spouse; and
    - (iii) the spouse of the person referred to in (a).
- 20.4 In the context of a family law settlement, if spouses are already divorced at the time of the making of settlement, then the distribution of assets from the trust to the ex-spouse will trigger FTDT.
- 20.5 However, in the 2006 Federal Budget, Mr Peter Costello announced a proposed amendment to family trust elections namely that trust distributions to former spouses and to widows or widowers of family group members who have new spouses, will be exempted from FTDT.

## **21. SUPERSPLITTING AND TAX CONSEQUENCES**

- 21.1 In the 2006 Federal Budget, Mr Peter Costello announced some significant reforms to superannuation which will come into effect from 1 July 2007. The new measures include
- (a) abolishing of reasonable benefits limits (RBL's);
  - (b) tax free benefits for those over 60 as long as their contributions and earnings have been taxed in the fund;
  - (c) For individuals aged under 60 there be an exempt component and a taxed component:
    - (i) The exempt component would be tax free. This would comprise pre July 1983, CGT exempt component, post June 1994 invalidity, concessional and undeducted components; and
    - (ii) Taxed component (the current post June 1983 component and non-qualifying component) would be tax free up to a low threshold (\$129,751 for 2005/06) and taxed at 15% (plus medicare levy) above the threshold. For those aged under 55, this component will be taxed at 20%.
  - (d) the ability of retirees to take their super as lump sum or pension.
- 21.2 Notwithstanding the changes announced by the Federal Treasurer, there may be still opportunities to enlarge the asset pool (by reducing the incidence of tax) by doing a superannuation split. Below, we outline some of the benefits of supersplitting under the current law.

## **22. NEW ETP AND ETP COMPONENTS SPLIT**

- 22.1 The effect of a super split is to create a new ETP. That is, each of the member and the previously non member spouse will have separate ETP's. For the 2006/2007 year, the ETP is \$135,591. This effectively reduces the tax payable on a super interest by approximately \$22,372.33 (\$135,590 x 16.5%).
- 22.2 In addition, where there is a super split, the components of the ETP will be split between parties. If there are for instance any undeducted contributions, these will be split between the parties based on the following formula:

$$\frac{\text{new ETP}}{\text{pre-split amount}} \quad \times \quad \text{Corresponding Amount}$$

**Example:**

*Jack and Jill separated 10 years before Jack's retirement. The Court decided that the base amount for the split is \$210,000.00 which grows at the rate of 7.5% as per the Regulations. At retirement, Jack has \$800,000. (this example assumes Jack's super is defined or SMSF and Jill's entitlement is not rolled out after the orders are made). Jill's entitlement is \$432,816.62.*

*Jill will therefore receive the \$432,816.62. She will have her own ETP.*

*Assume that Jack's undeducted contributions were \$100,000.00. This amount will also be split between the parties so that Jack's will be \$45,898 and Jill will receive \$54,102.*

*So Jack will pay tax on his interest as follows:*

		\$367,183.38	
<i>less</i>	\$45,898.00		
<i>less</i>	\$135,590.00		
<i>equals</i>		<u>\$185,695.38</u>	@ 16.5%
<b>Tax</b>		<u><b>\$30,639.73</b></u>	

**23. REASONABLE BENEFITS LIMIT (RBL)**

- 23.1 The effect of super splitting law is that you can create a second RBL. That is, a super split can provide a non member with an RBL and effectively reduce the tax payable on a superannuation interest or enable a larger lump sum amount to be received. The lump sum RBL for 20062007 is \$678,149 and the pension RBL is \$1,356,291.
- 23.2 Assume that at retirement Jack has a superannuation interest of \$1,300,000.00. If Jack and Jill are separating, then, it may be more beneficial to Jack and Jill for a transfer of some of Jack's super to bring him within the pension RBL limit. Jill will also have her own RBL limits

**24. ELIGIBLE SERVICE PERIOD (ESP)**

- 24.1 ESP refers to the period where an employee has a period of service prior to 1 July 1983. 5% of the ETP is taxed at the member's marginal tax rates and the balance (95%) is tax free. How does the ESP help in super splitting?
- 24.2 Assume that the non member has a pre 1 July 1983 service and has accumulated in the fund \$20,000. The member, however, has no pre 1 July 1983 service and at retirement he will receive \$300,000. It would be of interest to the parties to split the superannuation interest and for the wife to, say, receive \$200,000 of the member's super. The effect is that the non member will now have \$220,000.00 in her super fund. 5% of \$220,000 is \$11,000 which is taxed at say 46.5% (in 2006/07 tax year). The non member will therefore pay tax of only \$5,115.00. The 95% balance of \$209,000 is tax free.
- 24.3 Note that unlike the other components of the ETP which are apportioned according to the relevant percentage split, ESP is not splittable. Therefore, if the member spouse has an ESP component and there is a super split, there will be a loss of pre 1 July 1983 ESP if there is a super split.

**25. CAPITAL GAINS TAX AND SUPERSPLITTING**

- 25.1 CGT rollover relief is available where the super split is made under a Court Order. An in-specie transfer of property for instance owned by an SMSF to another SMSF under a Court order will give rise to a CGT Rollover relief.

- 25.2 However, if the asset owned by the SMSF is sold to effect the super split, CGT Rollover relief will not apply. CGT will be payable and it will be levied on the SMSF which sold the asset so again caution is required to ensure that the CGT liability is taken into account at the time of settlement. If the asset has been held for more than 12 months, there is a 30% discount (not 50% as is the case with individual ownership) and then 15% is levied on the capital gain.
- 25.3 The same would apply in relation to a member client's interest in a retail fund whereby the supersplit will require the sale of shares or managed funds and the rolling out of the interest to the non-member spouse. It is noted though that retail super fund managers engage in buying and selling of shares regularly and therefore the CGT is paid on sale.
- 25.4 As indicated above, in the May 2005 Federal Budget, the Treasurer announced that CGT rollover relief will be available for Financial Agreements (and Superannuation Agreement) and Agreements between domestic partners, however this has not become law. Accordingly, at this stage, CGT Rollover relief is not available in relation to Superannuation Agreements. Therefore, any super split made by way of a Superannuation Agreement may trigger a capital gain or loss when the rollover/transfer is made and caution should be applied in relation to supersplitting.

## **26. TAX OPPORTUNITIES AND RISKS**

### **26.1 Income From Companies/Trusts/Partnership**

- (a) During the course of marriage or relationships, parties generally split the income of partnerships, companies or trusts between the spouses. There is nothing unusual in this.
- (b) However, on separation, one of the spouses generally retains control of the entity or entities and the other spouse is shut out. As family law cases can take up to two years plus to be determined, it is important to consider whether it is appropriate for the splitting of income to continue during the separation period and until orders are made. There are tax consequences for the spouse who is shut out of the entity from income or distributions allocated to them and for which income tax has not been paid or insufficient amounts have been paid when one takes into account the spouse's other income.
- (c) On occasions, where the controlling spouse is ordered by the court to pay spouse maintenance, they may wish to pay that maintenance through income splitting which again will trigger an income tax liability. The recipient spouse should ensure that if such an arrangement will or may likely be put in place by the controlling spouse, that they are not liable to pay the tax by obtaining an indemnity from the controlling spouse.
- (d) It is also important that at the time of making final orders that indemnities be provided by the controlling spouse in relation to all taxes that may be payable as well as other indemnities which will be outlined below. Such indemnities could prove valuable if the client later finds out that their former spouse had made declarations or distributions of income which they never received (or which were paid pursuant to a spouse maintenance order which is a personal net amount order).

## **27. CHILD MAINTENANCE TRUSTS**

- 27.1 A Child Maintenance Trust is a trust that arises as a result of the family breakdown. As the name suggests, it is a trust which is set up to receive child maintenance payments.
- 27.2 One of the principal benefits of a Child Maintenance Trust is that it enables tax effective income splitting to beneficiaries of a trust (including beneficiaries who are under 18 years of age) without attracting the penalty tax provisions contained in Division 6AA of the Income Tax Assessment Act. Ordinarily, minor beneficiaries receiving distributions of trust income enjoy a tax free threshold of

only \$416.00. In addition, any amount received by the minor beneficiaries in excess of \$416.00 will be taxed at the penalty rates applying under Division 6AA of the Tax Act which can be as much as 66%. With the low income tax rebate of \$235.00 this means that a minor beneficiary can receive a distribution of \$772.00 without being subject to any tax.

- 27.3 Specifically excluded from these penalty provisions is income received by minor beneficiaries of a Child Maintenance Trust.
- 27.4 Under the tax rules applying to Child Maintenance Trusts, minor beneficiaries are given the benefits of ordinary tax treatment. That is, each minor beneficiary of a Child Maintenance Trust will enjoy a tax free threshold of \$6,000.00 **and** the usual marginal tax rates applying to income distributions from the Child Maintenance Trust in excess of \$6,000.00. By recognising the circumstances where a Child Maintenance Trust can be used considerable amounts of after tax dollars can be saved.
- 27.5 But there are also benefits to the person making the child maintenance payments. Ordinarily, child maintenance or child support payments are made from after tax dollars, that is, from the pool of money on which tax has already been paid. A properly structured Child Maintenance Trust can enable child maintenance payments to be effectively paid out of pre-tax dollars.

Example:

*Robert has recently been separated from his wife Janet, who has residence of their two children, Jack aged 7 years and Jill aged 5 years.*

*In accordance with a Child Support Agreement agreed between the parties, Robert must pay \$10,000.00 per annum to Janet for the benefit of Jack and Jill.*

*Robert currently earns \$45,000.00 as an accountant, and \$10,400.00 (being \$200.00 a week) as income from an investment vehicle (eg a private company) in which he has an interest.*

*Robert's total income is \$55,400.00 and he pays tax of \$12,480.00 (including Medicare Levy) with an after-tax income of \$42,920.00. As a result of his \$10,000.00 child support obligations Robert is left with \$32,920.00 per annum.*

*Robert's after-tax and "after-child support" income position could be improved by the effective utilisation of a Child Maintenance Trust.*

*Robert could transfer property (for example an interest in the investment vehicle, cash, income generating shares or income generating property) to the Child Maintenance Trust for the benefit of the children. The property transferred to the Child Maintenance Trust is invested to generate income and, as trustee of the Child Maintenance Trust, Robert can direct that \$10,000.00 per year be distributed to Jack and Jill (ie \$5,000.00 to each). If the income generated in the Child Maintenance Trust was \$10,400.00 per year the balance of the income (\$400.00) could be distributed to Robert.*

*What is Robert's income position now? His income is \$45,400.00 (salary of \$45,000.00 and Child Maintenance Trust income of \$400.00). His tax liability is \$9,480.00, leaving an after-tax and after child maintenance income of \$35,920.00. What is Robert's child support obligation? Still the same \$10,000.00. Only now it has been paid from the Child Maintenance Trust.*

*Robert has been able to improve his after tax and after-child support position by \$3,000.00 per year by utilising a Child Maintenance Trust. Robert will make a saving of \$3,000.00 each year for the next 11 years (until the eldest child reaches 18 years of age) with further savings being made in years 12 and 13 (ie. until the youngest child reaches 18 years of age).*

- 27.6 There are a number of important factors to consider in the establishment of a Child Maintenance Trust arrangement including the following:
- (a) the terms of the Child Maintenance Trust must comply with the prevailing tax laws (see section 102AG(2)(c)(viii) and section 102AGA (below) - principally, the trust must have arisen as a result of a family breakdown and the children must acquire trust property on vesting day);
  - (b) the Child Maintenance Trust arrangements must be consistent with existing child support obligations;
  - (c) the transfer of property to the Child Maintenance Trust to generate income may give rise to capital gains tax and stamp duty implications depending on the nature, cost and value of the property transferred.

## **28. INDEMNITIES AND GUARANTEES**

28.1 Generally, the exiting spouse must ensure that they obtain indemnities from the controlling spouse in relation to:

- (a) all claims made against the entity by a third party;
- (b) any claim that the entity or the controlling spouse has against the exiting spouse of the entity;
- (c) all tax liabilities including CGT, GST, income tax and all other tax liabilities;

that may arise in respect of any act or thing done or omitted to be done by the exiting spouse whether by reason of the exiting spouse having been an employee and/or director and/or officer of the entity and/or by reason of exiting spouse shareholding within the entity and/or any loan account in exiting spouse's name and/or the receipt by exiting spouse of any moneys at any time from the entity or otherwise.

- 28.2 It is also important to ensure that the exiting spouse is released from all guarantees they may have been given during the marriage or relationship. Omission to obtain such a release means that the client may be called upon to make good any default by the entity even years after the spouse exited the entity.
- 28.3 Whilst an indemnity may be obtained from the controlling spouse that they be responsible for and indemnify the exiting spouse in relation to all guarantees, this is not ideal and in some cases not sufficient. The exiting spouse should be released from the guarantees as part of the orders to ensure that they will never be called upon to make good any default.

## **29. CONCLUSION**

- 29.1 The tax issues and opportunities that face family lawyers in advising their clients are significant and have far reaching consequences for clients and lawyers. Lawyers should liaise with the client's accountant to ascertain any tax issues.
- 29.2 Single experts must be asked to prepare reports taking into account the various tax consequences of the parties and the orders sought by each of the parties as well as any other consequence that the court may likely order in relation to particular assets.
- 29.3 With the right planning during the course of the matter, clients' expectations will also be met.