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Taxation Discussion Group No 14

Tax and Divorce

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1. Introduction

This discussion paper covers the impact of income tax and the CGT rollover relief that is available in the division of property following divorce for married couples or relationship break down between de facto couples including those in same-sex relationships.

The Australian Bureau of Statistics report 3310-0- *Marriages and Divorce, Australia, 2010* states that there were 50,240 divorces granted in Australia, an increase of 792 compared to 2009. The median age for divorce has been increasing for the last 20 years. Between ages of 50-54 years it was 8.9%, 55-59 (6.6%) and 60-64 (4.6%). As a general proposition, it is the couples in this demographic that have accumulated a greater amount of assets during their working lives and the stakes are higher when it comes to division of property.

The following points should be noted at the outset:

divorce is the formal process by which a marriage is brought to an end 30 days after the issue of the decree nisi by the Family Court or the Federal Magistrates Court;

application for property division, spousal maintenance and child maintenance are separate;

once a divorce is granted couples have 12 months in which to bring applications for property division and spousal maintenance and within 2 years from the date the de facto relationship ended; the rules for de facto partners apply after 1 March 2009.

all assets form part of the matrimonial assets available for division irrespective of whether held solely in the name of either spouse, jointly owned, or with a third party. There is no distinction between matrimonial property and business property regardless of whether those assets are held in a corporate or trust structure;

the extent and value of the property is based on the date of the hearing or the date of the property settlement and not at the date of separation. This can give rise to other issues such as one party receiving an inheritance or winning the lottery after the separation;

transfers of property outside the ambit of a binding financial agreement may be subject to stamp duty and may trigger capital gains tax payable by the transferor spouse; (In some cases it may be advantageous to transfer property prior to orders or a financial agreement being entered into where the transferor spouse has unrecouped carry-forward losses that can be offset against the deemed market value of the property transferred):

CGT rollover relief is available when certain conditions are met. The rollover ensures that the transferor spouse disregards any capital gain or loss that would otherwise arise and the transferee spouse receives the cost base of the asset; (See Div 126-A of the ITAA 1997).

2. Family Law Act 1975 (FLA) - some essentials

As the division of property comes under FLA, there is a need to appreciate some of the key sections.

The Family Court and the Federal Magistrates Court have substantial discretionary powers to vary or divide the ownership of property that is owned by one or both spouses. (Section 79 of FLA)

The duty to make full and proper disclosure of all property is set out in Family Law Rule 13.04 which states:

- (1) A party to a financial case must make full and frank disclosure of the party's financial circumstances including:
 - (a) the party's earnings, including income that is paid or assigned to another party, person or legal entity;
 - (b) any vested or contingent interest in property;
 - (c) any vested or contingent interest in property owned by a legal entity that is fully or partially owned or controlled by a party;
 - (d) any income earned by a legal entity fully or partially owned or controlled by a party including income that is paid or assigned to any other person or legal entity;
 - (e) the party's other financial resources;
 - (f) any trust:
 - (i) of which the party is the appointor or trustee;
 - (ii) of which the party's child, spouse or de facto spouse is an eligible beneficiary as to capital or income;
 - (iii) of which a corporation is an eligible beneficiary as to capital or income if the party, or the party's child, spouse or de facto spouse is a shareholder or director of the corporation;
 - (iv) over which the party has any direct or indirect power or control;
 - (v) of which the party has the direct or indirect power to remove or appoint a trustee;
 - (vi) of which the party has the power (whether subject to the concurrence of another person or not) to amend the terms;
 - (vii) of which the party has the power to disapprove a proposed amendment of the terms or the appointment or removal of a trustee; or
 - (viii) over which a corporation has a power mentioned in any of the subparagraphs (iv) to (vii), if the party, the party's child, spouse or de facto spouse is a director or shareholder of the corporation;
 - (g) any disposal of property (whether by sale, transfer, assignment or gift) made by the party, a legal entity mentioned in paragraph (c), a corporation or a trust mentioned in paragraph (f) that may affect, defeat, or deplete a claim:
 - (i) in the 12 months immediately before the separation of the parties; or
 - (ii) since the final separation of the parties and
 - (h) liabilities and contingent liabilities.
- (2) Paragraph (1) (g) does not apply to a disposal of a property made with the consent or knowledge of the other party or in the ordinary course of business;
- (3) In this rule:

“legal entity” means a corporation (other than a public company) trust, partnership, joint venture business or other commercial activity.

Section 71 CA of the FLA defines a "Family Law agreement" as

- (a) a maintenance agreement; or
- (b) a financial agreement; or
- (c) a splitting agreement:

"Family Law order" means an order of the court under Part VIII, VIIIA or VIIIB of the FLA

"financial agreement" means a financial agreement made under section 90B, 90C or 90D of the FLA... that is binding on the parties to the agreement. (Note the agreement can be made before, during or after marriage).

"splitting agreement" includes a "superannuation agreement"

"superannuation agreement" has the same meaning in Part VIIIB of the FLA

Under section 106B a spouse can make application to the Court to set aside or make orders where there has been action made or proposed to defeat any order.

3. Information gathering

The professional adviser has the unenviable task of carrying out due diligence on the existence and ownership of matrimonial assets, ownership and control of business structures and trust structures, existence of joint ventures, interests in partnerships, identifying all existing and contingent liabilities, superannuation interests, independent valuation issues, identifying the commercial issues and minimising the tax and managing the client's perceptions in an emotionally charged atmosphere. Bearing in mind that the FLA requires the parties to make a full and frank disclosure this would hopefully make the due diligence task easier. Apart from the most obvious assets such as real property, shares, motor vehicles and collectibles there may be other assets such as a chose in action, put and call options and identifiable intangibles such as patents, licensing agreements that give right to royalties.

4. Trusts and the FLA

The ability to bring trust assets into the matrimonial pool and the ability of the Family Court to make orders against third parties under Part VIIIAA still creates concern. The wide interpretation is that the Court can make orders that divest third parties of property in favour of a party to the marriage.

The High Court decision in *Kennon v Spry* (2008) HCA 56 shows how trust assets can be drawn into the net for family law purposes.

The ICF Spry Trust was established by Dr Spry before the marriage. He was the settlor and trustee and had the power of appointment. The beneficiaries were Dr Spry, his siblings, his and their issue and the spouses of all of them. During the marriage the trust acquired substantial assets from Dr Spry. By deed in 1983 the husband excluded himself as a beneficiary and in 1998 when the marriage was in trouble, Dr Spry as trustee excluded his wife as a beneficiary. In 2002 after separation, he set up four trusts for his daughters and transferred assets from ICF Spry Trust to those trusts and retired as trustee of the four trusts.

Mrs Spry sought orders that certain transactions be set aside under 106B of the FLA and the Court exercised its power to set aside her exclusion as a beneficiary (notwithstanding she was a discretionary object and was therefore always only a potential beneficiary and her husband was an excluded beneficiary).

Query what would happen if neither spouse had made a contribution of trust capital and the original trust property was settled a generation earlier by a grandparent.

In *Essex & Essex* (2009) FLC 93-423 the Full Court considered the position where the husband's elderly mother set up the S Trust and the N Trust over some of her property. The husband's brother was the sole director of the corporate trustee of both trusts.

In evidence before the trial judge it became clear that one of the reasons for the establishment of the S Trust for the husband was to quarantine those assets from being included as matrimonial property. The trial judge found that as neither party had made a contribution to the trust property and the husband was neither trustee nor controller of the corporate trustee that the trust property wasn't a financial resource of the husband to take into account in the division of property.

The wife appealed to the Full Court. The Court ruled that the trust property was a financial resource of the husband and reduced the husband's share of the matrimonial split. This was based on evidence of an email from the accountant to the husband's brother that the plan was for the brother to resign as corporate director of the trustee of the S Trust and the husband would take that role as soon as his matrimonial problems were behind him.

5. CGT issues

Generally, a capital gain or loss arises on transfer of an asset under a property settlement. The transfer is for deemed market value so that the transferor spouse is deemed to have received market value for the sale proceeds (sec 116-30 of the ITAA 1997) and the transferee spouse has a deemed cost base equal to that market value (sec 112-20 of the ITAA 1997).

There are CGT exemptions as well as CGT rollover relief opportunities in a property division.

General CGT exemptions

(a) Cars

A capital loss or gain arising from transfer of a car or motorcycle will not have any CGT consequence but care should be exercised regarding the tax issues if the vehicle was partly used to derive assessable income. (sec 118-5 of ITAA 1997).

Note that trucks and other work vehicles will not fit into the definition of a car in (sec 995-1 of ITAA 1997)

(b) Collectables and personal use assets

A capital gain or loss is disregarded on the transfer of a collectable if it has a cost base of \$500 or less or a personal use asset if it has a cost base of less of \$10,000 or less. Any capital loss is quarantined and available to future gains from sale of assets in these categories.

(c) Marriage or relationship breakdown settlements

Section 118-75 of ITAA 1997 disregards a capital gain or loss made as a result of CGT event C2 happening. An amount received by a spouse by way of a settlement of a legally enforceable right in connection with the marriage or relationship breakdown is disregarded for CGT purposes.

Example 1

Brad pays Jen \$10m as a cash settlement of all claims that she has in relation to their matrimonial property. Jen's right to the amount is extinguished on receipt of the funds and there is no CGT consequence to her.

(d) Small business CGT concessions

If a small business has business borrowings supported by a mortgage over the matrimonial home and if there are difficulties in refinancing the business loan when the home is sold, the business could be sold to access the funds tax-free under the small business CGT provisions.

(e) CGT rollover relief for superannuation payment splits

Discussed at paragraph 11 of this paper.

Main residence exemption

A capital gain is disregarded to the extent that the main residence was the main residence of the transferor spouse throughout the period of ownership. However, this simple proposition is complicated if there are multiple residences. Where the rollover relief is available under subdivision 126-A, section 118-178 of ITAA 1997 applies to a person selling that dwelling having regard to the total use of the property by the former spouse and the current owner.

Example 2

Harry and Sally marry and live in the dwelling owned by Harry that was his main residence 2 years before the marriage. Harry and Sally live in the house for another 3 years and Harry transfers ownership of the house to Sally as part of the divorce settlement. Sally rented the property out for another 5 years and claimed another house as her main residence. Sally sells the house. Sally is entitled to a partial exemption of 50% of the capital gain having regard to the total period of ownership as the principal residence of Harry for 2 years and during their marriage of 3 years. A total of 5 out of the 10 years.

Example 3

Richard transfers 100% ownership of his investment apartment in the Toaster at Sydney's Circular Quay to Elizabeth under the roll over provisions in sec 118-178. Elizabeth occupies it as her main residence. Elizabeth will only be able to claim a partial main residence exemption from the time that she occupies it as such.

There is also only a partial exemption available where a dwelling is acquired from a company or trust pursuant to rollover under Subdivision 126-A. The dwelling cannot be treated as the main residence during the period it was owned by these entities. (sec 118-180 of the ITAA 1997).

6. CGT events that apply to marriage or relationship breakdown rollover

Rollover relief under Subdivision 126-A of ITAA 1997 applies to a range of CGT events involving the transfer of the ownership of assets between the individual spouse or former spouse (sec 126-5) or transfer from a company or trustee to a spouse or former spouse (sec 126 –15) where these events occur as a result of :

- a court order under the FLA or corresponding foreign law;
- a binding financial agreement made under Part VIIIA of the FLA or a corresponding foreign law;
- an award made under arbitration under section 13H of the FLA or a corresponding foreign law;
- a maintenance agreement approved by a court under sec 87 of FLA or corresponding foreign law;

For rollover to apply, one of the following events must occur. The transferor spouse, company or trustee

- disposes of an asset to the transferee spouse (CGT event A1)
- enters into an agreement with the transferee spouse under which
 - . the right to use and enjoy an asset transfers to the transferee spouse
 - . title in the asset will, or may pass to the transferee spouse at the end of the agreement (CGT event B1)
- creates a contractual or other right in favour of the transferee spouse (CGT event D1)
- grants an option to the transferee spouse or renews or extends an option granted to the spouse (CGT event D2)
- grants the transferee spouse a right to receive income from a prospecting or mining entitlement (CGT event D3)
- is a lessor and grants, renews or extends a lease to the transferee spouse (CGT event F1).

The rollover provisions do not apply where:

- none of the CGT events specified above occur;
- the asset is transferred to the legal personal representative of the deceased transferee spouse (the spouse having died after the commencement of the proceedings); (ID 2008/103)
- the CGT asset is trading stock of the transferor;
- the transfer occurs before the court order or agreement, even if a court order later sanctions it (TD 1999/53)
- there is no Family Court order or financial agreement;
- despite court orders or a financial agreement, there is no relationship breakdown;
- where an asset other than that specified in court order is transferred.

7. Consequences of the rollover

- rollover is automatic and the parties do not need to elect to use it nor can they opt out of it;
- the status of any pre CGT status is maintained in the hands of the transferee spouse;
- the transferee spouse gets the assets with its historic cost attributes of the transferor and any potential CGT tax liability remains embedded until the transferee spouse sells the asset;
- the transferor has no CGT liability;
- the transactions are stamp duty exempt.

8. An example of the effect of the rollover is below.

Example 4

Donald and Ivana had the following assets at the time of their marriage breakdown:

Asset	Purchase date	Cost \$
Family home (jointly owned)	January 1985	2.0 m
Beach house (jointly owned)	October 1990	3.0 m
Share portfolio (owned by Donald) (carry forward capital loss of \$1.5m)	All acquired in March 2007	4.0 m
Trumpet Properties Pty Limited owns 2 commercial strata title office suites. All shares in the company are owned by Donald. Pursuant to court orders the company transfers one of the suites to Ivana	The investment suites were retained by the company after it has developed Trumpet Towers in July 2008. Cost of the suite transferred to Ivana is \$ 800k.	\$1.0m (market value) \$.428m (gross up under 109RC) <u>\$ 1.428m</u> This is a deemed dividend under Div 7A
Trumpet Developments Pty Limited is carrying out a land subdivision on the north coast. Under the agreement one parcel is to be transferred to Ivana.	As the land is trading stock the rollover provisions do not apply. The land will be deemed to have been transferred at market value of \$1m .The company pays tax on the profit.	\$1.0m (market value)
Vintage motor vehicle collection including a Morgan plus 4 and a Vincent Black Lightning 1952	Acquired over the last 10 years. Note these are CGT exempt under 118-5	1.0m

After receipt of their decree nisi on 14 February 2012 (Valentine's Day) the Family Court issues consent orders to the division of their property as per their financial agreement.

Ivana wants a sea change so she gets the beach house. She also gets the share portfolio at Donald's cost base, the commercial strata title suite and the block of land She also wants the Morgan plus 4 but Donald, who is a very good talker, let's her have the Range Rover instead. This transaction is CGT exempt. (Note the Range Rover was not used for business purposes)

Donald receives the family home and because it is pre CGT he is taken to have acquired his original interest and Ivana's share before that date at the cost base of \$2.0m. He continues to reside in it as his main residence. Any capital gain is disregarded in relation to the transfer of the beach house and the share portfolio to Ivana under the marriage breakdown rollover provisions.

Ivana receives the beach house at its historical cost of \$3.0m and the share portfolio at the cost of \$1.0m. When Ivana sells these assets she would calculate her gain/loss using these cost bases.

What are the implications for Ivana?

Ivana will get partial capital gains exemption for main residence from the period that she occupies it as her main residence. There are latent CGT liabilities in the share portfolio which will emerge as she sells those shares based on their historical cost. Ivana should have been made aware of this during the settlement negotiations and presumably an allowance has been made for the CGT liability.

The transfer to her of the commercial office suite will be treated as a deemed dividend under Div 7A. However as this transfer is pursuant to a court order and as Trumpet Properties has franking credits, the amount can be fully franked. Note that even though Ivana is not a shareholder of Trumpet Properties she is treated as a member (sec 109RC (4) of the ITAA 1936. Ivana will be liable to pay the top-up tax on the deemed dividend. Ivana has a cost base of \$800k and any top-up tax paid on the deemed dividend does not form part of the cost base.

Ivana's cost base for the development land is its market value.

What are the implications for Donald?

As the rollover provisions have been used, Donald is not able offset his carry forward CGT losses of \$1.5m. on his investment share portfolio. Depending on the current and projected market of the portfolio it may have been better to have not sought the rollover relief. Donald would have recouped his capital loss and paid the CGT and Ivana would have had a cost base equal to market value.

Donald, it seems, is prepared to pay any price for his freedom, the transfer of the block of development land which is trading stock will result in Trumpet Developments paying tax on that profit as well as the unpaid consideration will be a loan that will need to be dealt with under Div 7A.

Example 5 – the adverse effects of informal agreements

Adam and Steve separate after a long defacto relationship. To avoid legal costs they decide to work out their property division themselves.

During their relationship they lived in the house that is wholly owned by Adam and some years ago they had bought an investment property together. They agree that Adam would retain sole ownership of his house and that Steve would pay Adam \$ 60,000 representing his share of the principal mortgage repayments. Steve would then take over the investment property and re-finance the mortgage. The market value had increased appreciably over time. As this is not a financial agreement under FLA, there is no CGT rollover relief and the market value substitution

rules apply. The result is that Adam will be liable to pay tax on his share of the gain on the property.

Division 7A and property settlements

Under Division 7A a transfer of property by a private company to a shareholder or associate is also a payment for Division 7A purposes. The amount of the deemed dividend is the amount that would have been paid for the transfer by parties dealing at arm's length, less any consideration given by the shareholder for the transfer. (Sec 109 C (4) of ITAA 1936).

Under section 90AA and 90AC of the FLA a court can make an order that a company pay an amount or transfer an asset to a spouse or a former spouse irrespective of whether that spouse is or was a shareholder.

109RC ITAA 1936 allows the dividend to be franked if it arises under Div 7A as a consequence of a family law obligation.

9. Some typical issues that will arise

The settlement negotiations may cover such items as:

- restructuring of ownership of business entities such as share transfers and selective share buy-backs;

This may raise issues regarding the ability to recoup carry forward losses if there is more than a 50% change of ownership and pre-CGT assets may become post CGT assets under Div 149 unless rollover relief applies.

- debt release or forgiveness by the entities or the individuals
- refinancing debt and arranging new loan securities and release of personal guarantees
- transfer of assets from a company or trust
- Div 7A issues
- UPEs

10. Trust assets

As noted earlier, the Family Court has power to set aside distributions or make orders against the trustee. It can:

- bring trust assets into the property pool and this occurs where the trust assets have accrued from the family efforts and have been used for the benefit of one or both parties to the marriage;
- under sec 106B of the FLA to set aside any attempts to remove control from a party to the marriage or from varying the trust deed;
- the Court can declare a trust is a sham pursuant to sec 78 of the FLA

- the court can make orders against a third party changing the ownership of assets. However this would be in limited circumstances.

Consider the circumstances where the Court declares certain trust distributions invalid or trust distributions to be suspended pending resolution of the dispute. It may result in certain beneficiaries incurring tax liabilities on net income that was appointed to them and now that is no longer the case and default beneficiaries or the trustee (if no beneficiary is deemed presently entitled) being liable for the tax and amendment periods may have expired.

CGT or stamp duty issues may arise if on divorce the outgoing spouse is removed as a beneficiary and therefore cannot benefit from any distribution of capital or income.

Unintended Div 7A issues can arise if the court orders a trustee to transfer assets to the outgoing spouse and there are UPEs to a corporate beneficiary of which the outgoing spouse or relatives is a shareholder. The result would be that the outgoing spouse will be treated as having received a frankable dividend equal to the market value of the property transferred. (Advisers for the outgoing spouse should factor in this tax liability or seek appropriate indemnities from the trustee or the continuing spouse).

Similarly, the forgiving of a loan to the outgoing spouse where an amount is owed by the trust to a related corporate beneficiary will give rise to a deemed dividend.

Care should be exercised where there are unrecouped carried forward trust losses and there is a change in ownership or control, the tests are in Schedule 2F of the ITAA 1936.

11. Superannuation orders, property and the FLA

Following the introduction of the Family Law Legislation Amendment (Superannuation) Act 2001 superannuation is now defined as “property” within sec 4(1) of the FLA.

Prior to the introduction of the amendment, superannuation was unable to be treated as property and the only way that the parties could receive a just and equitable outcome was to adjourn any proceedings until the superannuation was vested. The result was that one party ended up with the superannuation asset but with no realisable assets and vice versa. The introduction of the amendment vested powers in the court to “flag” or “split” superannuation assets. Note, however, that the member can still only access superannuation when a condition of release is satisfied under the SIS Act. The amendments also provided for superannuation to be valued which allowed parties to proceedings to access information with regards to each other’s superannuation benefits.

Flagging orders

Under 90 MU of the FLA the court has the power to issue a flagging order to the trustee of a superannuation fund that prevents one party from transferring their superannuation without a court order or agreement. The court can make the following orders in relation to a superannuation interest:

- direct the trustee not to make any splittable payment in respect of the interest without the leave of the court and

- requiring the trustee to notify the member and non-member when a splittable payment becomes due for payment.

Splitting orders

Section 90T of the FLA outlines the requirements for a splitting order under which the courts can split the superannuation interest of one party and add it to the superannuation interest of the other party.

Rollover relief for small superannuation funds

Section 126-D of the ITAA 1997 provides rollover relief in relation to transfers of the personal interest of either spouse in a superannuation fund with less than five members to another complying fund. It applies automatically to:

- a transfer of any asset reflecting the personal interest of either spouse in a small superannuation fund to another complying fund;
- a transfer of any asset reflecting a spouse's entitlement under a payment splitting order or agreement to another complying superannuation fund: (note the acquisition of assets from a related party is permitted in such a situation); Section 66 (2B) of the SIS Act permits a trustee to acquire an asset from a related party without breaching the prohibition in section 66 of the SIS Act in the event of divorce or relationship breakdown;
- note that where units in a pre- 1999 unit trust are transferred to a new fund, their pre-1999 status is maintained (sec 71EA of the SIS Act)

The effect of the rollover is that accrued capital gain or capital loss is deferred until a subsequent CGT event happens to the asset which is deemed to be acquired at the original cost base with the same attributes i.e. pre CGT assets remain pre CGT.

Parties can split the superannuation interest based on a superannuation agreement but must provide evidence that the parties are divorced by providing the trustee a copy of the decree absolute dissolving the marriage or a separation declaration.

The tax consequences of a payment split are as follows:

Superannuation lump sums: Lump sum paid to or created for a non-member spouse is treated as a separate superannuation benefit for the non-member spouse.

Superannuation income streams: If a non-member's entitlement is paid as an income stream it is treated as a separate superannuation income stream for the non-member spouse.

Capital gains tax: Capital gains or losses arising from the creation of rights when a superannuation agreement is entered into or terminated are disregarded.

Apportionment of the components of a superannuation benefit

The two components of a superannuation benefits being the taxable and tax-free components for the member and non-member spouse are allocated proportionally. The amount allocated to the non-member is called the “base amount”. This is a dollar amount that is noted in the superannuation agreement that the non-member will receive from the member’s superannuation interest. If the amount is not received immediately the trustee will adjust for the growth in the base amount until it is paid out. This is referred to the “adjusted base amount”.

Example 6

Assume Fred’s superannuation interest is \$100,000 made up of \$75,000 which is taxable and \$25,000 is tax-free and assume that Wilma is entitled to receive \$40,000 as a splittable payment pursuant to a binding superannuation agreement. Wilma’s share of the tax-free component is $25,000/100,000 \times 40,000 = \$10,000$ and her taxable component would be $75,000/100,000 \times 40,000 = \$30,000$. Fred’s components are reduced accordingly and become tax-free component of \$15,000 and taxable component of \$45,000.

Superannuation pensions and annuities

As with lump sums, when an income stream is split, both the member spouse and the non-member spouse are entitled to a share of the pension or annuity. The tax-free and taxable components are worked out immediately before the split and are then allocated between the member and non-member spouse and apportioning them in the same proportion as the pension is split.

A partial commutation of an income stream may be required if there is a requirement to pay a superannuation lump sum to the non-member spouse. Note however that each member is entitled to his or her post 1983 threshold. A non-member does not inherit the ex-spouse’s pre July 83 service period.

References

Tax traps arising from family breakdowns by David Marshke in *Taxation in Australia Vol 45* (10)

Tax Issues in Family Law Property Divisions written and presented by Arlene Macdonald, Barrister at the South Australian Convention 6-8 May 2010

CCH Australia Limited Superannuation Law & Practice

Superannuation and Divorce in Australia: An evaluation of post reform practice and settlement outcomes-Grania Sheehan, April Chrzanowski and John Dewar published in the *International Journal of Law, Policy and Family* 22 (2008)

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