Navigating family law settlements

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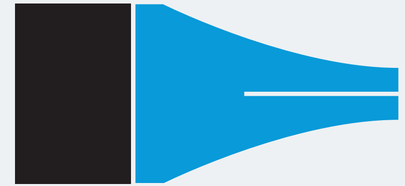

This article provides a summary of select taxation and trusts issues for consideration when assisting clients with financial settlements following a marriage or relationship breakdown.

Introduction

This article discusses some of the taxation and trusts issues encountered when structuring family law settlements. Managing these issues appropriately through careful planning and the preparation of appropriate documentation can ensure the best financial and taxation outcome for clients.

Unless otherwise stated, legislative references in this article are to the *Income Tax Assessment Act 1936* (Cth) (ITAA36), the *Income Tax Assessment Act 1997* (Cth) (ITAA97), and the *Family Law Act 1975* (Cth) (FLA). Consistent with the definition in the ITAA97,[1] the term "spouses" is used in this article to refer to both married and de facto couples, including same sex couples, albeit in the context of a marriage or relationship breakdown.

Capital gains tax roll-over relief

The most common issue encountered in a family law settlement is the transfer of assets, either from one spouse to another, or from an entity controlled by either or both spouses.

Capital gains tax (CGT) roll-over relief applies to CGT events happening between spouses as a consequence of the breakdown of the relationship in a number of circumstances, including:

(1) a court order under the FLA, a state or territory law, or a corresponding foreign law;

(2) a maintenance agreement approved by a court;

(3) a financial agreement prepared for the purposes of Pts VIIIA and VIIIAB FLA;

(4) an award made in arbitration under the FLA, a state or territory law, or a corresponding foreign law; or

(5) a written agreement under the FLA, a state or territory law, or a corresponding foreign law.

The roll-over relief applies for:

(1) transfers of property between spouses;[2]

(2) transfers of property from a company or trust to an individual;[3] and

(3) the division of superannuation by transfers of assets from a small superannuation fund to a complying superannuation fund where there is a payment split under the FLA and the non-member spouse has served a waiver notice[4] on the trustee of the fund.[5]

It is important to note that, in the first two instances, the roll-overs only apply to transfers *to* an *individual* and in the third instance, to a complying superannuation fund. There is no roll-over relief where the transfer is to an *entity* controlled by an individual. Therefore, in the latter event, any potential CGT liability should be appropriately adjusted for or indemnified as part of the overall settlement.

For the transferor, any capital gain or loss made from the CGT event[6] is disregarded. For the transferee, the first element of the asset's cost base (or reduced cost base) in the hands of the transferee is the asset's cost base (or reduced cost base) (in the hands of the transferor) at the time when the transferee acquired it.[7]

If the asset was a pre-CGT asset of the transferor, the asset will retain that status on the transfer to the transferee spouse.[8]

In the case of transfers out of companies and trusts, there may be a reduction in the cost base and reduced cost base of other associated assets (such as shares in the company, loans to the company, or an interest or unit in the trust, or loan to the trustee) that "reasonably reflects" the fall in the market value of those assets because of the trigger event.[9]

The roll-over only applies in the case of a financial agreement or other written agreement where, at the time of the CGT event, the spouses or former spouses are separated, there is no reasonable likelihood of cohabitation being resumed, and the transfer occurred because of reasons directly connected with the breakdown of the relationship.[10]

Subsequent disposal by the transferee spouse

A subsequent disposal of a CGT asset by the transferee spouse would generally be subject to CGT.[11] The resulting CGT liability could be considerable, especially if the asset was held by the spouses for a considerable period of time prior to the relationship breakdown. It would be prudent, therefore, for the transferor spouse's "share" of any unrealised capital gain as at the time of executing the financial agreement to be factored into the proposed settlement and an adjustment in favour of the transferee spouse made accordingly.

Alternatively, the financial agreement could provide for the transferor spouse to indemnify the transferee spouse for their "share" of the amount of the CGT liability at the time of the execution of the financial agreement, if the asset is disposed of by the transferee spouse within a specified time frame. However, this is often not an ideal outcome, especially if the transferor spouse's circumstances were to change within that period.

Payments of cash out of private companies

While a CGT roll-over may apply to a transfer of property out of a company to an individual in the context of the breakdown of the relationship between spouses, such a transfer (or a payment) could still be subject to Div 7A ITAA36.

This was made unequivocally clear in TR 2014/5[12] in which the ATO formally reversed its position on the taxation treatment of payments of cash from a private company to a shareholder or an associate of the shareholder made pursuant to a court order under s 79 FLA.

The ATO had (in private binding rulings issued previously[13]) accepted that, in accordance with s 109J ITAA36, such payments would not be treated as deemed dividends for the purposes of Div 7A.

The ruling states that such payments or transfers to a shareholder are an ordinary dividend assessable as income of the shareholder pursuant to s 44 ITAA36. The ruling also states that payments to associates of a shareholder are a deemed dividend for the purposes of Div 7A, despite the operation of s 109J. Consequently, payments of company profits made to a spouse in satisfaction of Family Court orders are subject to income tax at up to 49% (less any applicable franking credits). Depending on the actual cash payment sought by the recipient spouse, it may be prudent therefore for the financial agreement to provide for the recipient spouse to be indemnified for the amount of the resulting income tax liability, or to be paid a sum "grossed up" for the amount of that liability.

It is arguable that, despite the policy intent behind the issue of the ruling and the operation of Div 7A in the context of FLA obligations, the ATO is seeking to achieve an outcome that can only be achieved by amending s 109J.

Section 109J states:

> "109J A private company is not taken under section 109C to pay a dividend because of the payment of an amount, to the extent that the payment:
>
> (a) discharges an obligation of the private company to pay money to the entity; and
>
> (b) is not more than would have been required to discharge the obligation had the private company and entity been dealing with each other at arm's length."

In the reasons for decision in TR 2014/5, the ATO states:

> "93. Paragraph 109J(b) of the ITAA 1936 requires consideration of whether the payment made is more than would be required to discharge the obligation had the private company and the entity who received the payment (in this case, the shareholder's associate) been dealing at arm's length.
>
> 94. It is not sufficient to test what ought to be paid to discharge the relevant obligation. A test of what the relevant obligation would be, had the parties been dealing at arm's length, is also required. So much is evident from the Explanatory Memorandum to Taxation Laws Amendment Bill (No. 3) 1998, which inserted section 109J of the ITAA 1936, which relevantly states at paragraph 9.49:
>
>> An amount paid to discharge a pecuniary obligation owed by a private company to a shareholder or associate will not be treated as a dividend to the extent that the payment is **not more than the amount the pecuniary obligation would have been if the private company and shareholder or associate had been dealing with each other at arm's length** *[new section 109J]*. This section ensures that such commercial dealings are not unfairly taxed and that, for example, disguised distributions are not made by inflating the amount of a debt owed to a shareholder or associate by a private company.
>
> …
>
> 105. How then do these principles apply in the context of orders made by the Family Court under section 79 of the FLA?
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> 106. … Section 79 orders cannot be said to be the outcome of a bargain that is struck between the matrimonial parties. Such orders, or even what transpires in comparable Family Law proceedings, do not therefore involve a dealing in the relevant sense between the private company and the associate of the shareholder.
>
> …
>
> 108. The question then necessarily becomes what would a private company be obliged to pay (if anything) to a non-shareholder, outside the family law setting?" (emphasis added)

The ruling further states:

> "137. An alternative view exists that section 109J of the ITAA 1936 does not require a comparison between the payment made pursuant to the order under section 79 of the FLA 1975 and a commercial transaction.
>
> 138. This view focuses on the fact that the obligation and the amount required to discharge the obligation are determined, ultimately, by a court of law, sitting in judgement of a dispute between two parties. The proponents of this view argue that the relationship between the parties and the nature of their dealings (that is, whether or not they deal with each other at arm's length) is irrelevant to the amount of the court order, such that it cannot be said that the amount the company is obliged to pay is more or less than it would have been had the parties been dealing at arm's length.
>
> 139. But this overlooks the fact that it is only because the parties are not at arm's length, specifically because of their association with the matrimonial dispute, that the order is made against the private company in the first place.
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> 140. Proponents of this view then argue that the amount the private company is required to pay is not more than what an arm's length party would be required to pay to satisfy such a court order. This however glosses over the technical construction of paragraph 109J(b) of the ITAA 1936 which requires a testing of what obligation would have arisen had the parties been 'dealing with each other at arm's length' …
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> 141. The Commissioner is of the view this requires a comparison between what has actually occurred and what would occur if the parties were dealing with each other in a genuine commercial setting, a context drawn in with the use of the term 'at arm's length', and not just an assumption that because the obligation was imposed by a court of law as a third party arbiter, the obligation and the amount required to satisfy the obligation are at arm's length…

The ATO is seeking to eliminate the use of s 109J in the FLA context by reasoning that a private company may only be subject to an order under the FLA because it is not at arm's length to one or more of the matrimonial parties and because a matrimonial cause does not involve any "dealing" or "bargaining" between the parties to the proceedings. However, this reasoning fails to acknowledge that:

- family law property settlements are often litigious, requiring the parties to act and conduct negotiations (ie "dealing" and "bargaining") through their lawyers, and the court orders reflect the position presented to the Family Court by the parties after protracted "dealing" and "bargaining"; and
- even though a private company that is subject to an FLA order may not be at arm's length to one of the matrimonial parties, it is at arm's length to the recipient of that payment.

Section 109RC ITAA36 enables Div 7A payments that are made by private

companies because of FLA obligations to be franked. The policy intent behind s 109RC was to ensure that payments made as a consequence of a marriage or relationship breakdown are within the ambit of Div 7A. The explanatory memorandum to the Taxation Laws Amendment (2007 Measures No. 3) Bill 2007 (which inserted s 109RC) states:

> "1.44 Under the current law, transfers of property and other 'payments' in respect of marriage or relationship breakdown are caught by Division 7A even though they may be non-voluntary (e.g. by court order). As such a deemed dividend may arise.
>
> 1.45 The amendment provides that deemed dividends arising from 'payments' in respect of marriage or relationship breakdowns, may be frankable by the company …
>
> 1.99 While these payments could be completely removed from being caught by Division 7A this would arguably be providing a tax benefit to these taxpayers which is not the intention of these provisions."

Section 109J should be amended to state that it does not apply in the context of FLA orders so that it is consistent with s 109RC. This would eliminate the need for the ATO's interpretation of s 109J in TR 2014/5.

Child maintenance trusts

A child maintenance trust (CMT) can, in the context of a relationship breakdown, provide a tax-effective means of funding the expenses associated with the education and maintenance of a child[14] (referred to in the present context as the "beneficiary") where there are significant assets involved.

Income derived by a minor beneficiary from the investment of property transferred to a trustee for the benefit of the minor as the result of a family breakdown is treated as excepted trust income.[15] This means that such income is assessable to the trustee and taxed at normal adult marginal tax rates.[16] As illustrated in Table 1, this can translate into significant tax savings, especially where there are a number of children and the parent responsible for paying maintenance is assessed at the highest marginal tax rate.

For example, in a situation where $20,000 maintenance is required for each child each year, a parent who is assessed at the highest marginal tax rate would encounter the tax outcome in Table 1.[17]

Other benefits

There are a number of other benefits associated with the establishment of a CMT, including:

(1) asset protection advantages associated with holding assets that may be distributed to the beneficiaries at a later date;

(2) subject to creating a present entitlement in favour of the children, the ability for the trustee to either distribute the income to the beneficiaries or accumulate or reinvest it after the trustee is assessed on the excepted trust income;

(3) the opportunity to invest the tax savings each year, enabling the beneficiary to benefit from the compounding growth of investments; and

(4) if the assets of the trust fund include shares in a company or units in a unit trust controlled by one parent, the beneficiary could (once the interest is vested in the beneficiary) have an interest in the underlying family business from an early stage. Depending on the particular family circumstances, this could provide succession planning opportunities.

Table 1

	Without a CMT: responsible parent to pay	With a CMT: investment income derived by the CMT	Tax saving each year, for each child
Pre-tax income required in order to pay $20,000 in maintenance for each child	$44,444	$20,342	
Tax liability	($24,444)	($342)	$24,102
After-tax amount	$20,000	$20,000	

Compliance

The requirements for the establishment of a CMT and ongoing compliance are stringent and must be carefully adhered to. It is imperative that the trust deed of the CMT be appropriately drafted in order to ensure compliance.

The following requirements must be satisfied in order to establish a CMT:[18]

(1) the property must be transferred due to a "family breakdown" where a person ceases to live with another person as the spouse of that person, or, when the beneficiary is born, the parents are not living together as spouses;[19]

(2) at least one of the persons is the parent or has legal custody or guardianship of the beneficiary; and

(3) an order, a determination or an assessment of a court, person or body (whether or not in Australia) is made wholly or partly because of the family breakdown, the effect of which is that a person has a legal obligation to maintain, transfer property to, or do some other thing for the benefit of the beneficiary, and the property is transferred in order to effect that obligation.

The following additional requirements must also be satisfied in order for the income to be excepted trust income:

(1) the income must be derived by the trustee from the "investment of any property transferred to the trustee for the benefit of the beneficiary"[20] — whether the transfer of assets to a trustee, without more, would constitute "an *investment* of any property transferred to the trustee" would need to be carefully considered to ensure compliance. It may be more appropriate to transfer cash to the trustee and for the trustee to use that cash to purchase investments or, alternatively, for the trustee to resolve to continue to hold the transferred assets as an "investment" of the trust fund of the CMT;

(2) the trust property must be acquired by the beneficiary when the trust ends;[21]

(3) the income derived by the trustee must be derived at arm's length;[22] and

(4) the income must not have been derived by the trustee directly or indirectly, under, or as a result of, an agreement that was entered into or carried out for the purpose of securing that that

assessable income would be excepted trust income, other than where that purpose is merely incidental.[23]

Disadvantages

The disadvantages associated with the establishment and maintenance of the CMT include:

(1) a significant trust fund is required. For example, at least $400,000 in assets would need to be invested at the (relatively conservative) rate of return of 5% pa in order for the CMT to derive $20,000 of pre-tax income for each child;

(2) the settlement the trust fund of the CMT could trigger a CGT liability (and potentially stamp duty) on the transfer of property from one spouse (or an entity) controlled by that spouse to the trustee of the CMT. Consequently, where cash is available, it may be appropriate to transfer cash into the CMT to constitute the trust fund of the CMT. The trustee could use the cash to purchase investments or shares or units in an entity associated with the spouse; and

(3) ongoing annual costs associated with the maintenance of the CMT, including accounting, taxation and administration fees and ASIC fees (if the CMT has a corporate trustee).

Administration of family trusts

If, under the terms of the family law settlement, one spouse remains in control of a family trust (the remaining spouse), the following issues should be considered.

The involvement of the other spouse (exiting spouse) in the trust

The trustee merely determining not to distribute income or capital to an exiting spouse, rather than formally excluding the exiting spouse by way of a trustee declaration (where the trust deed provides the trustee with the power to do so), would create greater flexibility in planning future trust distributions.

Further, if the relationship between the spouses is amicable, there may be succession and estate planning opportunities in relation to such a trust to enable the exiting spouse to assume a role in the administration of the trust or trustee in the event of the death or incapacity of the remaining spouse. This possibility requires careful consideration and planning, especially in the context of blended families.

It is also necessary to carefully review the trust deed to ensure that the exiting spouse, the remaining spouse, and any children outside of that relationship are in fact eligible beneficiaries of the trust. If not, any purported income or capital distributions may be ineffective, resulting in tax being assessed to the trustee at penalty rates under s 99A ITAA36.

Former spouses (of married and de facto same-sex and opposite-sex relationships) and former children of the spouse are exempted from the family trust distribution tax (otherwise currently imposed at the rate of 49% on distributions made to them), as they are included in the definition of “family group” for the purposes of the family trust election provisions.[24]

The treatment of beneficiary loans and unpaid present entitlements

Any unpaid present entitlements (UPEs) of the exiting spouse, or any loans made by the exiting spouse to the trust, should be repaid by the trustee to the exiting spouse either in cash or through the adjustment of other assets. Alternatively, these amounts could be assigned by the exiting spouse to the remaining spouse.

It is important to structure a release or waiver of a debt appropriately (even though it is arguable that, in a family law settlement, there may be no true “forgiveness” of a debt as such due to an adjustment in the settlement for such a debt) as failure to do so could result in inadvertent taxation consequences where the “debtor” or “creditor” is a trustee. For example, if a debt that is released or waived or otherwise extinguished by the exiting spouse is a commercial debt for the purposes of Div 245 ITAA97 (as in the case of UPEs placed on sub-trust[25]), the trustee would ordinarily need to adjust the losses, deductible expenditure or the cost base of the assets of the trust under Subdiv 245-E in order to avoid the duplication of losses. An assignment of the debt by the exiting spouse to the remaining spouse may also be a debt forgiveness if the remaining spouse does not seek to recover the debt.[26] The cancellation, release or waiver of a UPE may trigger CGT event C2 and the assignment of a UPE may trigger CGT event A1.[27]

Conclusion

Family law settlements have the potential to trigger unfavourable taxation outcomes. However, with some prior consideration and careful planning, it is possible to take advantage of the tools and opportunities afforded in the tax legislation.

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References

1 S 995-1(1) ITAA97.
2 S 126-5(1) ITAA97.
3 S 126-15(1) ITAA97.
4 Pursuant to s 90MZA FLA.
5 S 126-140(2) ITAA97.
6 CGT events A1, B1, D1, D2, D3 and F1. See s 126-5(2) ITAA97.
7 Ss 126-5(5), 126-15(4) and 126-140(4) ITAA97.
8 Ss 126-5(6) and 126-140(5) ITAA97.
9 S 126-15(3) ITAA97.
10 Ss 126-5(3A), 126-15(5), 126-25 and 126-140(2C) ITAA97.
11 Exceptions including the disposal of the main residence or pre-CGT asset.
12 Issued in draft form on 13 November 2013 as TR 2013/D6.
13 For example, PBR 1012457494141, PBR 1011482127581, PBR 1011482821555, and PBR 1011434884971.
14 Biological, step, or adopted children.
15 S 102AG(2)(c)(viii) ITAA36.
16 Based on the 2014-15 marginal tax rates.
17 Based on the 2014-15 income tax rates for residents and excluding the 2% Medicate levy.
18 S 102AGA(2) ITAA36.
19 S 102AGA(2)(a) ITAA36.
20 S 102AG(2)(c) ITAA36.
21 S 102AG(2A) ITAA36.
22 S 102AG(3) ITAA36.
23 S 102AG(4) to (5) ITAA36.
24 S 272-90(2A) ITAA97.
25 See para 115 of TR 2010/3.
26 S 245-36 ITAA97.
27 Refer to PBR 1012113065944. However, the ruling confirms that s 118-20 ITAA97 applies “… to the extent that, in respect of the UPE, an amount or amounts have been included as assessable income by the respective beneficiary pursuant to either the ITAA 1997 or the ITAA 1936”.