Delbridge
forensic accounting

The Tax Man and a Family Law Matter

FLPA Twilight Seminar
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Expert Accounting Assistance that is on point, on time, on budget

Case Study

- John (45) and Mandy (43)
- 18 year marriage, two children
- Total pool of assets = $5,550,000 (including FMH, shares in Gorgeous Designs Pty Limited, boat, SMSF less debts)

The parties have reached a settlement (50:50) and consent orders have been drafted, without regard to any current or future tax consequences

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Case Study

- FMH acquired in early 2010 for $1.2million
- Funded by proceeds from property and $400K loan from Gorgeous Designs Pty Limited
- John purchased an apartment with his girlfriend post separation
- Mandy will retain the home

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Case Study

Gorgeous Designs Pty Limited

- Incorporated in 2000
- John and Mandy each hold one ordinary share
- John runs the architecture practice and is sole director
- Mandy was the bookkeeper until December 2010
- Owns cars used by Mandy and John
- Single expert valued at $3.5 million, including commercial investment property worth $1million

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Case Study

Gorgeous Designs Pty Limited

- In addition to the $400K loan to fund the purchase of the FMH, the parties have made significant drawings from the company
- Additional loans total $350,000
  - Mandy's drawings account for $300,000
  - John's drawings account for $50,000

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Case Study

Gorgeous Superannuation Fund

- Owns the business premises, cash and shares
- John's accumulated benefit $600,000
- Mandy's accumulated benefit $200,000

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Case Study

Pool of assets	$
Former matrimonial home	1,500,000
Equity in John's new apartment	Nil
Shares in Gorgeous Designs Pty Limited	3,500,000
Loan owing to company re home purchase	(400,000)
Loan owing to company re lifestyle drawings	(350,000)
Boat	500,000
John's superannuation	600,000
Mandy's superannuation	200,000
Total	5,550,000

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Proposed split	John	Mandy
Former matrimonial home		1,500,000
Equity in John's new apartment	Nil	
Shares in Gorgeous Designs Pty Limited (net of loan forgiven, property transferred and Audi)	2,160,000	
Commercial property transferred out of coy		1,000,000
Audi transferred out of coy		40,000
Loan owing to company re home purchase	(400,000)	
Loan owing to company re lifestyle drawings (Mandy's debt will be forgiven)	(50,000)	
Boat	500,000	
Superannuation	600,000	200,000
Cash payment	(35,000)	35,000

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Case Study

Will Mandy end up with $2,775,000?

- Do the proposed orders have any tax liabilities associated with them, now or later?
- Will Mandy achieve the 50:50 split once any tax crystalises?

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Why are these structures used?

Companies, trusts and superannuation funds

- **Asset protection**
- **Legitimate tax minimisation**
  - Company tax rate < highest individual rate
  - Superannuation concessions
  - Discretionary trusts facilitate reduced income tax across a family group

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Why are these structures used?

Companies, trusts and superannuation funds

- While the structure is effective while there is a status quo, it becomes problematic when it is to be unravelled to achieve an equitable property settlement

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Will the Court take tax into account?

Rosati [1998] FLC92-804

- **Method of valuation** applied to a particular asset
- **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
- If the **Court orders** the sale or is satisfied a **sale is inevitable** or would **probably occur** in the near future, or if asset is solely acquired as an investment with a view to sale for profit, then allowance should be made for CGT payable upon a sale
- If the Court is satisfied **significant risk** asset will have to be sold the Court make take risk into account as a section 75(2) factor with weight varying with degree of risk

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Will the Court take tax into account?

Jarrott and Jarrott [2012] FamCAFC29

- Entitlements of the parties determined in percentage terms (65/35 favouring the Husband, including a s.75(2) allowance for potential CGT)
- Order made in monetary terms ($765,000 to the Wife)
- Finding - that in complying with the orders a CGT liability "could" arise depending on how he raised funds to pay the Wife $765,000 (selling shares being one possibility or company borrowings (with consequent interest or Div 7A costs)
- Full Court found that an "all or nothing" approach of either including CGT or not including it but trying to take it into account under section 75(2) had potential to visit an injustice upon one of the parties, because incidence of the tax was only a possibility
- Appropriate course - Make a percentage, contingent order which would operate if and when a CGT liability arose, because it was not "inevitable"

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Will the Court take tax into account?

Lovine and Connor and ANOR [2012] FamCAFC168

- 60/40 property settlement division
- Finding that the Husband could either:-
  - Sell shares and other property giving rise to CGT liability
  - Borrow money which would require the payment of interest
  - Sell a PPR (no CGT) but would incur acquisition costs in purchasing another property
- Anticipated CGT of $300,000 flowing from potential sale of shares (as calculated by the husband)
- Full Court Held - appropriate order was a **conditional percentage order**, such that if the Husband did incur a liability under the orders, the parties would share in that liability in proportion to their entitlements

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What taxes might be incurred?

- **Capital gains tax**
- **Income tax**
- **GST**
- **Stamp duty**

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Capital gains tax

- Normally payable on the differential between the capital proceeds and the cost base
- Applies to all assets with the exception of:
  - Assets acquired pre 20 September 1985;
  - Cars and motor cycles;
  - Collectables (<$500) and personal use assets (<$10,000);
  - Assets used to produce exempt income;
  - Main residence
- Certain small business exemptions may be available to reduce the amount of CGT payable in certain circumstances

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Capital gains tax

- The transfer of assets between spouses, or from an entity to a spouse will constitute a "CGT event"
- The marriage breakdown rollover relief is compulsory where an individual disposes of an asset to his/her spouse (including same sex spouse) as a consequence of:
  - A court order under the Family Law Act 1975 or a corresponding foreign law
  - A court order under a state, territory or foreign law relating to de facto marriage breakdowns.
  - A binding financial agreement made under the Family Law Act 1975 or a corresponding foreign law;
  - An arbitral award made under the Family Law Act 1975 or a corresponding foreign law; or
  - A binding written agreement that is made under a State law, Territory law or foreign law relating to de facto marriage breakdowns and that, because of such law, cannot be overridden by an order of a court (except to avoid an injustice)

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Capital gains tax

- The transfer of assets between spouses is dealt with pursuant to **s126-5** of ITAA 1997
- The transfer of assets from a company or trust to a spouse is dealt with pursuant to **s126-15** of ITAA 1997 (the recipient of the asset must be an individual for roll over relief to be available)
- The transfer of assets between self managed superannuation funds is dealt with pursuant to **s126-140** of ITAA 1997
- Any gain or loss on transfer is ignored at the time of transfer
- Deemed cost base, not the value at the time of transfer
- CGT will be payable by somebody at some stage…

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Main residence exemption

- A taxpayer will generally not pay capital gains tax on any gain made on sale of their main residence (ie. their home)

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

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Main residence exemption

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

The use of the home by both the transferor and transferee party will be relevant when a future CGT event takes place

The main residence election of a transferor spouse may result in a future CGT liability for the transferee spouse (even on the FMH) – s 118-178 of ITAA

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Main residence exemption

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

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

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Income tax implications

- Misconception that because there is relief from CGT other tax traps won't bite…
- **Division 7A – Applies where a company:**
  - Pays an amount to shareholder or associate
  - Advances a loan to a shareholder or associate
  - Forgives a shareholder loan
  - Meets an obligation under a guarantee

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Income tax implications

- An "associate" of a shareholder is broadly defined in s318 ITAA 1936 as a relative, partner, trust controlled by the shareholder or company controlled by the shareholder
- The person who receives the benefit is taxed, not necessarily the shareholder.
- Per s 109RC (ITAA 1936) deemed dividends arising from "payments" in respect of a marriage breakdown may be franked

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Relevant taxation issues

Certain payments excluded from Division 7A:

- Loans made from one private company to another
- Loans made on "commercial terms" (s 109N)
- Payment of a genuine debt (s 109J)

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Loans made on "commercial terms" (s 109N exemption)

- Written agreement
- Maximum term of 7 years (unsecured)
- Maximum term of 25 years (secured by real property, market value of security must be at least 110% of loan advanced)
- Interest must be charged at the minimum benchmark rate
- Minimum repayments must be made annually

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Payment of a genuine debt (s 109J exemption)

- Payment of a genuine debt (s 109J) occurs where the payment:
  a) Discharges an obligation of the company to pay money to the person; and
  b) Is an arm's length amount required to discharge that obligation.

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Payment of a genuine debt (s 109J exemption)

Previously, an explicit order of the Family Court binding the company to specifically pay <u>cash</u> to a shareholder or associate was treated as a 109J payment and excluded from Div 7A however:

ATO taxation ruling TR 2014/5, issued as a draft last year, reversed that position from 13 November 2013 – 109J cannot be applied

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Income tax implications

- Misconception that Div 7A will only apply if there is a loan between the company and a shareholder
- Subdivision EA – may catch intervening trusts

Other taxes

- **GST – no general relief**
  - Not normally a material problem
- **Stamp Duty**
  - Various concessions
  - Check on a State by State basis

Order 1
John's 50% interest in main residence transferred to Mandy

Summary of tax consequences (capital gains tax)	
Now	
John:	Compulsory CGT rollover relief therefore no CGT implication
Mandy	No immediate CGT consequence due to roll over relief Acquisition of 50% interest is exempt from stamp duty
Later	
Mandy:	John's main residence election will affect the CGT payable by Mandy on her eventual disposal of FMH

Order 1 – Main residence
Future CGT Consequences to Mandy

Capital Gains Tax – Compulsory rollover relief

The main residence exemption applies to Mandy's original 50% interest and any gain on that component is CGT free

However, the use of the property by John post separation will be taken into account when Mandy ultimately sells the property

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Order 1 – Main residence
Future CGT Consequences to Mandy

Capital Gains Tax – Compulsory rollover relief

John has presumably elected to treat the apartment he purchased with his girlfriend as his main residence from February 2011, rather than the FMH

CGT will be payable on John's former 50% share in the FMH when Mandy sells the house

Assume Orders made December 2014, Mandy sells the home in June 2015, when the value has increased to $1.7million

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Order 1 – Main residence
Future CGT Consequences to Mandy

Notional sale proceeds (50% x $1.7 million)	$850,000
Less: Cost base (50% x purchase price of $1.2 million)	($600,000)
Capital gain before main residence exemption	**$250,000**
Days from 2 January 2010 to 30 June 2015	2,006
Days from 1 February 2011 to 31 December 2014	1,429
Taxable days (1,429 / 2,006)	**71%**
Capital gain after main residence exemption (71% x $250,000)	$177,500
Less: 50% general discount	($88,750)
Taxable capital gain	**$88,750**
Capital gains tax payable assuming highest marginal rate (45% + Medicare Levy of 2.0%, debt repair levy of 2%)	**$43,500**

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Order 2
Gorgeous Designs Pty Limited
share transfer from Mandy to John

Summary of Tax Consequences	
John:	Deemed to acquire Mandy's one ordinary share for her cost base at the time of the transfer – s126-5 Acquisition of share is exempt from stamp duty
Mandy:	No CGT consequences as compulsory CGT marriage breakdown rollover relief applies – s126-5 Transfer of one ordinary share is a GST input taxed supplied, therefore no GST is payable

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Order 3
Gorgeous Superannuation transfers $200,000 to Mandy's new Super Fund

Summary of Tax Consequences	
Mandy:	Benefits retain the same tax components and assets are roll-overed for CGT purposes – s126-140
Gorgeous Super Fund:	No CGT consequences

Rollover relief will not apply if the fund sells assets to meet a splitting order, the assets themselves must be rolled out

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Order 4
Mandy's share of the loan owing to Gorgeous Designs Pty Limited for home purchase is transferred to John

Summary of Tax Consequences	
Mandy:	No CGT, GST or stamp duty consequences
John:	No CGT, GST or stamp duty consequences However, a new complying loan agreement will need to be made following the loss of FMH from the security position to ensure the loan retains it's Division 7A exemption pursuant to s109N

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Order 5
Gorgeous Designs forgives Mandy's "lifestyle" loan

Summary of Tax Consequences	
Gorgeous Designs Pty Limited:	No CGT, GST or stamp duty consequences Franking account reduced for deemed dividend
Mandy:	Division 7A deemed dividend of $300,000 Tax payable if unfranked of $147,000 Tax payable if franked of $81,400 No CGT, GST or stamp duty consequences

Forgiveness of debt falls foul of Division 7A

Opportunity to frank the dividend per s 109RC of ITAA

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Order 6
Commercial property transferred from Gorgeous Designs to Mandy

Summary of Tax Consequences	
Gorgeous Designs Pty Limited:	No CGT, GST or stamp duty consequences Franking account reduced for deemed dividend
Mandy:	Division 7A deemed dividend of $1,000,000 Tax payable if unfranked of $490,000 Tax payable if franked of $271,400 No CGT, GST or stamp duty consequences

- Transfer of property falls foul of Division 7A
- Opportunity to frank the dividend per s 109RC of ITAA
- The problem for Mandy does not end there…

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Order 6
Commercial property
Beware – Double Taxation

- Despite Mandy paying tax on receipt of the property pursuant to Division 7A, the CGT cost base of the asset still rolls over via s126-15
- **The consequence for Mandy on a future sale is a disaster**

- Property purchased in 2004 for $300,000
- The cost base to Mandy is $300,000
- If she sells the property for $1,000,000 (being the mkt value at the time of the property settlement) she would pay capital gains tax of $171,500 (CGT on the $700,000 gain less the 50% general discount)

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Order 6
Commercial property
Beware – Double Taxation

- ATO's Double taxation explanation:-

TR2014/5 – "132. Just as in ordinary circumstances where an in specie distribution to a shareholder might give rise to an incidence of taxation to the private company under the CGT regime and also any incidence of taxation to the shareholder under section 44 of the ITAA 1936, so too may a dividend arise upon a transfer of property in compliance with a section 79 order (under section 44, whether or not via Division 7A) and CGT consequences separately arise in respect of that transferred property"

If unable to frank the deemed dividends, Mandy would net only $338,500 from the $1million sale proceeds after paying income tax on the dividend and CGT on the sale

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Double Taxation
Will the Court entertain 'poor' Mandy?

Greenwood v Greenwood [2009] FamCA787

- Order made by consent for property settlement
- Husband to pay Wife cash on assumption he could borrow sufficient funds, Wife to transfer interest in properties to Husband and regime of sale if Husband defaulted on payment
- Severe drought, Husband unable to borrow monies, unsuccessful auction, GFC and subsequent serious floods
- Husband submitted "impracticable" to carry out consent orders
- Husband's application dismissed
- With benefit of hindsight, orders should have provided for percentage division rather than a fixed lump sum to the Wife from net sale proceeds
- Notwithstanding significant adverse financial consequences, orders were not impracticable to carry out

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Order 7
Gorgeous Designs transfers
Audi to Mandy

Summary of Tax Consequences	
Gorgeous Designs Pty Limited:	No CGT or stamp duty consequences GST implication if input tax credits previously claimed Franking account reduced for deemed dividend
Mandy:	Division 7A deemed dividend of $40,000 Tax payable if unfranked of $19,600 Tax payable if franked of $10,900 No CGT, GST or stamp duty consequences

Transfer of the vehicle for no consideration falls foul of Division 7A
Opportunity to frank the dividend per s 109RC of ITAA

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Orders 8 and 9
Cash payment to Mandy
John's boat, shares and new apartment retained

There are no immediate taxation implications of any of these orders

The franking account of Gorgeous Designs will be materially reduced as a consequence of the orders between Mandy and the Company

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Summary of Tax Consequences if Mandy received unfranked deemed dividends

	Total $	John $	Mandy $
Original pool	**5,550,000**	**2,775,000**	**2,775,000**
		50%	*50%*
Less: Immediate taxes			
Forgiveness of lifestyle loan	(147,000)	-	(147,000)
Transfer of commercial property	(490,000)	-	(490,000)
Transfer of Audi	(19,600)	-	(19,600)
Revised pool	**4,893,400**	**2,775,000**	**2,118,400**
		57%	*43%*
Less: Future tax – Sale of FMH	(43,500)	Nil	(43,500)
Future sale of the commercial property	(171,500)		(171,500)
Revised pool	**4,678,400**	**2,775,000**	**1,903,400**
		59%	*41%*

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Summary of Tax Consequences if Mandy received franked deemed dividends

	Total $	John $	Mandy $
Original pool	**5,550,000**	**2,775,000**	**2,775,000**
		50%	*50%*
Less: Immediate taxes			
Forgiveness of lifestyle loan	(81,400)	-	(81,400)
Transfer of commercial property	(271,400)	-	(271,400)
Transfer of Audi	(10,900)	-	(10,900)
Revised pool	**5,186,300**	**2,775,000**	**2,411,300**
		54%	*46%*
Less: Future tax – Sale of FMH	(43,500)	Nil	(43,500)
Future sale of the commercial property	(171,500)		(171,500)
Revised pool	**4,971,300**	**2,775,000**	**2,196,300**
		56%	*44%*

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Summary

- Careful review is required where there is a corporate structure that needs to be unraveled
- The "109J" exception is no longer available
- The Court cannot take tax consequences into account unless you have both identified and quantified them

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Questions

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