

DIVISION 7A AND FAMILY LAW PROPERTY SETTLEMENTS

Many family law property settlements include some form of taxation issues, particularly in cases which involve family businesses and companies. In these circumstances Division 7A of the *Income Tax Assessment Act 1936* (Cth) must be considered by the parties and often expert advice is required to navigate through the complex and seemingly ever-changing relationship between Division 7A and family law property settlements.

On 30 July 2014, the next stage in this relationship occurred when the Australian Taxation Office released the Taxation Ruling 2014/5 titled "*Income tax: matrimonial property proceedings and payments of money by a private company to a shareholder (or their associate)*".

The Taxation Ruling has impacted upon family law property settlements when private companies are involved, including how parties and their professional advisors approach and deal with the splitting of the parties' assets.

The question is – are these changes just and equitable for the individuals involved in family property settlements?

Section 109J of the *Income Tax Assessment Act 1936* (Cth) excludes payments made from private companies that are paid to discharge an obligation of the company from being treated as a dividend.

This section does not clarify if the obligation was intended to include both commercial and non-commercial obligations, specifically in relation to this paper if a family law obligation was intended to be captured by section 109J.

Section 109J has been relied upon in family law property settlement matters as a court order or financial agreement can impose an obligation to make on a private company to make a payment of an amount and thus fall within the exception.

The most recent change in the application of Division 7A to family law property settlements has occurred pursuant to the Taxation Ruling 2014/5, which came into effect on 30 July 2014. This ruling relates to a situation in which an order of a Court, exercising jurisdiction under the *Family Law Act 1975* (Cth), requires a private company to pay money or transfer property to a shareholder or an associate of a shareholder. Pursuant to the Ruling if this situation occurs the payment of the money or transfer of the property is considered as an ordinary dividend paid to a shareholder from the private company.

To understand this change consider the following example.

Mr X and Mrs X have a property settlement matter before the Family Court of Australia. Mr X and Mrs X are both shareholders of ABC Pty Ltd, which operates the family business. ABC Pty Ltd has retained profits of \$1,000,000.00 and the Court makes an order for Mr X and Mrs X to cause ABC Pty Ltd to pay Mrs X \$500,000.00. Pursuant to the Tax Ruling the payment of \$500,000.00 to Mrs X will be considered as an assessable dividend paid to Mrs X for that financial year and will be taxed as such.

As such the exemption pursuant to section 109J is no longer applicable in these circumstances and instead section 44 applies to payments made to a shareholder of a private company even if this payment is made pursuant to an order of a Court exercising jurisdiction under the *Family Law Act*.

The Tax Ruling affects not only individuals involved in family law property proceedings, it also has an impact upon professionals advising parties involved in these types of proceedings.

The purpose of Division 7A, in basic terms, is to prevent the profits of private companies from being inappropriately accessed. The question is, should a family law property settlement be characterised as inappropriate access to company profits, and if so, is that outcome just and equitable?

The effect in cases where parties are unaware and have not been provided advice of the changes to the application of Division 7A is that a party receiving a payment from a private company in their family law property settlement may receive a significant and unexpected tax bill. The effect of such a tax bill has the potential to result in an outcome not intended by the division of the matrimonial property pool to the parties.

Referring to the example above, if Mrs X had not received advice in relation to the effect of receiving the payment of \$500,000.00 from the company ABC Pty Ltd, at the end of the relevant financial year she would receive a tax bill of approximately \$245,000.00, based on a 49% tax rate including the Medicare and temporary budget repair levy. This means that the division of matrimonial property intended by the parties has been substantially altered by effectively reducing Mrs X's portion of the property settlement by \$245,000.00. Conversely, it is often included in family law orders and agreements that one spouse will indemnify the other for liabilities arising from the orders. In this example if Mr X agreed to indemnify Mrs X from any liabilities arising from their property settlement it is likely Mrs X would be relying upon that order to pursue Mr X to pay her tax liability as a result of the dividend paid to her. Neither of these results could be considered just and equitable.

Any payment or transfer under Division 7A due to a family law property settlement which are treated as deemed dividends are frankable. This may lessen the blow to individuals receiving the dividends but this will only occur if the franking credits applied to the payments have been ordered to occur in the property settlement. Otherwise, the individual in control of the company will not have an obligation to frank the dividends provided to their former spouse.

The assets accessed by a spouse held in a private company due to a family law property settlement are not accessed for taxation avoidance purposes they are accessed because their relationship to the other party has broken down and their assets must be divided.

The *Family Law Act* imposes a duty on the Court when making property settlement orders to finally determine and end the financial relationship between the parties. The parties and the Court must sever the financial relationship between the parties and divide their assets regardless of whether their assets are held within private companies. This is an obligation imposed on the parties, which must be adhered to.

In relation to family law property settlement matters it is the case that but for the relationship breakdown of the parties the payments of transfer of property would not occur. Generally, it is not a commercial decision of the parties to end their relationship and divide their assets for commercial gain therefore the transactions associated should similarly not be treated as such.

The current approach to the Ruling is for professional advisors to advise their clients of options available to them, which may minimise the tax they would incur in their family law property settlement.

Currently a remedy available to parties who have had a property settlement which has not taken Division 7A into account, is that they may approach the Commissioner of Taxation to exercise their discretion under section 109RB to disregard the dividend which has been paid under Division 7A pursuant to a court order or financial agreement. The Commissioner must consider a wide range of factors surrounding the circumstances of the deemed dividend payment. The Commissioner may entirely disregard the deemed dividend or determine that the deemed dividend should be franked. This remedy will not likely be a sustainable or long-term solution to the issues that may arise from the Tax Ruling 2014/5.

For more information about this issue and all areas of family law, please contact our family law department on 4036 9700.