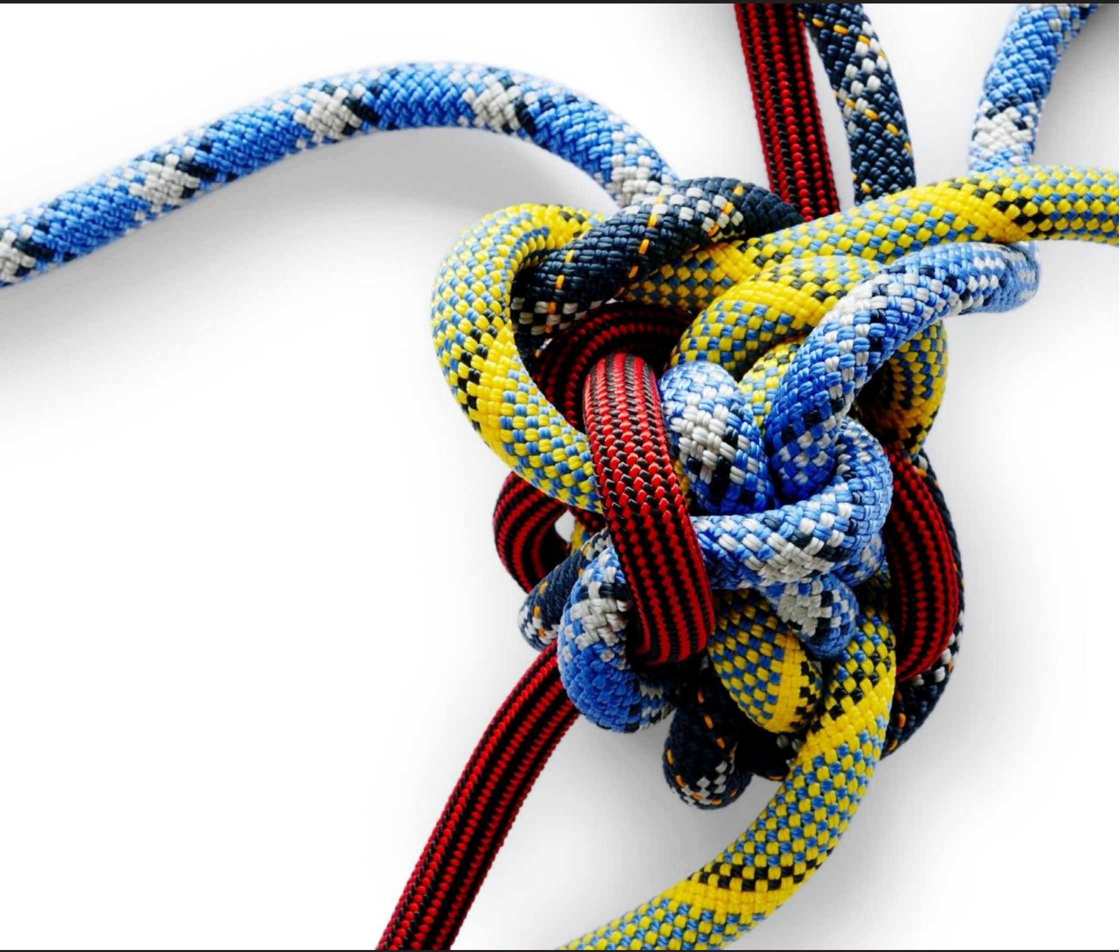
Tax Issues in Family Law - The difference between hacking and carving



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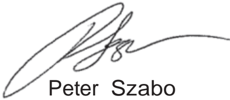
INTRODUCTION - FORCED ESTATE PLANNING

Family lawyers involved in financial matters are really undertaking forced estate planning. As such, they and the financial experts also involved need to come to grips with the full ramifications of their work in this regard.

This practical booklet covers the strategies that need to be understood by family lawyers when negotiating a family law property settlement or formulating orders to be made by the Family Court. Accountants and financial planners may also find this booklet of assistance when creating a financial plan for their clients. With care, the inevitable financial loss to both parties can be kept to a minimum, and unwanted revenue expenses can be avoided. Failure to take such issues into account can have disastrous consequences for the client, with a corresponding negligence action against the professional adviser.

This booklet was first published for the Australian Family Lawyer's National Convention in October 1998, and has been constantly revised and updated. Television Education Network has produced several videos and audios based on this booklet.



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WARNING: This booklet is intended as a guide only as to when further expert tax, accounting or financial planning advice is needed. Every case is different, and different fact situations can impact substantially on what otherwise might be a straightforward case. It is trite to say that our tax laws are complicated. As indicated, what follows is designed to prompt you to take care in what you are doing when you restructure your client's financial affairs during a relationship breakdown.

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TAX ISSUES IN FAMILY LAW PROPERTY SETTLEMENTS

Distributing the spoils – the difference between hacking and carving

The Family Court gives consideration to the parties' respective contributions and to their special needs. An enforced distribution of assets may take place, with the resultant taxation consequences. It is very much up to the parties' legal and financial advisers to ensure that all of the possible consequences are taken into account. This is done either when negotiating a final resolution, or when making submissions to the Family Court regarding what orders it should make.

At this stage a good level of co-operation between the parties or at least their respective advisers is desirable.

It is not uncommon for a Family Court judge to indicate broadly the likely orders they will make after a contested hearing. The parties' legal practitioners are then invited to submit draft minutes of orders designed to give effect to that intention, and for the judge to then settle those orders. There have been instances of the Court requiring one party to co-operate in tax minimisation arrangements recommended by the other party's accountants. It is important to have such information available for consideration by the judge during a hearing. Unnecessary revenue consequences clearly should be avoided. The distribution should also provide for legal and other professional advisers' costs.

Careful attention to the method of dismantling existing structures will be appreciated by clients. The approach by the Family Court is to group all of the parties' respective assets (whether in corporate structures or otherwise) and categorise them as their assets or financial resources. When considering how to distribute and restructure the assets, the tax issues as they apply to the different entities must be carefully considered. The entities may have been established for estate and tax planning reasons, or to achieve limited liability. While the structures may have been effective in minimising tax during the accumulation phase, tax is likely to be payable when dismantling, restructuring or disposing of such assets.

It is impossible to cover all the issues given the enormous complexities involved with taxation. CGT alone is highly complex. Incessant amendments to taxation laws have forced financial advisers to constantly rethink strategies in tax planning, with family breakdown situations being no exception.

A number of situations are outlined below, with a view to prompting the family lawyer or financial adviser to seek appropriate help should the warning bells ring. There is a very real danger that should a party find out that their expected property settlement is substantially eroded by unforeseen revenue consequences, they will look to their professional advisers for compensation. On the other hand, the ability to now split superannuation may offer planning opportunities which can significantly increase the net asset pool for distribution between the parties. You need to be aware of these opportunities. Expert advice should be obtained when you first obtain instructions, not when the parties are about to sign off on consent orders.

De facto & same sex couples come under Family Law Act as of 1 March 2009

As of 1 March 2009, (1 July 2010 for South Australia) de facto and same sex couples who separated on or after those dates, came under the *Family Law Act* 1975 ("FLA"). Now, all references to 'spouses'

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in that Act include de facto and same sex couples. If a couple separate before, they can ‘opt in’ provided that both parties agree. This is an important option if a

superannuation split is contemplated.

REAL ESTATE AND OTHER PERSONAL ASSETS

Introduction

Transfers of otherwise dutiable assets are almost always exempt from duty where they occur between spouses as a result of a breakdown of their relationship. This is either because State/Territory stamp duty legislation allows such transfers between spouses regardless of the situation (as is the case in Victoria) or there is an exemption specifically for family breakdowns.

The main residence is exempt from CGT in most instances. After separation however, a jointly owned residence becomes the main residence of only one of the parties. That is, CGT can become applicable to one half of that property. Careful attention to this situation must now be paid having regard to amendments to tax laws effective 12 December 2006. An obvious solution would be to affect a transfer of the former matrimonial home to the party in occupation. The issue arises in circumstances where the exiting spouse purchases another property to live in and (naturally enough) would want to have that residence treated as their main residence.

Rollover relief

A property purchased prior to 19 September 1985 can be transferred to the other spouse free of any CGT. It retains its exempt status in the hands of the other spouse if the requirements for rollover relief are satisfied.

Inter-spouse transfers of assets subject to CGT (e.g. investment properties, shares and equities) attract rollover relief if they are consequential to a family breakdown. However to qualify, the transfer must be

undertaken pursuant to a Family Court or Federal Circuit Court order or a Binding Financial Agreement.

The rollover provisions have the effect that the transferring spouse does not incur a CGT liability at the time of transfer. Rather, the spouse taking over the asset acquires the same CGT cost base as the other spouse had. CGT is incurred as and when the asset is realised. When calculating the net worth of a settlement to a client, this affect should be kept in mind. There may be some instances where rollover relief is deliberately avoided so that a CGT event is triggered. This would be to offset existing losses in appropriate instances. Another example might be where a main residence which is exempt from CGT will later be used for income-earning purposes. In that case, a high cost base may be desirable. The client's advisors should carefully check the particular circumstances of each case to see whether any estate planning opportunities are present. Changes to tax laws effective 12 December 2006, referred to above, now also mean that a jointly owned main residence has potential CGT issues to deal with.

The impact of amendments to the *Income Tax (Assessment) Act* 1997 ("ITAA") introduced in response to the Ralph Report (1999) is a perfect example of how quickly changes to tax legislation can impact on family law settlements. The tax burden arising from the sale of personally owned assets, including shares and real estate, was effectively halved from what it was.

Minimising CGT on a sale of real estate

Investment properties are often registered in the name of the higher income-earning spouse, to attract the most effective negative gearing. Remembering that the capital gain on the disposed asset is taxed at the same marginal rate as the owner is taxed, and that the transfer of such an asset to the other spouse is usually not an

expensive exercise, there is scope for tax minimisation.

For example, one might transfer an investment property from the higher income-earning spouse to the the other spouse. That transfer would probably be free of stamp duty and, if properly timed, would attract rollover relief from CGT. (The spouse who acquires the property
will, for the purposes of the 50% discount, be treated as having acquired it at the time the transferring spouse acquired the property.) The property could be sold and the proceeds apportioned between the parties, taking into account the tax saved. Alternatively, the transferee could retain
it. In that case, an adjustment in favour of the other party would be warranted given the higher net worth of the property to the new owner. If one of the parties
has capital losses, the property could be transferred to that party instead, to take advantage of those losses. Any tax savings can be apportioned between the parties.

Two Main Residences

If the Main Residence is in joint names and one of the parties purchases a main residence in their own name, the jointly owned residence attracts CGT and Land Tax on one half. The solution is to transfer the jointly owned property into the name of the occupier. That transfer is virtually cost free and does not affect the other party's rights under Family Law.

Legal and other costs associated with obtaining title to the asset are relevant to the acquisition costs. Of course, any tax planning must be undertaken with anti- avoidance provisions of tax legislation in mind.

Motor vehicles

Transfers of motor vehicles between spouses are usually exempt from stamp duty. Most

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