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**What happens when the commercial and Family Law worlds collide?  
The Accountant's Perspective<sup>1</sup>**

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The separation of financial interests following a relationship breakdown often casts a spotlight on less than ideal tax structures and practices that may have been utilised by the parties for many years. Contrary to the advice of their tax accountant, many taxpayers operating a small business conduct their affairs with a blatant disregard for relevant tax laws. As such, when looking to unravel the structure at the end of a relationship, the 'tax awakening' may be seriously unpalatable. Troy and Cheree, the subject of the case study problem, are up to their necks in chicken poo, not only as a consequence of the lawn spraying activities!

This brief paper focuses only on the consequences faced by Troy and Cheree as set out in the case study outline provided separately. This paper does not provide a comprehensive analysis of all of the issues faced by Troy and Cheree, rather a summary of the big ticket items only. I have also included a suggested structuring of the settlement, highlighting the advantages of recent changes to the 'deemed dividend' rules. Divorce may provide an opportunity to restructure business affairs tax effectively, with relief from stamp duty and capital gains tax that may be otherwise unavailable.

***Issues within the structure presented***

**Director Loan accounts**

Over many years Troy and Cheree utilised the funds generated by Troycher Pty Limited as their own. While we are led to believe that private expenditure was properly accounted for, with Cheree allocating non-business expenses against a directors loan account, unfortunately for Troy and Cheree the problem does not end there. The primary problem with the loan accounts is the "deemed dividend" provisions of the **Income Tax Assessment Act 1936** ("ITAA"). The relevant legislation pertaining to the director loan accounts has changed over the period of operation of the company, with **Section 108** prevailing until December 1997, and **Division 7A** thereafter. As detailed in the background to the problem, Troy and Cheree owed \$2,000,000 to Troycher at December 1997 and I have assumed that the amount owing at that date is effectively quarantined from Division 7A. Unfortunately the loans have continued to accumulate, with the parties now owing debts back to the company of approximately \$3,717,000.

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<sup>1</sup> Case study and paper first presented at the Family Law Section Sydney Intensive, February 2008

## Overview of Division 7A

Where a private company pays an amount to a shareholder or associate, advances or forgives a shareholder (or associate) loan, Division 7A may treat that payment, advance or forgiveness as a deemed dividend (s109C). A "payment" includes the transfer of property or the granting of guarantees and meeting of guarantee obligations. The effect is that the payment is taxed in the hands of the recipient as an unfranked dividend.

For Division 7A to apply to a payment, loan or forgiven loan to a shareholder, there must be a distributable surplus in the company, calculated as at the end of the financial year in which the Division 7A payment occurred. A company's distributable surplus is calculated as:

- the company's net assets at market value (with certain inclusions and exclusions)
- less any non-commercial loans, repayments on non-commercial loans and paid-up share capital

An "associate" of a shareholder is broadly defined in s318 ITAA 1936 as a relative, partner, trust controlled by the shareholder or company controller by the shareholder.

## Excluded Payments

Certain payments may qualify as excluded payments, ie Division 7A does not apply to the payment by the company. Some of the exclusions are:

- Loans made from one private company to another private company are excluded (s109K)
- Payment of a genuine debt (s109J)
- Loans made on commercial terms.

A loan made on commercial terms is excluded from the application of Division 7A. The minimum loan requirements are contained in s109N of ITAA 1936, including:

- Loan must be made under a written agreement
- Maximum term of 25 years for secured loans and 7 years for unsecured
- Security must be real property
- Market value of security must be at least 110% of the loan advanced
- Interest must be charged at the minimum benchmark rate (2007 - 7.55%pa)
- Minimum loan repayments must be made annually

On the assumption that Troy and Cheree have not entered a commercial loan agreement with Troycher, the problem is multi-faceted as follows:

Loan component	Amount \$	Relevant legislation	Consequence
Pre Dec 1997 loans	2,000,000	S108 ITAA 1936	Top up tax on winding up of Troycher; Quarantined from Div 7A; Outside of likely scope of ATO audit activity
Loans advanced between December 1997 and June 2002	810,000	Div 7A ITAA 1936	Top up tax on winding up of Troycher; Outside of likely scope of ATO audit activity
Loans advanced after July 2002	907,000	Div 7A ITAA 1936	Seek Commissioner discretion under s109RB. Top up tax payable of up to \$214,000; Risk of ATO audit activity – unfranked deemed dividends

In the 2007 tax year, changes were made to Division 7A to reduce both the extent to which taxpayers were inadvertently caught by Division 7A and the punitive nature of the provisions. Under s 109RB, the Commissioner set out arrangements for a one-off opportunity to correct past mistakes, that applied from the 2001-2 to 2006-7 tax years that enabled him to provide relief for deemed dividends that had arisen under Division 7A because of an honest mistake or inadvertent omission. Under these provisions, the Commissioner may have disregarded the dividend that would otherwise arise under Division 7A, or have allowed the private company to frank the deemed dividend, previously not an option. The key to these provisions was the “honest mistake or inadvertent omission”. While the one-off opportunity to correct past mistakes is not available after 30 June 2008, the Commissioner’s discretion to disregard a deemed dividend (or frank it) under s109RB is an ongoing discretion and continues after 30 June 2008.

On the assumption that Troy and Cheree were poorly advised by their accountant, they may apply or the Commissioner’s discretion using the “honest mistake” provisions. The discretion to disregard the dividend was available to the Commissioner subject to a condition that:

- the shareholder, associate of the shareholder, or any other entity must make specified payments to the private company or another entity within a specified time – for example, an amount equal to the minimum yearly repayments that would have been made if all the conditions of Division 7A had been complied with, and/or
- a specified requirement of Division 7A be met within a specified time – for example, that the full amount of any payments made to a shareholder be converted into a loan that satisfies all the requirement set out in section 109N for the income year in which the loan was made.

Alternatively, the Commissioner may allow the dividend to be franked, but only where the dividend has been paid to a shareholder not an associate. The effect would be top up tax payable on receipt of the franked dividend, in this case \$214,000.

The s 109RB provisions should enable the potential deemed dividend arising on the \$452,761 advance of funds to Troy (taken from the term deposits and on-lent to Shampoo for acquisition of the Queensland development) to be rectified. The shareholder and company have until lodgement of the income tax return for the relevant tax year to put in place the necessary loan agreement to ensure that the adverse ramifications of Division 7A are avoided.

As detailed above, loans made from one private company to another are excluded payments under Division 7A s109K. As such the loans advanced by Troycher to Chertroy and Shampoo are without consequence as to the deemed dividend rules.

Regardless of the measures taken by the parties under s 109RB, and assuming an absence of ATO audit activity, the tax problem will ultimately crystallise on the winding up of Troycher. The credit loan account owing by Chertroy to the parties (\$487,000) may be utilised via inter-entity transactions, to offset the exposure to an extent. The party who retains Troycher will more than likely face significant tax consequences in the future.

#### **Other tax issues**

The parties have used company structures to purchase private use assets, such as boats and motor bikes. There may be an exposure to fringe benefits tax in relation to the boats in both Troycher and Shampoo and the Harley Davidson in Troycher. This will be dependent on the manner in which the benefits were provided, the tax treatment of expenses incurred in relation to these assets and so on. A general awareness of the potential exposure is required.

#### ***The proposed settlement***

Leaving aside the value of Shampoo and the potential tax on winding up of Troycher, the net pool of assets available for division is \$4,928,031. Assuming a 50:50 split between the parties, net assets to a value of \$2,449,000 will be retained by each party.

In any division of assets, it is essential to consider the taxation implications of the proposal.

#### **Deemed dividends on marriage breakdown (s109RC)**

Prior to amendments to Division 7A in 2007, the transfer of assets from a company structure to a spouse was usually avoided, as the deemed dividend consequences were unavoidable.

However, amendments to Division 7A provide that deemed dividends arising from “payments” in respect of marriage or relationship breakdowns, may be frankable by the private company taken to have paid the deemed dividend (see s109RC of ITAA 1936). The dividend may be franked irrespective of whether it was made to a shareholder or associate of the shareholder (for example, a former spouse). Accordingly, while the transfer of property from a private company to a spouse who is a shareholder or associate will continue to be treated as a dividend, this deemed dividend may be franked by the transferor company.

While top up tax may be payable by the recipient, dependent on their marginal tax rate, the use of deemed dividends should now be explored where there is a benefit in restructuring company assets to an individual. The dividend may only be franked in the same circumstances that CGT roll-over relief applies in relation to marriage breakdowns, as discussed below.

### **Capital Gains Tax (CGT) consequences**

Capital gains tax is normally payable on the differential between the capital proceeds from disposal (or deemed market value when the transaction is not arm’s length) and the “cost base” of an asset. The cost base includes the original purchase price as well as other purchase and disposal costs relating to the asset. Depending on whether the owner of the asset is an individual or an entity, the effective rate of capital gains tax will vary.

The transfer of assets between spouses, from an entity to a spouse, or between entities will constitute “a CGT event”. In the absence of any roll over relief, the transfer would ordinarily result in a capital gain being realised by the transferor.

In order to determine the capital gains tax consequences of a property settlement it is necessary to consider whether the asset being transferred is subject to CGT and whether there are any roll-over provisions available to reduce or eliminate the CGT.

### **Is the asset being transferred subject to CGT?**

Assets for CGT purposes include tangible assets such as real estate or shares as well as intangible assets such as the goodwill of a business. As a general rule, the following assets are normally **exempt** from CGT:

Assets acquired prior to 20 September 1985 (“Pre CGT assets”)

Cars and motor cycles

Collectables (eg artworks or jewellery) costing less than \$500

Certain personal use assets costing less than \$10,000

Assets used to produce exempt income

The main residence of the party/parties

## **Will there be roll-over relief on transfer of assets?**

Any capital gain or loss arising to the spouse on the notional disposal by them of their interest in an asset to the other spouse will be disregarded under the compulsory marriage breakdown rollover relief (s126-5 ITAA 1997).

The marriage breakdown rollover relief was extended in December 2006 on the enactment of **Tax Laws Amendment (2006 Measure No 4) Act 2006**, and is compulsory where an individual disposes of an asset to his/her 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).

The above rollover relief also applies where a CGT asset is transferred from a company or trust to an individual – s126-15. Where the marriage breakdown rollover relief is applied, any gain or loss to the company or trust is disregarded.

On receipt of the asset, there will be no CGT implications for the transferee spouse. There **may** be CGT on eventual disposal of the asset by the transferee spouse. This will depend on the differential at the time of sale between the sale price and the cost base of the asset. As the transferee spouse did not originally pay for the asset, the legislation provides a deemed cost base for the asset, based on whether the asset is a pre CGT asset (originally purchased prior to 20 September 1985) or a post-CGT asset (originally purchased subsequent to 20 September 1985) as follows:

- for post-CGT assets transferred between the parties, the cost base of the asset will be the asset's cost base to the transferor spouse at the time the transferee spouse acquired the asset.
- for pre-CGT assets transferred between the parties, the asset retains its pre-CGT status in the hands of the transferee spouse – ie there will be no capital gains tax on ultimate disposal of the asset.

## The proposal

Having explored both the CGT and dividend implications of the problem as presented, I have proposed the following assets be transferred to Cheree:

Matrimonial Home	1,750,000
Superannuation	134,500
BMW Sedan	45,000
Investment properties ex Chertroy	5,420,000
Cash payable by Cheree to Chertroy	(4,900,000)
<b>Net position achieved by Cheree</b>	<b><u>2,449,500</u></b>
<b>% allocation to Cheree</b>	<b>50%</b>

### *Why ?*

We are advised that Cheree is keen to retain the investment properties presently owned by Chertroy, as she believes that they will provide her with security.

We could simply transfer Troy's shares in Chertroy to Cheree and forgive part of the loan owing back to Troycher by Chertroy. However, the proposal results in a better long term outcome for Cheree.

Where an asset is held for longer than twelve months, an individual benefits from a 50% discount to the capital gain when CGT is assessed. This concession is not available to companies, and consequently the holding of appreciating property in a company structure is usually undesirable. At any other time, there would be stamp duty and capital gains tax costs associated with the unravelling of the corporate structure. In this instance there is an opportunity, by virtue of the marriage breakdown relief, to unravel the structure without incurring CGT or stamp duty costs. This results in Cheree holding the properties personally and as such the ultimate CGT payable will be significantly reduced due to the availability of the 50% discount.

The interest on the funds borrowed by Cheree to acquire the properties from Chertroy will be tax deductible to her, whereas borrowings to enable a cash payment to Troy to achieve the desired split would not be deductible.

The tax implications of this proposal, both immediately and on future sale are as follows:

1. Immediate consequence to Cheree	Cheree \$
Market value of properties acquired from Chertroy	5,420,000
Consideration paid by Cheree	(4,900,000)
<b>Deemed dividend (frankable under s 109RC)</b>	520,000
<b>Top up tax payable by Cheree on receipt of deemed dividend</b>	<b>123,000</b>

2. Tax payable on future sale of properties	Cheree \$	Chertroy \$
<b>Proceeds on future sale</b>	8,000,000	8,000,000
Cost base of properties (roll over under s126-5, 126-15)	(5,190,000)	(5,190,000)
Capital gain	2,810,000	2,810,000
50% discount for assets held longer than 12 months	(1,405,000)	<b>not available</b>
<b>Taxable capital gain</b>	1,405,000	2,810,000
Capital gains tax rate	46.50%	30.00%
Capital gains tax payable	653,325	843,000
Top up tax payable on distribution of net gain to Cheree	<b>not applicable</b>	463,650
Net proceeds on sale after repayment of mortgages (assumed to be \$4,900,000)	2,446,675	1,793,350
Top up tax paid by Cheree on receipt of deemed dividend now	123,000	<b>not applicable</b>
<b>Overall net proceeds taking into account all taxes</b>	<b>2,323,675</b>	<b>1,793,350</b>
<b>Tax saving due to restructure</b>	<b><u>\$530,325</u></b>	

This paper has been prepared to highlight the issues presented in the fictional case study only and does not constitute advice by Forsythes. This paper is not intended to be a comprehensive statement of law or practice and must not be relied on as such. If specific advice is required it should be sought on a formal professional basis. The paper has been prepared with due care and diligence herein however no warranty is given as to accuracy and completeness of the information contained.