

Tax Alert

Parties to family law proceedings slugged with unexpected tax bills!

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The new ruling

The ATO's new draft ruling (TR 2013/D6) deals with the tax treatment of money or property which is transferred in property settlement proceedings involving parties to a marriage.

Under the ruling, where a court makes an order under section 79 of the *Family Law Act 1979* requiring a private company, or a party to the matrimonial proceedings to cause the private company, to make such a transfer, that is taxed as follows:

- Money or property transferred by a private company to a party to the proceedings who is a shareholder of that private company is treated as dividends under section 44 of the ITAA36.
- Money or property transferred by a private company to a party to the proceedings who is an associate of a shareholder of that private company is treated as a division 7A payment under section 109C(3) of the ITAA36.

What has changed?

Payment to shareholders

The ATO considers that the payment of money or property to a shareholder under a section 79 order is a dividend within the meaning of section 6(1) of the ITAA36. It does not matter why the amount is distributed to a shareholder,

or the capacity in which the shareholder receives it. It is enough that the distribution is made.

The ruling also says that section 44 of the ITAA 1936 applies regardless of whether the order is made against the private company or against a party to the matrimonial proceedings to cause the private company to effect the transfer or payment. This means that if the recipient of the distribution is a shareholder, that will be enough to characterise the payment as a dividend.

Payments to associates of shareholders

Previously, taxpayers and advisors were able to rely on ATO ID 2004/462, which says that where an order under section 79 only binds a party to the proceedings, but not the private company, then this will not be an obligation of the private company to pay money under section 109J and therefore may be treated as a payment referred to in section 109C. Until now, the ATO has generally issued private rulings on the basis that:

- An order made under section 79, if directly binding on a private company, would satisfy section 109J(a); and
- Any settlement terms proposed by the parties to a property settlement proceeding must provide justice and equity between the parties (see section 79(2)). This was enough to satisfy the arm's length transaction test, and satisfy section 109J(b).

Under the ruling, this reasoning has been completely reversed. Section 109J can no longer apply, as

demonstrated in these three scenarios:

- **Orders are made against a matrimonial party to cause a private company to pay money or transfer property to an associate of a shareholder:**

The ruling says that no binding requirement in law is imposed upon the private company to comply, so section 109J(a) does not apply.

- **Orders are made requiring a private company to transfer property to an associate of a shareholder:**

The ruling says that section 109J(a) requires the obligation to be for a payment of money. It does not apply to an order to transfer property.

- **Orders are made requiring a private company to pay money to an associate of a shareholder:**

The ruling says that section 109J(a) applies. However, the ATO no longer considers that the arm's length test in section 109(b) would be satisfied:

[T]he Commissioner considers there is no identifiable circumstance under which a private company might make a gratuitous appropriation of profits to a non-shareholder in discharge of an obligation in an arm's length dealing as required by the test in paragraph 109J(b) of the ITAA 1936.

This is because, in a commercial setting, the ATO doubts whether the company would be capable of appropriating profits to a non-shareholder without breaching its obligations under the corporations law, or a director's fiduciary obligations, or even if it were, whether the company would make any payment, given that where the payment is not made in consideration for something of value in return, it would be in the nature of a gift.

What can taxpayers do?

The ruling says that it will not apply to taxpayers where it conflicts with the terms of settlement of a dispute agreed

to before the date the final ruling is issued, and that the ATO does not propose to undertake any active compliance activities in respect of any orders made before that date.

However, while it is open to an affected party to matrimonial proceedings to apply to the ATO for a private ruling to clarify their position, the ruling makes it clear that the ATO will now make any such private ruling based on the new tax treatment.

Therefore, parties to current matrimonial proceedings should consider the potential tax consequences that may arise if section 79 orders are made in those proceedings after the date the final ruling is issued.

Legal practitioners need to be acutely aware that orders involving a spouse providing an open-ended taxation indemnity in favour of a spouse in receipt of any money or property from a private company (or trust with an unpaid present entitlement in favour of a private company beneficiary) will now be enlivened. If the spouse providing the indemnity is not properly advised, there could well be adverse ramifications for the practitioner.

Additionally, directors of an affected private company should consider whether any proposed section 79 orders will affect the solvency of the company, as well as the tax treatment of any payments to be made. Directors should also consider whether they should make submissions to the court, where appropriate, on the financial circumstances of the company, as well as considering whether their duties as directors (particularly in relation to insolvent trading or voidable transactions) conflict with their own interests as a party to the matrimonial proceedings!

Written by:

Arthur Athanasiou

Partner

+61 3 8080 3563

aathanasiou@thomsonslawyers.com.au

Mark Gioskos

Lawyer

+61 3 8080 3657

mgioskos@thomsonslawyers.com.au

For further information, please contact our national **Tax** team.

www.thomsonslawyers.com.au