

Split decisions

Cover story

By Michael Laurence

Inconsistent judgements, judicial discretion and an onslaught of new laws are creating confusion and change in the Family Court.

The Family Court is in a state of uncertainty and upheaval about the division of matrimonial assets after a marriage breakdown. Legal practitioners are particularly disturbed over a lack of agreement between judges about how to split valuable superannuation savings and the fortunes of the super rich. There are also concerns that some couples may try to manipulate recent legislation on bankruptcy and family law by contriving a marriage breakdown to avoid creditors.

There is likely to be a High Court challenge to the validity of new Family Court powers that allow it to issue binding orders to third parties, which enables the court to break into the likes of trusts and private companies when dividing matrimonial assets.

And some lawyers describe prenuptial agreements, a favoured instrument of the wealthy to protect their assets if marriages fail, as timebombs because of expected legal attempts by disgruntled former spouses seeking to have them set aside. Prenuptials, which are in a class of agreements called binding financial agreements, are intended to be legally binding on couples without the involvement of the court, but Family Court judges have discretionary power to set them aside.

Despite their legal vulnerability, prenuptials and other binding financial agreements are certain to become much more popular this year. Federal Parliament is expected to pass legislation soon to provide rollover relief for capital gains tax on assets transferred between spouses under the agreements after the breakdown of their marriages.

In its first session of 2006, Parliament is expected to pass amendments to the Family Law Act that will transfer from state supreme courts to the Family Court the power to hear most property disputes involving de facto spouses. The amendments come after years of debate among politicians and lawyers and will lead to a fundamental change in the way the assets of de facto spouses are divided.

But this transfer of power is highly controversial because Western Australia and South Australia are not co-operating and the Federal Government is not allowing the Family Court to hear matters involving same-sex couples. The Family Court and the relatively new Federal Magistrates Court, which already hears family law matters, can expect a flood of cases instigated by de facto spouses hoping for a better deal.

The financial disruptions and uncertainty in the splitting of assets after the breakdown of marriages and de facto relationships will have a monumental effect on the community. About 52,000 couples are divorced each year and the National Centre for Social and Economic Modelling forecasts that almost half of all marriages will end in divorce if trends continue. Thousands more de facto couples than married couples would separate each year.

The breakdown in marriages and de facto relationships is the biggest single destroyer of personal wealth in Australia. Disagreement within the Family Court over splitting superannuation accounts – and the confusion this causes among lawyers and litigants – is particularly disturbing because Australia's burgeoning super savings have reached \$800 billion and individual savings sometimes equal or are more than the value of the family home.

A partner of Barkus Edwards Doolan Family Lawyers in Sydney, Paul Doolan, says separating couples face a virtual lottery with super and in big–money cases.

Writing in a recent issue of the professional publication *Current Family Law*, published by Thomson ATP, Doolan says the uncertainty often leads couples either to settle a matter because they will not take the risk of an unknown outcome of a court case, or pursue litigation because they think it is worth taking a gamble. "Neither of these outcomes is particularly satisfactory," Doolan says. "[Yet] lawyers are under increasing pressure to deliver cost–effective outcomes for clients while at all times ensuring rights are fully protected." Another family lawyer, who asks not to be identified, says: "Confusion in the Family Court is a disgrace. Litigants do not get the certainty they expect from the courts."

Super confusion

Few legal practitioners would have foreseen the confusion flowing from amendments to the Family Law Act in December 2003 that provided for the first time that superannuation could be split between separating couples upon the breakdown of marriage, by agreement or order of the Family Court. The key to the confusion is two seemingly conflicting judgements in the Full Family Court, the last case with five judges sitting.

In 2004, the Full Family Court held that the court should divide super in the same way as other assets or property (as assets are generally known as in the Family Court) such as houses and shares. In practice, this meant all assets should be included on a single list for splitting, with a percentage going to each spouse. But in another case in 2005, a majority of judges of the Full Family Court held that super should not be treated as property but "another species of asset". Stephen Bourke, the superannuation partner at the family law specialist firm Watts McCray, says the carving out of super in this way for consideration in isolation would "tend to downplay" the non–financial contributions to a marriage, such as home–keeping and bringing up children, when considering the split of the super pool. Bourke, who is also the principal of the superannuation consultancy SuperSplitting, adds: "I believe this would disadvantage those who stayed at home during a marriage."

Doolan says that to have such a fundamental disagreement within the Family Court as to how super should be treated makes it difficult for lawyers to predict for their clients how a case will turn out. "That uncertainty can then fuel legal costs for the parties.

"Judges dealing with [super] splitting orders have a very difficult task. Often one party, normally a mother with young children, does not want a super split. They would prefer to have their settlement upfront so they can buy a house." Doolan says judges then have to determine whether the husband in such cases should be required to keep his entire super while his wife receives her desired cash immediately. "Then the judges have to work out whether the husband getting less of the assets upfront should get some reward for having to wait 20–plus years for a large slice of their settlement."

Doolan says that after last year's full court decision dealing with how super should be treated, there has been a "dearth of reported cases" on super. "Whether this is because cases involving superannuation are settling out of court or litigants are shying away from [super] splitting orders because they are seen as too hard, is difficult to say. A large fan is needed to blow away the mist that has descended on this area of the law."

Big–money gamble

Family lawyers typically regard big–money cases as those with assets of at least \$10 million or \$15 million. The uncertainty over how the Family Court will split the assets of the rich largely concerns how much weight should be given to the so–called "special skills" of the creator of the great wealth, perhaps through terrific entrepreneurial abilities.

In so–called "house–and–garden matters" – in which the assets are usually little more than a mortgaged suburban home, a few shares and some super – the courts tend to treat the contributions of the spouses equally if there was a long marriage. Then adjustments are made in favour of the spouse who has custody of the children and for such factors as future income.

But in cases involving very wealthy spouses, the courts have tended to award a much larger share to the

spouse whose special skills created the wealth, yet still ensuring the other spouse is left with a valuable, although much smaller, slice of the assets.

Now, there is more disagreement among judges over the matter of special skills and whether this leads to discrimination against homemakers and parents. Although the skills of the creators of vast fortunes are recognised and rewarded, the same is rarely true for their spouses, who may, for 20 or 30 years, have raised their children and supported the spouse's career.

Doolan says: "The English courts stand poised on the precipice of doing away with the special-skills doctrine altogether, and there are those in Australia who would like to see our Family Court take that lead. But under the Family Law Act, judges have wide discretionary powers. The idea that that equality should automatically be the yardstick for fairness in all cases – big money involved or not – ignores the statutory obligations judges have in Australia under the Family Law Act to assess contributions of each spouse." This assessment was a value judgement.

Doolan says the Family Court's division of assets in big-money cases can vary greatly, even if couples have had long marriages and still have dependent children, because different judges place different weight on special skills.

"The general range at present is between wealthy spouses receiving an equal split at one end, to a split of 35% and 65% at the other – in favour of the wealth creator. But more and more, unless the facts are quite unusual, asset splits are moving closer to an equal division," Doolan says.

And the type of case falling within the special-skills category is becoming narrower, he says. "Parties who earn money as employees, regardless of how much they are paid, are now hard-pressed to convince a court that their contributions fit into that category. Investment bankers and brokers earning multi-million-dollar bonuses will normally not fit into the special-skills category any more, regardless of how much they have earned."

Tax relief for rich

Stephen Bourke of Watts McCray expects the pending provision of rollover relief on capital gains tax (CGT) will make binding financial agreements – which can be entered into before a marriage, during a marriage and after the failure of a marriage – more popular. The prenuptial version of these agreements should also become more sought after by the very wealthy as a way to sidestep the trend within the Family Court to move closer to 50:50 splits in big-money cases.

Under existing tax law, CGT is not payable when transferring assets between spouses pursuant to a court order upon the breakdown of marriage, but is still payable when the assets are eventually sold. By contrast, a transfer of assets between separating spouses under a binding financial agreement will immediately trigger CGT.

Binding financial agreements, which were not recognised by the Family Court until December 2000, became notorious in May 2001 when the apparently happily married Jodee Rich, the former joint managing director of the failed One.Tel, and his wife Maxine, a corporate lawyer, entered into one of the agreements. It was signed two days after One.Tel went into administration.

Under the agreement, Jodee transferred about \$5 million in assets to Maxine, including his share of their Sydney home, and his share of proceeds from the sale of one of Sydney's most valuable waterfront mansions. The Australian Securities & Investments Commission failed in an application to the Family Court to have the agreement set aside. The court ruled that it did not have the jurisdiction to make such an order. The agreement between Jodee and Maxine Rich was voluntarily withdrawn after two years of intense publicity. The controversy led to a tightening of the law, nicknamed the "Rich amendments".

Paul Doolan says: "We advise on prenups [binding financial agreements] in two main areas: where one spouse is wealthy and wants to protect their hard-earned assets in case of divorce, and also where one party will receive a large inheritance in the future that they want to protect.

"The number of people using prenups is increasing each year but there is still not a uniform take up, even among the super rich. The idea that you can, on the one hand, promise to love, honour and maybe even obey, and yet at the same time make plans for what happens if you divorce, is a difficult concept in itself."

Prenuptial timebomb

The principal at Pearson Family Lawyers in Sydney, Susan Pearson, says the inconsistency of outcomes in the Family Court is one of the reasons she is more often advising clients to enter binding financial agreements. "The agreements are the best protection clients can have against the uncertainty of the court, but they are by no means watertight."

Doolan says: "Prenuptials are a very important means of protecting assets from the Family Court, but they're not bullet-proof. The court's power to set aside agreements is quite broad and largely untested to date. There is a potential timebomb lying in wait for lawyers and clients alike when these agreements are finally tested in the courts.

"The power to set aside these agreements includes traditional grounds that are used to set aside contracts, such as where there has been fraud or unconscionable conduct when the agreement was made," Doolan says. "[But] the most difficult ground to guard against is one that enables a judge to set aside an agreement if there has been a material change relating to a child's circumstances, such that it would cause hardship if the agreement were enforced."

Doolan gives the example of a couple who sign an agreement before marriage that, if it fails, each partner will keep the assets they brought into the marriage. At the time of signing, each earned \$150,000 and there were no children.

"Fast-forward 10 years and they have three kids, the wife stopped work eight years ago, the husband is now on \$600,000 a year, and the assets and super are mainly in his name." Doolan suspects a judge would be likely to set aside the agreement because the enforcement would be harsh on the wife and children.

Bankruptcy tricks

Recent laws have closed some of the opportunities for debtors to use binding financial agreements and Family Court proceedings to escape from creditors. But some family lawyers are now concerned that couples may try to exploit possible new loopholes.

The three big changes in the relationship between creditors and the Family Court are:

- * The Bankruptcy and Family Law Legislation Amendment Act, in force from September 2005, gives the Family Court exclusive jurisdiction to hear bankruptcy and family law matters at the same time if one of the spouses in a matrimonial property dispute is insolvent.
- * Amendments to the Family Law Act in force since April 2005 give the Family Court the power to set aside a binding financial agreement, upon an application by a trustee in bankruptcy, if one of the parties becomes bankrupt. Creditors with legitimate claims who feel cheated by a deal between spouses using a binding financial agreement can also apply to the court to set it aside.
- * Amendments to the Family Law Act that have been in force since December 2004 allow the Family Court to make orders that are binding on third parties. Creditors have more power to intervene in Family Court proceedings to protect their interests and to seek the overturning of a court judgement.

The ability of the Family Court to hear bankruptcy matters is an important breakthrough that gives the court the ability to consider the interests of the non-bankrupt spouse along with the creditors. Previously, the Family Court could not hear a case if one of the spouses was bankrupt. In practice, this meant that the non-bankrupt spouse would miss out on the division of the bankrupt's unsecured assets among the creditors. When dividing a bankrupt's estate, the Family Court now considers such factors as the non-bankrupt spouse's non-financial contributions to a marriage, such as housekeeping and raising children. Crucially, the previous bankruptcy laws gave only limited consideration to any non-financial contributions of a non-bankrupt spouse.

Bourke says some angry spouses in the past would try to go bankrupt in an attempt to punish their spouses financially. "Now the legitimate interests of creditors and spouses can be examined on a level playing field." One family law practitioner warns that some dishonest couples with one of the spouses in bankruptcy may try to take advantage of the new laws by faking a marriage breakdown. By bringing their matter before the Family Court, the non-bankrupt spouse's non-financial contributions to the matrimonial assets would be

taken into account rather than perhaps being lost to creditors. Wendy Sylva, a special counsel with the legal firm Hall & Wilcox, says creditors should be vigilant and, if appropriate, apply to have a Family Court judgement set aside if the court has been misled by a couple in such circumstances.

One of the challenges for someone who is separating from a wealthy spouse is that the very wealthy rarely hold extensive assets in their own names but through a web of discretionary trusts and private companies. The Family Court could always attack trusts and companies that were a sham or the alter ego of a spouse. Now, the amendments to the Family Law Act in December 2004 empower the court to issue orders to third parties and crack these entities wide open.

Cracking into trusts

The amendments mean, for example, that the court can direct the trustee of a private trust to include a spouse as a beneficiary, and instruct the directors of a private company to pay dividends to a spouse or to wind up the company. The court can direct a financial institution to accept that one spouse, not both, is responsible for a debt, and can instruct not to repossess real estate.

Bourke says: "There is considerable doubt about the constitutional validity of the provision to give power to the Family Court to order a third party to surrender assets. I think this will end up with an appeal to the High Court, and that appeal should set some ground rules."

De facto mess

The Federal Parliament is expected soon to pass laws to transfer responsibility for hearing property disputes involving de facto couples from state supreme courts to the Family Court. South Australia has refused to refer de facto property disputes to the Family Court, and Western Australia has said that it will refer only superannuation matters.

Bourke says the failure of all states to agree to refer property disputes to the Family Court means "it will become a nice old mess". The Federal Government has added to the controversy by its same-sex couple stance.

The takeover by the Family Court of de facto property disputes is a landmark development for two central reasons. First, the Family Court is likely to give much more weight to non-financial contributions by a spouse, such as looking after the home and bringing up children, and, unlike the Supreme Court, considers future needs. This will change the balance of property settlements. Second, many more separating de facto spouses are likely to pursue their rights in court because the Family Court is perceived to be much more understanding of relationship problems than are state supreme courts.

Cut the costs of a marital split

1 Create a child-maintenance trust

The trusts provide a way to pay maintenance from pre-tax rather than after-tax income.

A senior manager for valuation services with Ernst & Young, Lauren Cusack, says income from the trusts qualifies as "excepted trust income". This means that standard adult tax rates apply – including the \$6000 tax-free threshold – instead of the high rates that usually apply to the trust income of minors. The benefits increase with the number of children involved.

Cusack says other benefits of child-maintenance trusts include the separation of assets or cash into the entities for future support of the children and protection of assets from future creditors of a spouse.

The income tax savings can accumulate within the trust, and the spouse contributing the assets to the trust to produce its income can borrow from it on commercial terms provided the capital is ultimately distributed to the children. Cusack says: "A disadvantage of a child-maintenance trust is that a parent will need to part with some cash or other assets upfront, though the children ultimately benefit."

2 Minimise tax on job loss

When couples are employed together in a family company, one spouse will often lose their job because of the marriage breakdown. Cusack says if the loss of employment qualifies as a bona fide redundancy, the

redundancy payment is concessionally taxed and tax-deductible to the company up to a limit. "Care needs to be taken to ensure that the redundancy is in accordance with Australian Taxation Office guidelines. For example, the termination of employment must be involuntary and the person losing their job should not be replaced."

3 Get assets out of family entities

A marriage breakdown is an opportunity to efficiently transfer assets from family companies and trusts to individuals. There are often tax and financial planning reasons for wanting to restructure the way assets are held. If assets are transferred from a trust or company to a former spouse under a court-approved property settlement or Family Court order, capital gains tax (CGT) is not immediately triggered. Because of special provisions for rollover relief, pre-CGT assets keep their tax-free status and the tax liability for post-CGT assets is postponed until eventually sold.

Cusack says that assets transferred from a company under a court order are subject to discounted CGT when eventually sold by one of the spouses. This valuable discount is unavailable to companies.

"A further benefit in most Australian states is an exemption from stamp duty if assets are transferred pursuant to a court order or binding financial agreement." (There is a potential tax trap with the transfer of assets out of a company. See strategy four.)

4 Avoid deemed dividends

A principal of Forsythes Forensic Accounting in New South Wales, Nick Gaudion, warns that the tax commissioner could declare that a company-owned asset transferred to a former spouse as part of a property division after a marriage breakdown is a deemed dividend under Division 7A of the tax act. Deemed dividends

are fully taxed at the recipient's marginal tax rate without the benefit of imputation credits, yet the company's franking account is debited.

Gaudion says one way to avoid the deemed dividend regime is for the company to declare a dividend to the value of the asset being transferred to the spouse, in effect paying for the asset with the dividend. Although tax would be payable on the dividend, it would be fully franked.

5 Claim hidden tax breaks

Cusack says spouses involved in a matrimonial property dispute can "potentially" claim tax relief for the cost of valuations by professionals such as accountants and real estate valuers when the valuation of the assets is an issue for tax purposes. A spouse who receives an asset as part of a property split can use a portion of these costs to offset any CGT payable when an asset is eventually sold.

Another opportunity is to claim tax deductions for interest on loans taken to buy income-producing assets from a former spouse. One spouse may decide, for example, to buy an investment home unit once held in joint names.

6 Get best capital gains tax result

Sometimes the capital gains tax rollover provisions (see strategy three) may not lead to the best tax outcome, Cusack warns. "For example, a husband may wish to crystallise some capital losses on shares by selling them to his estranged spouse rather than rolling them over to her. Such a sale ensures the husband has access to any capital loss in the year of sale to the other spouse and that the estranged wife receives the shares at the cost to her, which should be the market value at the time of transfer.

"Provided the transaction is pursuant to a court order or binding financial agreement, no stamp duty is payable on the sale of the shares to the wife at fair market value, and other assets can be exchanged in lieu of cash."

7 Control asset split

More couples are entering binding financial agreements before a marriage, during a marriage or after

marriage breakdown. These agreements, which include prenuptials, may allow couples to dictate how their assets are divided without the involvement of the Family Court. The agreements may, for example, provide a means for a wealthy spouse to keep assets acquired before a marriage from being split with a spouse if their marriage fails.

Following amendments to the Family Law Act, the agreements are legally binding on the spouses and can be enforced in the Family Court. But be warned, Family Court judges have the discretion in certain circumstances to overturn the agreements. (See main report.)

The tax benefits flowing from binding financial agreements are about to considerably improve. The Federal Parliament is expected to soon pass legislation to provide capital gains tax rollover relief for assets transferred under the agreements after a marriage breakdown. And most states already do not apply stamp duty on the transfer of assets under the agreements.

8 Hunt for undisclosed assets

Under the guidance of a family lawyer and a specialist accountant, a spouse can sometimes uncover valuable assets that have not been disclosed by the other spouse in a matrimonial dispute. These assets can then be included in the asset pool for splitting.

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Geographic area:

Australia

WA

SA

Classification:

Law/Family Law

Economy/Taxation/Capital Gains Tax

Economy/Finance

Economy/Taxation