TAXATION LIABILITIES: FOR BETTER OR FOR WORSE?

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Taxation in family law is a big topic. As family lawyers, we are neither qualified, nor insured to provide our clients with expert taxation advice. We are, however, required to understand the potential tax consequences of property settlements and to know when to refer our clients to their accountants or tax lawyers for taxation advice. We also need to know when certain financial arrangements that were entered into during a relationship may give rise to an audit or criminal prosecution for tax fraud, which can have disastrous effects on the matrimonial asset pool available for division between the parties.

The forms of taxation that we need be aware of are federal income tax, in particular Division 7A of the *Income Tax Assessment Act* 1936 (**ITAA**), capital gains tax (**CGT**) that may arise on the disposal of assets, the goods and services tax (**GST**) and various state taxes, including stamp duty, land tax and landholder duty. All of these taxes may become relevant in the context of asset valuations and transfers.

In some cases, tax liabilities may have been assessed by the Australian Taxation Office (**ATO**) and obviously must be factored into the matrimonial asset pool. In other cases, it may not be quite so straightforward. The calculation and timing of tax debts may be uncertain. There may also be an issue of which party should bear responsibility for the tax debts, which becomes particularly fraught when one spouse is made bankrupt by the ATO.

The scope of this paper is confined to two questions, being:

1. How does the court treat tax liabilities that have not yet crystallised?
2. When will the court decide that tax debts are not to be shared equally between the parties?

PART 1: TAX LIABILITIES THAT HAVE NOT CRYSTALLISED

The first step the court must take is to consider whether it is just and equitable to make a property settlement order by identifying, according to ordinary common law and equitable principles, the existing legal and equitable interests of the parties to property.[1] Generally, the court must take the assets and liabilities of the parties as they are at the date of trial. The general practice is that the court ascertains the value of the property of the parties to a marriage by deducting from the value of their assets the value of their total liabilities. There are, however, exceptions to this. The court may properly determine not to take into account or to discount the value of an unsecured liability in certain circumstances, such as where a liability is vague or uncertain, if it is unlikely to be enforced or if it was unreasonably incurred.[2]

Unassessed or contingent income tax, which is the main focus of this section of the paper, is one of those liabilities that may be excluded from the net asset pool available for division between the parties. However, if one party is liable for latent income tax it can mean that the settlement is not what it seems. As always, how the court exercises its discretion to deal with such liabilities will depend on the facts of the case.

Capital Gains Tax

CGT is a form of income tax. Basically, CGT is payable on the difference between the capital proceeds from the disposal of an asset and the “cost base”. The cost base is the original purchase price, as well as the acquisition and disposal costs and the costs of owning and maintaining the asset (unless such holding costs have already been claimed as a tax deduction). The rate of CGT depends upon whether the owner of the asset is a company or an individual, the taxpayer’s other sources of income and any capital losses incurred by the taxpayer that may be offset against the capital gain. If an asset is held for at least one year, then any gain is at

[1] *Stanford v Stanford* [2012] HCA 52
[2] *Biltof and Biltof* [1995] FamCA 45 at [57]

first discounted by 50% for individual taxpayers and 33.3% for superannuation funds.

Not all disposals of assets are subject to CGT. There is a main residence exemption for the family home, however, the main residence exemption can be tricky. It will not always be the case that the former matrimonial home will be free from CGT. The exemption may only be partial if the home was used as the taxpayer's main residence for only a part of the period he or she owned it. There may also be only a partial exemption if the home has been used for income producing purposes. Further, the ATO takes into account the way in which both the transferor and the transferee spouses have used the home when applying the main residence exemption, not only how the transferee has used it. This can have significant consequences if, for example, the transferor spouse moves out of the matrimonial home and buys another house before final settlement.

Any transfer of an asset between spouses or de facto partners pursuant to a Court Order or binding Financial Agreement made under the Family Law Act or State or territory legislation that would ordinarily be subject to CGT is subject to compulsory rollover relief (see s.126.5 ITAA). The rollover relief also applies to transfers of a CGT asset from a company or trust to an individual pursuant to a Court Order or binding financial agreement (see s.126.15 ITAA) but note that it does not apply in the reverse to transfers from an individual to a company or trust or between corporate entities.

Whilst the spouse receiving the CGT asset will not be liable to pay CGT upon the transfer of the asset, he or she may have to pay CGT on the eventual disposal of the asset. The deemed cost base of the asset upon disposal will be cost base to the transferor spouse at the time it was transferred pursuant to the Order or financial agreement. If you are acting for a party who is receiving an asset in a property settlement that may attract CGT in the future, it is important to ensure that your client has the documents relating to the purchase and holding costs of the asset, as these may be needed as evidence of the cost base of the asset upon its eventual disposal. The consequences of rollover relief can be more far-reaching if the asset

is being transferred from a company or trust to one of the parties, as the transfer of the asset out of the entity may reduce the cost base of the company shares or trust units.

CGT rollover relief also applies to self-managed superannuation funds if assets that would normally attract CGT are transferred in specie from one fund to another pursuant to Court Orders or a superannuation agreement, within the meaning of the *Family Law Act* 1975.

Obviously, if an asset must be sold to effect a property settlement, or has been sold, then the CGT crystallises and it is clearly a matrimonial liability that must be taken into account. The situation is more complicated where an asset is "pregnant" with CGT and may be sold in the foreseeable future but need not be sold to effect the settlement between the parties. Then the question arises, should CGT be taken into account and how?

The starting point to gain an understanding of CGT in the family law context is the case of *Rosati & Rosati*[3]. In relation to the issue of whether or not potential CGT should be taken into account as a liability when assessing the pool of assets available for division between the parties, the Full Court of the Family Court said as follows:

> *It appears to us that although there is a degree of confusion, and possibly conflict, in the reported cases as to the proper approach to be adopted by a court in proceedings under s.79 of the Act in relation to the effect of potential capital gains tax, which would be payable upon the sale of an asset, the following general principles may be said to emerge from those cases:-*
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> *(1) Whether the incidence of capital gains tax should be taken into account in valuing a particular asset varies according to the*

[3] [1998] FamCA 38

circumstances of the case, including the method of valuation applied to the particular asset, the likelihood or otherwise of that asset being realised in the foreseeable future, the circumstances of its acquisition and the evidence of the parties as to their intentions in relation to that asset.

(2) If the Court orders the sale of an asset, or is satisfied that a sale of it is inevitable, or would probably occur in the near future, or if the asset is one which was acquired solely as an investment and with a view to its ultimate sale for profit, then, generally, allowance should be made for any capital gains tax payable upon such a sale in determining the value of that asset for the purpose of the proceedings.

(3) If none of the circumstances referred to in (2) applies to a particular asset, but the Court <u>is</u> satisfied that there is a significant <u>risk</u> that the asset will have to be sold in the short to mid term, then the Court, whilst not making allowance for the capital gains tax payable on such a sale in determining the value of the asset, <u>may</u> take that risk into account as a relevant s.75(2) factor, the weight to be attributed to that factor varying according to the degree of the risk and the length of the period within which the sale may occur.

(4) There may be special circumstances in a particular case which, despite the absence of any certainty or even likelihood of a sale of an asset in the foreseeable future, make it appropriate to take the incidence of capital gains tax into account in valuing that asset. In such a case, it may be appropriate to take the capital gains tax into account at its full rate, or at some discounted rate, having regard to the degree of risk of a sale occurring and/or the length of time which is likely to elapse before that occurs.

To some extent, *Rosati* has lulled practitioners into thinking that unless an asset must be sold pursuant to Court orders, or is going to be sold imminently, then CGT

may not be taken into account and need not be calculated. That way of thinking was perhaps reinforced when the automatic capital gains tax rollover provisions were introduced in 1997. A vague assertion that CGT may be payable at some unspecified time in the future is unlikely to be given any weight by a Court. However, a submission that CGT should be taken into account, at least under sections 79(4)(e) and 75(2) of the *Family Law Act,* may succeed if an asset was purchased during the marriage for investment purposes and it has substantially increased in value. Any such submission must be supported by expert valuation and accountancy evidence about the estimated CGT. There may also need to be evidence of the course of the parties' dealings with their property during the relationship and their financial circumstances, with particular reference to the likelihood of that the CGT asset will be sold.

A lack of evidence can be fatal to a submission that CGT should be taken into account. In *J & J*[4] the Husband unsuccessfully sought to have his accountant's CGT estimates upon the sales of the parties' investment properties taken into account. The Full Court at paragraphs 35 to 38 said the following:

> *35. Many factors mitigate against the admission of this evidence. First, is the calculation of CGT itself. In order to determine whether a capital gain has been achieved, it is necessary to determine the cost base of the CGT asset. The elements of the cost base are set out in the Australian Taxation Office's Guide to Capital Gains Tax 2006 (pages 12 to 13). They include:*
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> - *the money paid for the asset and the market value of property given to acquire the asset;*
> - *a range of nine incidental costs of acquiring the CGT asset or of the CGT event (including remuneration of professional advisers, costs of advertising, and conveyancing, stamp duty and borrowing costs);*
> - *the costs of owning the asset, including rates, land taxes,*

[4] [2006] FamCA 951

repairs and insurance premiums;

- *capital costs to increase or preserve the value of the asset or to install or move it; and*
- *capital costs of preserving or defending the ownership of or rights to the asset.*

36. In addition there are three different methods of calculating CGT of which one enables increasing the cost base by applying an indexation factor and another which allows discounting of the gain.

37. Secondly, even if the liability could be more accurately estimated (which absent the matters referred to, it cannot), the impact on the parties or either of them depends upon their own income in the year in which the capital gain occurs (including all capital gains for that year), any and all capital losses for the year, any unapplied net capital losses from previous years, and any concessions to which they might be entitled.

38. Given the complexity of the calculation of CGT, the inadequacy of the estimates sought to be put before us can hardly be clearer.

By comparison, in *IABH & HRBH*[5], there was detailed expert evidence about the potential CGT (over $1m) that may have been payable upon the sales of properties in the future and His Honour Justice Watts made an adjustment of 7.5% in the Husband's favour under section 79(4)(d)-(g) to take this into account. His Honour said at paragraphs 359 to 364 of his judgment:

359. .....There is a proper basis, adopting the principles in Rosati to make a significant adjustment under s 79(4)(d)-(g) FLA for notional capital gains tax, sale expenses and tax on retained earnings.

360. As I have already said, although I have not accepted that an amount should be placed on the balance sheet for capital gains tax on a discounted basis, I am attracted to taking Mr ON's discounted rate as a starting guide for making a s 75(2) adjustment arising out of

5 [2010] FamCA 110

potential capital gains tax and tax on retained earnings. However I also accept that there is no current necessity to sell and there are variables dependent upon future events which may or may not come to pass.

361. Using Mr ON's assumptions and calculations and looking ahead five years, the present value calculation of capital gains tax and realisation costs if all properties were disposed of (apart from the villa) would be in a sum of $1,313,688 ($1,367,015 - $590,695 - $122,482 + $552,522 + $107,328). The present value of capital gains tax and realisation costs of the sale of all properties in a ten year time frame will be $1,131,339.

362. Those amounts are 15.5 percent and 13.4 percent respectively of the overall pool of net assets. Mr ON's present day calculations, of course, assume that the properties actually will be sold within either of those time frames. I accept that there is some possibility that the sales and winding up contemplated by those assumptions will not occur in the predicted time frames. There is also some force in the argument that the husband will wait and sell the income producing properties only when they have substantially improved in value. Mr ON's calculations cannot be an exact indicator of what costs might be incurred but they do indicate that the 2.5 to 3 percent adjustment suggested by senior counsel for the wife is inadequate. I am mindful of some of the variables referred to in J & J, but most of those concerns have been addressed in the expert evidence. As I have already said, there is no current necessity to sell any of the properties and there are variables depending on future events which may or may not come to pass.

363. At the end of the day future predictions need to be balanced in the context of current factual circumstances and what has happened historically.

364. The properties might be kept by the husband and in trust by his estate, for a very long time. Capital losses might be incurred in future investments which offset the gains and reduce the current incidence of tax on the current gains. As Nicholson CJ said in Carruthers and

Carruthers (1996) FLC 92-707 at para 83,486:

> *"...tax law is not a constant and differing views have been taken in this country to rates and incidents of capital gains tax from time to time....the person who holds the property may, over a period, be able to arrange his or her affairs as to heavily reduce, if not completely eliminate, the liability. This history of tax minimisation schemes....in this country is not such as to make one able to say with any confidence that this will not occur".*

In the case of *Carruthers v Carruthers* the husband sought to have anticipated CGT and notional sale costs on the sales of various properties brought into account as matrimonial liabilities, on the basis that he would need to dispose of properties to fund the purchase of another property that he was committed to buying. Nicholson CJ allowed "a substantial proportion of these costs", but not all of them. Timing was important. His Honour said, "the longer the likelihood of particular property being retained, then in my view the less justifiable to treat the property as being subject to a present notional liability".

Another case in which only a partial allowance was made for CGT was *JEL V DDF*[6], perhaps best known for what the Full Court said in that case about "special contributions". It was a large asset pool. The husband was a geologist and created the largest gold mine in Queensland. The effect of the trial Judge's Orders was the wife would be liable for 35% of any CGT incurred as consequence of the sale of assets to satisfy the Orders. This was upheld on appeal. The assets had mostly been acquired for investment purposes and had been valued on a net realizable asset basis. Further, the assets were held in a trust structure, which meant that they would have to be transferred out of the trust or liquidated for either party to access them. Nevertheless, Justice May at trial did not make any allowance for CGT in relation to assets that were not to be sold or transferred pursuant to her Orders, as it was far from clear that the potential CGT would ever arise.

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[6] (2001) FLC 93-075

Two cases in which an allowance for CGT was contended for at trial and an adjustment was made under section 75(2) to take potential CGT into account by the trial Judge are *Jarrott & Jarrott*[7] and *Lovine & Connor and Anor*[8]. The Full Court allowed the appeals in each of those cases on the basis that there was insufficient evidence upon which the trial Judge made the adjustments for CGT and the sales of the properties that would attract CGT were not inevitable. Instead, the Full Court found in each of those cases that a contingent Order should have been made, which provided for how the parties would pay the CGT if it actually arose in the future upon the sales of assets.

This may be seen as a more just and equitable approach than making a speculative adjustment in favour of one party when dividing the presently available assets, however, it has the disadvantage of causing a potential delay in the severing of the financial ties between the parties. It also has potential enforcement problems for a party seeking to enforce an indemnity from the other spouse with respect to the payment of a percentage of the CGT when it eventually crystallises.

Division 7A of the ITAA

Another form of income that may be taxable and which family lawyers need to be mindful of is deemed dividends. In cases where a private company pays money or transfers property pursuant to a Court Order to party to the marriage/de facto relationship who is a shareholder, or to the spouse of a shareholder, the payment or transfer may be treated as a taxable dividend. The dividend may be franked, at the discretion of the directors, to the extent that it is paid out of the company's profits, which may ameliorate the tax consequences for the recipient spouse. To the extent that the dividend is not franked, it will be assessable income in the hands of the recipient or create a tax liability in the company that may need to be taken into account.

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[7] (2012) FamCAFC 29

[8] (2012) FamCAFC 168

A payment or transfer of property to an "associate" of the shareholder is a deemed dividend and is treated in the same way as a dividend paid to the shareholder. An associate of a shareholder includes a spouse, relative, trustee of a trust under which the shareholder is a beneficiary and a company under the control of the shareholder.

Essentially, what Division 7A means is that if personal expenses are paid by a family company, company assets are used for personal purposes, or money is withdrawn from the company's bank account and not recorded as a wage or director's fee, then these payments will be treated by the ATO as unfranked dividends and taxed as income. If they are recorded in a loan account, then to avoid being taxable, the money needs to be repaid pursuant to a complying loan agreement, which must be in writing and include details such as the interest rate, term of the loan and the minimum loan repayments required every year.

Further, if payments are made to an interposed entity, such as trustee company, which then makes a payment to a shareholder, or an associate of the shareholder, then the payment will still be caught by Division 7A if a reasonable person would conclude that the payment is intended for the shareholder/associate. The payment will be exempt from Division 7A if the interposed entity pays tax on the payment as a dividend in its hands. Division 7A applies to debts created or forgiven after 4 December 1997 and to loans in place before that date if the amount or term of the loan is extended.

It is common for a family business to be run through a company, or trust structure and upon final property settlement, for one spouse to take over full control of the entity. It is also common for debit, or credit loan accounts to exist in the books of the company, or trust in the names of the husband and wife. These loan accounts need to be dealt with in order to sever the parties' financial ties.

Loan accounts can have a neutral impact on the matrimonial balance sheet, as a credit loan account in the name of a spouse will be a company liability which reduces the value of the entity (and vice versa with debit loan accounts which are

an asset of the company). Also, we often assume in settlement negotiations that the accountant will magically make loan accounts disappear on the basis that "it's not real money" but if personal expenses have been paid from untaxed company funds and recorded in a loan account, instead of paid by a party from taxable income received from the company, a very real "Division 7A" problem could arise in the future. The court will not take that into account unless the parties' tax affairs are brought up to date and there is evidence that there is, or imminently will be a tax debt payable.

In a decision of Baumann J in *Edgar & Edgar*[9] the court had to grapple with how to treat both contingent CGT and Division 7A liabilities in an asset pool of $77.5m. There was prospective CGT on the sale of a business of $3,597,396 and prospective Division 7A liabilities estimated to be $4,354,445 arising from retained earnings in various entities. Competing expert evidence was given on behalf of both parties as to the quantum of the estimated tax debts. The husband sought to maximise the tax estimates and include them in the net asset pool. The wife argued that the tax liabilities could be minimized or reduced and said they were too speculative to include in the asset pool. The quantum of the tax debts was not substantially in dispute at the end of the trial but questions of when and how the tax debts may crystallise were very much alive.

Baumann J did not include the prospective CGT in the asset pool because it was too uncertain. The liability had not cystallised and his Honour was not persuaded it would crystallise in the near term. There were other exacerbating factors, including whether a particular historical exemption would be available to the husband, uncertainty about the issue of re-assessments for past tax years and the availability of tax losses to offset the gains. However, his Honour decided that the potential CGT could not be ignored and made a small adjustment in favour of the husband under section 75(2)(o), which partly offset the adjustment made in favour of the wife for the disparity in future income earning capacity.

[9] [2021] FamCA 433

Conversely to CGT, the prospective Division 7A debts were treated as a debt in the balance sheet because there was more certainty about the calculation. His Honour said that when it came to the form of the orders he would make, "it will be clear that I propose each party accept some liability for the consequences of their agreed past tax strategy of retaining earnings" (rather than paying a taxable dividend in each year available) in the proportions in which they will benefit from the division of the pool. In other words, the burden would be shared in the future. It was anticipated by the court that each party would obtain expert advice about how to deal with their Division 7A tax debts attaching to the assets they would each retain in the settlement in the most effective and commercial manner available to them.

PART 2: IT'S ALL YOUR FAULT!

Under section 79 of the *Family Law Act* 1975(Cth) ("the Act") the court can order that one party pay the taxation liability of the other spouse party. That does not, however, provide a defence against the Commissioner of Taxation, unless the Commissioner is a party to the proceeding and is bound by the order. The court's power bind the Commissioner is set out in section 90AE of the Act which provides that the court may make an order under section 79 binding a third party.

By way of summary, this section gives the court the power to substitute one party or both parties in relation to a debt owed to a creditor by a party/parties to a marriage, including a tax debt. It also enables the court to order that the parties be liable for different proportions of the debt owed. The court may only make such an order if it's reasonably necessary or appropriate to effect a division of property between the parties to the marriage and if it's not foreseeable at the time that order is made that it will result in the debt not being paid in full. The third party creditor must also be accorded procedural fairness in relation to the making of the order.

The Commissioner of Taxation contended unsuccessfully in *Tomaras & Tomaras and Anor and Commissioner of Taxation*[10] in a case stated for the consideration of the Full

[10] [2017] FamCAFC 216

Court of the Family Court that section 90AE did not bind the Commissioner. In that case, the wife had a significant tax debt of over $256,000, including penalties. The Commissioner had obtained a judgment debt against her and intervened in the family law proceedings. The husband had become bankrupt. The wife sought an order that the husband be substituted for her in relation to the debt owed to the ATO.

The Commissioner argued, following the decision of the High Court in *Bropho v State of Western Australia*[11] that there is a legal presumption that statutory provisions expressed in general terms do not bind the Crown. This is not an inflexible rule. It is ultimately a matter of statutory construction and legislative intention, which means that the presumption may be rebutted. Furthermore, the presumption only applies to provisions that impose an obligation or a restraint on the Crown. The Full Court decided that the presumption did not apply to section 90AE as on a proper construction of the section, it could only confer a benefit on the Crown and not impose a burden. It could provide the Commissioner with a remedy that might not otherwise have been available, by enabling one spouse to be substituted for the other spouse who owed the tax debt. It would only be to the detriment of the Commissioner if a tax obligation was imposed on a spouse who, although he or she appeared to be able to meet the liability at the time, for some unforeseen reason became unable to do so in the future.

Even if the presumption had applied, the Full Court said that Parliament's failure to include a provision to the effect that section 90AE did not apply to tax debts, "given the Commissioner's history of availing himself of benefits flowing from directly associated provisions in the Act, is a strong indication that there is a legislative intention that the Commissioner be bound by s 90AE."

If a tax debt can be characterized as "waste" by one party then the court might decide to make one party either wholly or disproportionately more liable for it or make an addback to the asset pool to account for the unnecessarily incurred tax debt. In the leading case on "waste" of *Kowaliw v Kowaliw*[12], Baker J said at [10] to [11] that:

[11] [1990] HCA 24
[12] [1981] FamCA 70

As a statement of general principle, I am firmly of the view that financial losses incurred by parties or either of them during the course of a marriage whether such losses result from a joint or several liability, should be shared by them (although not necessarily equally) except in the following circumstances:

(a) Where one of the parties has embarked upon a course of conduct designed to reduce or minimise the effective value or worth of matrimonial assets; or
(b) Where one of the parties has acted recklessly, negligently or wantonly with matrimonial assets, the overall effect of which has reduced or minimised their value.

Conduct of that kind referred to in para (a) or (b) above having economic consequences is clearly relevant under sec 75(2)(o) to applications for settlement of property instituted under the provisions of sec 79.

It is not necessary to carry out a forensic exercise of identifying a dollar amount to be notionally "added back" into the asset pool to compensate for such conduct. The court has two options once being satisfied that wasteful conduct has occurred. It can give one party a greater share of the available assets or order that one party be solely liable for the losses.

There has arguably been a reassessment by the court of the principles applicable to addbacks since *Stanford*. In *Watson & Ling*[13], Murphy J said at [30] that the notion that money or property that has been disposed of should be treated as a "notional asset" or "notional property" appears to run contrary to the thrust of the decision in *Stanford*. In relation to wasteful conduct, he said at [33]:

How might that be recognised? First, consistent with existing authority, it can be recognised pursuant to s 75(2)(o)....Secondly, it might be contended that it might be recognised within the assessment of contributions. This Court has long eschewed the notion of 'negative contributions'....Nevertheless, it might be argued that the 'non-dissipating party' can be seen to have made a

[13] [2013] FamCA 57

> *disproportionally greater indirect contribution to the existing legal and equitable interests (for example to their preservation) if it is established that, but for the other party's unilateral dissipation, those existing legal and equitable interests would have been greater or had a greater value.*

More recently, the Full Court re-confirmed in *Trevi & Trevi*[14] that addbacks of money that has been expended by the parties is the exception rather than the rule and said at [27]:

> *The Full Court held in Omancini and Omancini that addbacks fall into "three clear categories": where the parties have expended money on legal fees; where there has been a premature distribution of matrimonial assets; and "waste" or wonton, negligent, or reckless dissipation of assets.*
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> The Full Court went on to say at [30] that:
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> *Two fundamental premises emerge from Omancini and the authorities preceding it. First, "adding back" is a discretionary exercise. When the discretion is exercised in favour of adding back, it reflects a decision that, exceptionally, in the particular circumstances of a case, justice and equity requires it. The second premise is its corollary: in cases that are not "exceptional" justice and equity can be achieved, not by adding back, but by the exercise of a different discretion – usually by taking up the same as a relevant s 75(2) factor. Indeed, it has been said that the latter is "a course which is, perhaps, technically more correct" than adding back to the list of existing interests in property.*

There have been many cases in which the court has had to grapple with unpaid taxation liabilities and to determine whether or not they fall within the category of "waste". The relevant considerations that a court might take into account when deciding how to apportion responsibility for tax debts between spouses are:

[14] [2018] FamCAFC 173

1. How the debt was accumulated, in particular, the degree of negligence or recklessness on the part of the spouse who incurred the debt;
2. How the funds were applied, in particular, the extent to which the parties shared in the money that should have been paid to the ATO;
3. The timing of debt, in particular, was it incurred before or after separation?
4. The degree of knowledge of the other spouse and complicity in the tax evasion;
5. How much of the tax debt is unpaid tax and how much is penalties and interest;
6. The rights of third party creditors and whether they will be fully paid; and
7. The size of the asset pool and the quantum of the debt relative to that asset pool.

In the case of *Commissioner of Taxation & Worsnop and Anor*[15] the husband had a tax debt exceeding the value of the assets. It was argued by the Commissioner that both parties had benefited from the non-payment of tax and the wife's innocence in the tax evasion should not be given significant weight. There was evidence that the wife asked the husband during the marriage if they should perhaps curb their extravagant lifestyle. The Full Court upheld the trial Judge's findings that the husband's conduct fell within the exceptions in *Kowaliw*, with significant weight given to the wife's knowledge, or lack thereof, of the liabilities.

The tax debts were determined to be the sole responsibility of the husband in *Worsnop* but the wife's entitlement under section 75(2) was reduced pursuant to section 75(2)(ha), which requires the court to take into account the effect of an order on the ability of creditors to recover debts, because the liabilities exceeded the assets. The outcome was an equal division of the proceeds of the matrimonial home between the Commissioner and the wife.

There was a different outcome in In *Trustee of the property of G. Lemnos & Lemnos and Anor*[16], although the facts were similar. The husband had accrued a large tax debt over many years. The wife was not complicit in the tax fraud but enjoyed their comfortable lifestyle without question. The husband was a bankrupt and the tax debts far exceeded the value of the matrimonial home, which was the only significant asset

[15] [2009] FamCAFC 4
[16] [2009] FamCAFC 20

of the marriage at trial. The wife said the husband had wasted assets in the *Kowaliw* sense by negligently or recklessly filling in his tax returns to claim deductions to which he was not entitled. The husband argued that the wife was equally liable for the tax because she had also enjoyed the fruits of the money that had not been paid to the ATO and the parties would not have accumulated their assets if tax had been paid.

The trial judge in *Lemnos* held that the husband should satisfy the ATO debt from his own resources. The source of the discretion to make that determination was to be found in section 75(2)(o). There was no other adjustment in favour of the wife or the Trustee under section 75(2). The Trustee appealed and was successful. The outcome on appeal was the that the primary tax debt was <u>not</u> considered "waste" by the husband, notwithstanding the wife's lack of knowledge and complicity in the husband not filing accurate tax returns.

So, why was the outcome in *Lemnos* different from that in *Worsnop*? In *Worsnop*, the husband was not bankrupt, as he was in *Lemnos* (although there was still not enough in the asset pool to go around). It is unclear whether or not that was a distinguishing factor. The different approaches taken by the Full Court in *Lemnos* and *Worsnop* can be attributable to the facts, being the different degrees of recklessness of the husband's conduct in each case, the extent to which the wife willingly shared in the fruits of the unpaid tax and the relative effect of the overall outcome on creditors.

In *Worsnop* the tax debt was about $12m and the matrimonial home, being the only significant asset, was worth $1.5m. By contrast, in *Lemnos* the tax debt was $5.7m and the net value of the matrimonial home was about $2.5m. In *Lemnos,* whilst the opportunity to accumulate assets as a consequence of the husband's tax fraud was given significant weight, the Full Court held that the husband's conduct in falsely claiming tax deductions did not amount to "recklessness" in the *Kowaliw* sense. By contrast, the husband in *Worsnop* engaged in a tax avoidance scheme that involved the use of offshore bank and stock trading accounts to hide income from the ATO and which led to a massive tax debt. His conduct <u>was</u> held to meet the *Kowaliw* test.

An example of a case where the court refused to include a tax liability in the property pool to be divided between the parties is *Hagan & Gerald*[17]. The husband asserted that he had been unable to pay his tax for three financial years since separation. He owed about $40,000 and submitted the debt had arisen because of amounts spent by him on the wife and the children, including money spent by him when the children were in his care. The court found that the husband had not demonstrated that he was unable to pay his tax. It was determined that from his income of $596,584 from a family trust, after payment of $146,682 expended for the benefit of the wife and children, he still had $449,902 available to him to pay his tax and living expenses. The court found that he had chosen to spend his income and not pay his tax. The outcome was that the court decided it was not just and equitable to treat the tax debt as a joint liability.

Another example where the husband's tax liability was not included in the asset pool as a joint liability is the case of *Devonpoulos & Devopoulos*[18]. Loughnan J listed the husband's tax debt as solely a debt of the husband in circumstances where, amongst other reasons, no meaningful explanation was provided by the husband for his failure to lodge tax returns, pay his tax or keep the wife advised about the potential liability. It should be noted that the debt comprised penalties and interest, as opposed to prime tax, and was incurred after separation.

Another example where one party's tax liability was not included in the net asset pool is *Tobey & Rezek*[19]. In that case, the tax liability was incurred post-separation and was referable to post-separation income from which it could not be established the other party derived any benefit.

In *James & Snipper and Anor*[20] the husband had tax debts at the date of the trial in the sum of $2.01m. The wife had a tax debt of $113,000. A significant proportion of the husband's tax debt comprised penalties and interest and was accumulated post-separation, during a time when the husband wasted money by gambling. The trial judge took into account that the wife received a substantial benefit from the husband's post-

[17] [2013] FamCA 714
[18] [2014] FamCA 224
[19] [2017] FamCAFC 84
[20] [2018] FamCAFC 235

separation income and concluded that it was just and equitable for the wife to contribute $200,000 to the husband's tax debt, being 10%. The liability was not shared equally.

In *Murray & Murray*[21] the Full Court dismissed an appeal against a decision in which the trial judge excluded the husband's tax debts and also notionally added back cash as an asset in the husband's hands. The husband was an accountant and had engaged in money laundering activities. There were two tax debts. One was omitted because of lack of evidence of its origin, or the husband's incapacity to meet the debt. Significantly, there was no evidence of whether the income on which the tax was assessed was applied for the benefit of both parties. The second tax debt was omitted because the husband's estimate of the quantum was entirely contingent upon the content of draft documents which had not yet been submitted to the ATO and had not been divulged to the wife until the trial commenced. It was about $400,000 according to the husband's own arithmetic, but he suddenly refined it down to $221,699 during the trial. The anticipated tax debt was not included in the balance sheet because it was "vague or uncertain" in accordance with *Biltof.*

In *Murray,* the husband did not alter his extravagant lifestyle despite the shrinkage of his income and it was deemed by the court to be unreasonable for him to resort to credit to maintain such a lifestyle. The tax debts were not included in the balance sheet by the trial Judge but they were taken into account under section 75(2), although not with any precision. Notwithstanding that, the wife received an adjustment in her favour of 23.2% under section 79(4)(d)-(g) and in accordance with considerations of justice and equity.

In summary, the old saying, "what is good for the goose is good for the gander" seems generally to apply when it comes to tax debts. If a tax debt is incurred in relation to income from which both parties have had the benefit then, provided the debt is certain, it will be included in the net asset pool as a joint liability. However, if the debt comprises penalties and interest, incurred due to one party's tax evasion of which the other spouse was ignorant, then it is much more likely that the "guilty" spouse will have to wear it (or at least the component of the debt that comprises penalties).

[21] [2020] FamCAFC 293

The knowledge or otherwise of the “innocent” spouse of tax evasion may come into much sharper focus in cases where the liabilities exceed the assets and there are insufficient assets to meet a party’s section 79 claim after the debts are paid.[22] The most difficult family law cases are often those in which there are simply not enough assets to go around and the court must balance the interests of the parties to the marriage against those of their creditors. The court is more likely to determine that one party should shoulder all or most of a debt for prime tax (in addition to ATO penalties and interest) arising from tax evasion if the other spouse did not know about it and he or she will be left “high and dry” after the Commissioner is paid.

24 November 2022

[22] *Worsnop supra* at [70]