TR 2014/5 - Income tax: matrimonial property proceedings and payments of money or transfers of property by a private company to a shareholder (or their associate)

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This ruling is being reviewed as a result of a recent court/tribunal decision. Refer to Decision Impact Statement: Sandini Pty Ltd atf the Karratha Rigging Unit Trust & Ors v Ellison & Ors v Commissioner of Taxation of the Commonwealth of Australia & Ors (Published 27 November 2018).

There is a Compendium for this document: **TR 2014/5EC** .

Taxation Ruling

Income tax: matrimonial property proceedings and payments of money or transfers of property by a private company to a shareholder (or their associate)

Contents Para

LEGALLY BINDING SECTION:

What this Ruling is about 1

Ruling 4

Date of effect 40

NOT LEGALLY BINDING SECTION:

Appendix 1:

***Explanation* 43**

Appendix 2:

***Alternative views* 137**

Appendix 3:

***Detailed contents list* 162**

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What this Ruling is about

1. In matrimonial property proceedings,[1] under section 79 of the *Family Law Act 1975* (FLA 1975), the Family Court can order:

- a private company, or
- a party to the matrimonial proceedings to cause the private company,

to:

- pay money, or
- transfer property,

to a party to the matrimonial proceedings.

[1] This ruling only applies to matrimonial property proceedings. However, the approach adopted in this ruling (with the exception of paragraphs 9 and 10) would be equally applicable to property settlement proceedings as they apply to de facto couples, where the governing legislation is substantially similar to section 79 of the FLA 1975. Paragraphs 9 and 10 of this ruling would be equally applicable to property settlement proceedings of the kind described in subsection 126-5(1) of the *Income Tax Assessment Act 1997,* subject where relevant to the conditions in section 126-25 of that Act.

2. This Ruling is concerned with the taxation effect under section 44 of the *Income Tax Assessment Act 1936* (ITAA 1936), Division 7A of Part III of the ITAA 1936 (Division 7A), Subdivision 126-A of Part 3-3 of the *Income Tax Assessment Act 1997* (ITAA 1997) and Division 207 of the ITAA 1997 of private companies paying money or transferring property in compliance with such orders.

3. In this Ruling, a reference to:

- **an associate of a shareholder**, includes an entity that receives a payment or transfer of property from a private company because it was formerly a shareholder or an associate of a shareholder of that company, and
- **the Family Court** means a reference to another court exercising jurisdiction in relevant proceedings by virtue of the FLA 1975, which includes the Federal Circuit Court (formerly the Federal Magistrates Court).
- **a section 79 order** means an order made under section 79 of the FLA 1975 that requires:
  - a private company, or
  - a party to the matrimonial proceedings to cause the private company,

  to pay money or transfer property to a party to the matrimonial proceedings, otherwise than as discharge of a debt in existence apart from the matrimonial proceedings,

Ruling

Money or property to be paid or transferred to a shareholder

4. Where a section 79 order requires:

- a private company, or
- a party to the matrimonial proceedings to cause the private company,

to pay money or transfer property to a shareholder of the private company, the payment of money or transfer of property in compliance with that order is an ordinary dividend to the extent paid out of the private company profits and is assessable income of the shareholder under section 44 of the ITAA 1936. (See Examples 1 to 4 of this ruling).

Money or property to be transferred to an associate of a shareholder

5. Where a section 79 order requires:

- a private company, or

- a party to the matrimonial proceedings to cause the private company,

to pay money or transfer property to an associate of a shareholder of property in compliance with the order, the payment of money or transfer of property is a payment for the purposes of subsection 109C(3) of the ITAA 1936.

6. Section 109J of the ITAA 1936 does not prevent the payment from being treated as a dividend under subsection 109C(1) of the ITAA 1936. (See Examples 5 to 8 of this ruling)

Dividends frankable

7. Dividends described in paragraph 4 and payments described in paragraph 5, to the extent they are taken to be dividends, are frankable.

8. Where a dividend that is taken to be paid to an associate of a shareholder under section 109C of the ITAA 1936 is franked, that associate is themselves treated as being a shareholder (having the same characteristics as the shareholder with whom they are associated) for the purposes of Division 207 of the ITAA 1997, including for the purposes of determining whether:

- the franking credit is included in their assessable income, and
- they are entitled to claim a tax offset equal to the amount of that franking credit.

CGT Rollover applies

9. Where a private company transfers property to a shareholder in compliance with a section 79 order, the rollover consequences in section 126-5 of the ITAA 1997 apply and the cost base of the shareholder's shares in the private company (if acquired after 20 September 1985) are both reduced pursuant to subsection 126-15(3) of the ITAA 1997 and increased pursuant to subsection 126-15(4) of the ITAA 1997.

10. Where a private company transfers property to an associate of a shareholder in compliance with a section 79 order, the rollover consequences in section 126-5 of the ITAA 1997 apply and the cost base of the shareholder's shares in the private company (if acquired after 20 September 1985) are reduced pursuant to subsection 126-15(3) of the ITAA 1997.

Examples

Money paid or property transferred to a shareholder

Example 1: Section 79 orders to pay money to a shareholder

11. In the 2014 income year, Mal, Justine and DEF Coy are parties to matrimonial property proceedings before the Family Court. Mal and Justine are both shareholders of DEF Coy which is the vehicle for the family business and has retained profits of $500,000. On 29 March 2014, the Family Court makes a section 79 order for DEF Coy to pay Justine $250,000.

12. On 30 April 2014, DEF Coy makes the payment of $250,000 to Justine in compliance with the Family Court order. The payment of $250,000 is an assessable dividend to Justine under section 44 of the ITAA 1936.

Example 2: Section 79 orders to transfer property to a shareholder

13. In the 2014 income year, Tim, Helene and MNO Coy are parties to matrimonial property proceedings before the Family Court. Tim and Helene are both shareholders of MNO Coy which is the vehicle for the family business and has retained profits of $2,000,000.

14. On 15 May 2014, the Family Court makes a section 79 order for MNO Coy to transfer a rental property with market value of $1,000,000 to Tim.

15. On 30 June 2014, MNO Coy makes the transfer of the property to Tim in compliance with the Family Court order.

16. The transfer of property is an assessable dividend of $1,000,000 to Tim under section 44 of the ITAA 1936.

Example 3: Section 79 orders against a matrimonial party to cause a private company to pay money to a shareholder

17. In the 2014 income year, Bobby and Pat are parties to matrimonial property proceedings before the Family Court. Bobby and Pat are the sole shareholders/directors of LMN Coy which is the vehicle for the family business and has retained profits of $3,000,000. LMN Coy is not a party to the proceedings.

18. On 15 February 2014, the Family Court makes a section 79 order for Bobby and Pat to cause LMN Coy to pay to Pat an amount of $1,500,000. On 25 March 2014, LMN Coy makes the payment of money to Pat as directed by Bobby and Pat.

19. The payment of $1,500,000 is an assessable dividend to Pat under section 44 of the ITAA 1936.

Example 4: Section 79 orders against a matrimonial party to cause a private company to transfer property to a shareholder

20. In the 2014 income year, Robert and Marg are parties to matrimonial property proceedings before the Family Court. Robert and Marg are the sole shareholders/directors of ZAB Coy which is the vehicle for the family business and has retained profits of $7,000,000. ZAB Coy is not a party to the proceedings.

21. On 28 February 2014, the Family Court makes a section 79 order for Robert and Marg to cause ZAB Coy to transfer real property to Marg with a market value of $2,000,000. On 25 March 2014, ZAB Coy makes the transfer of property to Marg as directed by Robert and Marg.

22. The transfer of property is an assessable dividend of $2,000,000 to Marg under section 44 of the ITAA 1936.

Money paid or property transferred to an associate of a shareholder

Example 5: Section 79 orders for a private company to pay money to an associate of a shareholder

23. In the 2014 income year, Sam, Martha and ABC Coy are parties to matrimonial property proceedings before the Family Court. Sam is the sole shareholder of ABC Coy which is the vehicle for the family business and has retained profits of $200,000. The distributable surplus of ABC Coy as worked out under section 109Y of the ITAA 1936 is greater than $100,000.

24. On 29 May 2014, the Family Court makes a section 79 order for ABC Coy to pay Martha $100,000. On 30 June 2014, ABC Coy makes the payment of $100,000 to Martha in compliance with the Family Court order.

25. The payment to Martha is a payment as defined in paragraph 109C(3)(a) of the ITAA 1936. Section 109J of the ITAA 1936 does not prevent section 109C operating to treat the payment as a deemed dividend.

26. The payment of $100,000 is assessable to Martha as a dividend under section 44 of the ITAA 1936, by virtue of section 109C of the ITAA 1936.

Example 6: Section 79 orders for a private company to transfer property to an associate of a shareholder, deemed dividend franked

27. In the 2014 income year, Max, Denise and XYZ Coy are parties to matrimonial property proceedings before the Family Court. Denise has been the sole shareholder of XYZ Coy, which is the vehicle for the family business and has retained profits of $1,000,000, since its establishment several years ago. The distributable surplus of XYZ Coy as worked out under section 109Y of the ITAA 1936 is greater than $500,000.

28. On 28 April 2014, the Family Court makes a section 79 order for ABC Coy to transfer a rental property with market value of $500,000 to Max. On 30 June 2014, XYZ Coy makes the transfer of the rental property to Max in compliance with the Family Court order.

29. The transfer of property to Max is a payment as defined in paragraph 109C(3)(c) of the ITAA 1936. Section 109J of the ITAA 1936 does not prevent section 109C operating to treat the transfer of property as a deemed dividend.

30. XYZ Coy further resolves to frank the deemed dividend at the private company's benchmark franking percentage for the 2014 income year.

31. The transfer of property results in Max being:

- assessable on a franked dividend of $500,000 under section 44 of the ITAA 1936, by virtue of sections 109C and 109RC of the ITAA 1936
- assessable on the franking credit on that dividend under section 207-20 of the ITAA 1997, and
- entitled to a tax offset equal to the amount of that franking credit under section 207-20 of the ITAA 1997.

Example 7: Section 79 orders against a matrimonial party to cause a private company to pay money to an associate of a shareholder

32. In the 2014 income year, Roger and Michelle are parties to matrimonial property proceedings before the Family Court. Roger is the sole shareholder/director of PQR Coy which is the vehicle for the family business and has retained profits of $10,000,000. The distributable surplus of PQR Coy as worked out under section 109Y of the ITAA 1936 is greater than $6,000,000. PQR Coy is not a party to the proceedings.

33. On 15 April 2014, the Family Court makes a section 79 order for Roger to cause PQR Coy to pay money of $6,000,000 to Michelle. On 30 June 2014, PQR Coy makes the payment of $6,000,000 to Michelle in compliance with the Family Court order made against Roger.

34. The payment to Michelle is a payment as defined in paragraph 109C(3)(a) of the ITAA 1936. Section 109J of the ITAA 1936 does not prevent section 109C operating to treat the payment of money as a deemed dividend.

35. The payment of $6,000,000 is assessable to Michelle as a dividend under section 44 of the ITAA 1936, by virtue of section 109C of the ITAA 1936.

Example 8: Section 79 orders against a matrimonial party to cause a private company to transfer property to an associate of a shareholder

36. In the 2014 income year, Alan and Tania are parties to matrimonial property proceedings before the Family Court. Tania is the sole shareholder/director of UVW Coy which is the vehicle for the family business and has retained profits of $20,000,000. The distributable surplus of UVW Coy as worked out under section 109Y of the ITAA 1936 is greater than $12,000,000. UVW Coy is not a party to the proceedings.

37. On 15 February 2014, the Family Court makes a section 79 order for Tania to cause UVW Coy to transfer real property with market value of $12,000,000 to Alan. On 25 May 2014, UVW Coy makes the transfer of property to Alan in compliance with the Family Court order made against Tania.

38. The transfer of property to Alan is a payment as defined in paragraph 109C(3)(c) of the ITAA 1936. Section 109J of the ITAA 1936 does not prevent section 109C operating to treat the transfer of property as a deemed dividend.

39. The transfer of property results in Alan being assessable on its $12,000,000 value as a dividend under section 44 of the ITAA 1936, by virtue of section 109C of the ITAA 1936.

Date of effect

40. Subject to the exception mentioned in paragraph 42 of this Ruling, this Ruling applies both before and after its date of issue. However, this Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a taxation dispute agreed to before the date of issue of the Ruling (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

41. ATO Interpretative Decision ATO ID 2004/462 correctly explains that section 109J of the ITAA 1936 will only apply to prevent a payment by a private company giving rise to a deemed dividend under section 109C of the ITAA 1936 where, amongst other things, that payment discharges an obligation of the private company. The ATO ID explains that no relevant obligation can arise as a result of an order under section 79 of the FLA 1975, where that order does not bind the private company (for example, where the private company is not a party to the relevant proceedings). The ATO ID is silent on the role of section 109J of the ITAA 1936 where orders under section 79 of the FLA 1975 **do** bind the private company (as can now be the case). A significant body of private rulings issued subsequent to this ATO ID proceeded on the basis that an order made under section 79 of the FLA 1975 which **does** give rise to an obligation for a private company to pay money to an associate of a shareholder, will attract the protection of section 109J of the ITAA 1936.

42. The body of private rulings referred to in paragraph 41 of this Ruling evidence a prior general administrative practice contrary to the view, set out in paragraph 6 of this Ruling (and in Paragraph 6 of TR 2013/D6, published on 13 November 2013) that orders made (directly) to a private company under section 79 of the FLA 1975, to pay money to an associate of a shareholder of that company, will result in a deemed dividend arising under Division 7A. Example 5 (at paragraphs 23 to 26 of this Ruling) goes on to illustrate that view. To the extent that the view set out in paragraph 6 and / or Example 5 of this Ruling is less favourable to a taxpayer than the Commissioner's previous practice in respect of such orders against a private company, it will not apply in respect of any such orders made before the date of issue of this Ruling.

Commissioner of Taxation
30 July 2014

Appendix 1 – Explanation

This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.

Summary and context

43. This Ruling deals with certain income tax consequences that may arise where, as a result of the Family Court ordering that interests in property be altered upon the breakdown of a marriage, money or other property is transferred from a private company to a shareholder, or an associate of a shareholder, of that company. Specifically, it explains that in these circumstances, section 44 of the ITAA 1936 (dealing with dividends) or Division 7A (dealing with amounts deemed to be dividends) may apply to assess the recipient of that money or property.

44. In reaching this conclusion, this Ruling also considers the specific provisions contained within Division 7A that, in certain circumstances, can stop its application. One of those exclusions involves certain payments made in satisfaction of particular obligations (section 109J of the ITAA 1936). This Ruling explains why an obligation imposed by the Family Court cannot attract the protection of section 109J so as to stop the operation of Division 7A.

45. This Ruling goes on to consider those provisions in Division 7A that allow an amount treated as a dividend in relevant circumstances to be franked, and how this applies in the context of a dividend taken to be paid to an associate of a shareholder.

46. Finally, this Ruling explains that the CGT rollover provisions, and other related provisions in Subdivision 126-A of the ITAA 1997 apply in respect of property transferred by a private company in compliance with a section 79 order.

Family Law Context

47. Section 79 of the FLA 1975 enables the Family Court to make orders altering interests in matrimonial property on the breakdown of matrimonial relationships.

48. Section 90AE of the FLA 1975 commenced on 17 December 2004. Section 90AE gives the Family Court certain powers to make orders under section 79 of the FLA 1975 in relation to third parties. Paragraph 90AE(2)(b) of the FLA 1975 specifically empowers the Court to make an order that:

> alters the rights, liabilities or property interests of a third party in relation to the marriage.

49. Prior to 17 December 2004, the Family Court was not empowered to make orders directly against a private company. Rather, property of a party to matrimonial property proceedings was treated by the Family Court as including any property which a party had an ability to unilaterally invest in or divest as controlling shareholder, trustee or otherwise.[2] In such cases, the Family Court might have made an order against a party with a controlling interest to cause the private company to pay money or transfer property to the other matrimonial party.[3]

50. Paragraph 90AE(2)(b) of the FLA 1975 now empowers the Family Court to make orders directly against a third party such as a private company of which one or both of the matrimonial parties are shareholders.[4] In practice such orders have been for the private company to make a payment of money or a transfer of property to one or both of the parties to the matrimonial proceedings.

51. Rule 6.02(1) of the *Family Law Rules 2004* now requires that if a party seeks an order affecting a third party, the third party is a necessary party to the proceedings. Therefore, such orders would now be expected to be made directly against the third party rather than against a matrimonial party.

52. In making orders for the division of matrimonial property, the Family Court is required under subsection 90AE(4) of the FLA 1975 to take into account the taxation effect of the order on the matrimonial parties as well as to the third party.

53. The taxation effect of payments or transfers of property to shareholders or associates of shareholders primarily arise from the operation of section 44 of the ITAA 1936 and Division 7A.

54. Where the taxation effect of an order on the matrimonial parties was not taken into account, the Court may be empowered under subsection 79A(1) of the FLA 1975 to vary the order or set the order aside and, if it considers appropriate, make another order under section 79.

Income tax laws and matrimonial property proceedings

Section 44 of the ITAA 1936

55. A payment of money or transfer of property to a shareholder out of the profits of a private company is an assessable dividend under section 44 of the ITAA 1936.

[2] *In the Marriage of Harris* (1991) 104 FLR 458; [1991] FLC 92-254.
[3] *In the Marriage of Prince* (1984) 69 FLR 150; [1984] FLC 91-501.
[4] Paragraph 147 of the Explanatory Memorandum to the Family Law Amendment Bill 2003 explains that the range of orders available because of the insertion of section 90AE is intended to be broad and includes for example, the ordering of the transfer of shares between the parties to the marriage.

56. Subsection 44(1) of the ITAA 1936 relevantly provides:

> The assessable income of a shareholder in a company (whether the company is a resident or a non-resident) includes:
>
> (a) if the shareholder is a resident:
>
> (i) dividends (other than non-share dividends) that are paid to the shareholder by the company out of profits derived by it from any source.

57. The word 'dividend' is defined in subsection 6(1) of the ITAA 1936 to include:

> (a) any distribution made by a company to any of its shareholders, whether in money or other property.[5]

The meaning of distribution

58. The meaning of 'distribution' in context has been judicially considered and held:

1. to at least involve a dealing out or bestowal;[6]
2. to encompass a very broad range of applications of company property and money to shareholders while the company is a going concern;[7]
3. to undoubtedly be of wide import and concerned with the manner in which the shareholder receives the benefit of the dividend, emphasising that, in whatever manner the dividend reaches the shareholder it is to be regarded as assessable income;[8]
4. to not require the existence of the conditions necessary to declare a lawful dividend under the *Corporations Act 2001* ('*Corporations Act*').[9]

Paid out of profits

59. The High Court in *Federal Commissioner of Taxation v. Slater Holdings Ltd (No. 2)*[10] confirmed that it is the fact that a payment to a shareholder is sourced in the profits of a company (as opposed to whether that payment has the character of income in the hands of the shareholder) that is decisive of whether that payment is a dividend for

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[5] Excluding certain amounts not relevant in the circumstances considered in this draft Ruling – namely reversionary bonuses on life assurance policies and certain amounts debited against or to the company's share capital account.
[6] *Deputy Federal Commissioner of Taxation v. Black* (1990) 25 FCR 274 at 281; (1990) 21 ATR 701 at 707; 90 ATC 4699 at 4705.
[7] *Commissioner of Taxes (Victoria) v. Nicholas* (1938) 59 CLR 230 at 238; (1938) 1 AITR 266 at 268-9; (1938) 4 ATD 484 at 486 per Latham CJ.
[8] *Commissioner of Taxation (New South Wales) v. Stevenson* (1937) 59 CLR 80 at 108.
[9] *MacFarlane v. Federal Commissioner of Taxation* (1986) 13 FCR 356; 86 ATC 4477; (1986) 17 ATR 808.

the purposes of section 44 of the ITAA 1936. In that case, Gibbs CJ said:

> In *FC of T v. Uther, Kitto* J., in his dissenting judgment at pp. 638-640, advanced a criticism of the judgment of *Fullagar* J., which, with all respect, I find compelling. *Fullagar* J. was right in saying that the distribution made to the shareholders in *F.C. of T. v. Blakely* was a capital receipt according to general principles, but he gave insufficient weight to the change that had been effected to the law by defining ``dividend'' so as to include a distribution made by a company to any of its shareholders. As *Kitto* J. pointed out at p. 639, the effect of the amendments to the law, first made by the *Income Tax Assessment Act 1934* and repeated when the Act was passed in 1936, was to make shareholders in a company which is a going concern assessable to tax on a principle fundamentally different from that of the previous legislation. *Kitto* J. continued:
>
> > 'The criterion for the inclusion of a shareholder's receipts from the company is no longer the 'dividend' character of the receipts, that is to say their income character when considered from the shareholder's point of view; it is the profit character – from the company's point of view – of the source from which distributions should be made.'[11]

60. In terms of whether a distribution has been paid out of profits, the Commissioner has previously explained in paragraphs 15 and 16 of Taxation Ruling TR 2003/8: *Income tax: distributions of property by companies to shareholders – amount to be included as an assessable dividend*:

> 15. In deciding whether, as a question of fact, a distribution has been made out of profits derived by the company in cases where the distribution is not formally acknowledged as such, a substantive approach should be adopted. There does not need to be a formal debiting of an account of profit of the company. So long as the market value of the company assets exceeds the total amount (as shown in its books of account) of its liabilities and share capital what remains is profits. If the distribution is not debited to share capital the distribution is one of profits.
>
> 16. Such an approach was adopted by the NSW Supreme Court in *Masterman v. FCT* 85 ATC 4015. In reaching its decision that the payment to shareholders in that case was a payment out of profits derived by the company, the court noted (at page 4030) that the company was solvent and that there was no evidence that the relevant payment was out of non-profit sources, and that 'commonsense would require that the company be kept solvent and that only surplus amounts not putting that requirement at risk be paid out'.

[10] (1984) 156 CLR 447; (1984) 15 ATR 1299; (1984) 84 ATC 4883.
[11] At CLR 457, At ATR 1304, At ATC 4887.

A dividend for tax purposes

61. It follows for tax purposes that it does not matter whether a dividend is intended or predicated upon any particular process. Rather, a factual enquiry is required as to whether there is a distribution to a shareholder and whether it is made out of profits.

Section 79 orders to pay money or transfer property (or cause money to be paid or property transferred) to a shareholder

Distribution out of profits

62. A payment or transfer of property by a private company to a shareholder in compliance with an order of the Family Court in a matrimonial property proceeding falls for consideration under section 44 of the ITAA 1936.

63. It would ordinarily be expected that such orders would relate to money or other property comprising the net assets of the private company, being the private company's realised or unrealised profits. This is because under paragraph 90AE(4)(f) of the FLA 1975, the Family Court must take account of the economic, legal or other capacity of the private company to comply with the order.

64. If the net assets of a private company have a bona fide nil value, the directors of the private company would, in ordinary circumstances, be in breach of section 588G of the *Corporations Act* if they were to divest the private company of assets so as to cause the private company to be insolvent. Further, were that divesting of assets an uncommercial transaction, it may be voidable under section 588FE of the *Corporations Act*.

65. The Family Court would therefore not be expected to make an order under section 79 of the FLA for the private company to make a payment of money or to transfer property for less than market value in excess of the private company's retained profits.

To a shareholder

66. In complying with a section 79 order for a payment or transfer of property to a matrimonial party who is shareholder, a private company might recognise the payment or transfer of property as a distribution to a shareholder.[12] The terms of the section 79 order might also expressly require that the payment or transfer of property be effected by the making of a formal distribution.

[12] The accounting treatment describing satisfaction with an order of the Family Court for example might show a debiting of a ledger account of realised or unrealised profits of the private company and be coded as a distribution to a shareholder.

67. Nonetheless, the express characterisation by the private company of the payment or transfer as a distribution to a shareholder, or the express requirement by the section 79 order that such a payment or transfer be in the form of a distribution to a shareholder, is not essential. Paragraph (a) of the definition of dividend in subsection 6(1) of the ITAA 1936 merely requires a distribution 'to' a shareholder (unlike the second limb of that definition which only includes amounts credited to any of its shareholder 'as shareholders').[13]

Conclusion

68. In cases where there is a payment of money or transfer of property to a matrimonial party who is a shareholder representing the realised or unrealised profits of the private company, in compliance with an order of the Family Court, there will be:

(a) a bestowal by the private company upon a shareholder in terms of the transfer of property or payment of money, and

(b) in both substance and/or legal form, a Court ordered appropriation from the private company profits.

69. In these cases, the shareholder will have been paid a dividend as defined, out of profits, which is assessable under section 44 of the ITAA 1936. The characterisation of the payment or transfer of property as a dividend is not altered by the fact that it is made pursuant to an order of the Family Court. The cause for the directors resolving to make the payment or transfer the relevant property does not determine its character.

70. Section 44 of the ITAA 1936 applies in these circumstances 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 transfer the property or make the payment.

71. Given that a payment of money or transfer of property made in these circumstances is dealt with under section 44 of the ITAA 1936, Division 7A will not also apply.[14]

Franked dividends

72. Where a private company pays a dividend to a shareholder as described above, that dividend is frankable.[15] If the company choses to (and is able to) frank it in accordance with Part 3-6 of the ITAA 1997, the shareholder will generally, subject to certain exceptions:

[13] See paragraph (b) of the definition of dividend in subsection 6(1) of the ITAA 1936.
[14] See section 109L of the ITAA 1936.
[15] Even if the dividend is also taken to arise under relevant provisions in Division 7A, subparagraph 202-45(g)(i) of the ITAA 1997 will not apply to make the dividend unfrankable: See subsection 109RC(2) of the ITAA 1936.

- be required to include an amount equal to the franking credit on that dividend in their assessable income, and
- be entitled to a tax offset equal to the same amount.

73. One such exception is where the shareholder receiving the franked dividend is not a 'qualified person', as defined in Division 1A of the former Part IIIAA of the ITAA 1936, in relation to that dividend.[16] One way the shareholder will be so qualified, will be if they have held their shares in the private company at risk for a relevant 45 day period (or 90 days for preference shares) as described in that former Division.

Division 7A

74. Section 44 of the ITAA 1936 only applies on its face to shareholders. That is, without more, it does not apply where the recipient of the transfer of property or payment of money is an associate of a shareholder. In such cases, Division 7A needs to be considered.

75. Division 7A is broadly directed at ensuring that disguised or informal distributions of private company profits to shareholders or their associates are included in the assessable income of the shareholder or associate.[17]

109C Payments to associates can be deemed to be dividends

76. Under Division 7A (specifically, under paragraph 109C(1)(a) of the ITAA 1936), where a private company makes a payment or transfers property to an entity that is a shareholder or an associate of a shareholder of that company, the private company is taken to have paid a dividend to the shareholder or associate.

77. Under section 109ZD of the ITAA 1936, associate has the meaning given by section 318 of the ITAA 1936. Pursuant to paragraph 318(1)(a) of the ITAA 1936, a spouse[18] of a natural person is an associate of that person.

78. Under paragraph 109C(1)(b) of the ITAA 1936, Division 7A may also operate to deem a dividend where the payment or transfer of property is made to an entity that is a former shareholder or former associate of a shareholder. The paragraph operates where a reasonable person would conclude that the payment or transfer of property was made 'because' the recipient entity is a former shareholder or former associate of a shareholder. The Commissioner's view on the meaning of 'because' in context is

[16] See paragraph 207-145(1)(a) of the ITAA 1997.
[17] See for example, paragraph 1.4 of the Explanatory Memorandum to Tax Laws Amendment (2010 Measures No. 2) Bill 2010.
[18] Note that subsection 318(7) of the ITAA 1936 provides that for these purposes, a 'spouse' excludes a spouse who is living separately and apart from the person on a permanent basis. This means that matrimonial couples who are not formally divorced, but (physically) separated cease to be 'associates' of each other under this definition.

contained in Taxation Determination TD 2008/14.[19] Paragraph 1 of TD 2008/14 relevantly states:

> 1. In this context 'because' means by reason that. The reason must be a real and substantial reason for the payment, loan or debt forgiveness concerned, even if it is not the only reason or not the main reason for the transaction.

79. In the family law context, where the matrimonial parties are already divorced or separated, the very reason why the section 79 order is available to the Court is that a right to bring Family Court proceedings[20] is available by virtue of the recipient's status as a former spouse. Therefore, the 'real and substantial' reason for the payment or transfer of property (as contemplated in TD 2008/14) is the recipient's status as a former associate of a shareholder.[21] The temporal question of whether at the time a payment or transfer of property is made, the recipient is still an associate of a shareholder does not, therefore, affect the operation of Division 7A.

80. The explanation which follows only refers to associates but the reasoning is equally applicable to relevant former associates and former shareholders.

81. Subsection 109C(3) of the ITAA 1936 defines a payment to mean:

(a) a payment to the extent that it is to the entity, on behalf of the entity or for the benefit of the entity; and

(b) a credit of an amount to the extent that it is:

(i) to the entity; or

(ii) on behalf of the entity; or

(iii) for the benefit of the entity; and

(c) a transfer of property to the entity.

82. Both a payment of money and a transfer of property by a private company to an associate of a shareholder in compliance with an order of the Family Court is 'a payment to an entity', under paragraphs (a) and (c) of this definition respectively.

83. Accordingly, in either of these situations, a deemed dividend will arise under subsection 109C(1) of the ITAA 1936 unless an exclusion contained in Subdivision D of Division 7A applies.

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[19] Taxation Determination TD 2008/14 *Income tax: Division 7A of Part III of the Income Tax Assessment Act 1936 – what is the meaning of 'because' in the context of the expression 'because the entity has been such a shareholder or associate at some time' in relation to payments, loans and debt forgiveness made by a private company to the entity?*

[20] A right to bring Family Court proceedings is included in the definition of a 'matrimonial cause' in section 4 of the FLA 1975.

[21] Under the paragraph (ca) meaning of matrimonial cause in subsection 4(1) of the FLA 1975, such causes include proceedings between the parties to a marriage with respect to the property of the parties to the marriage or either of them, being proceedings:

(i) arising out of the marital relationship;

(ii) in relation to concurrent, pending or completed divorce or validity of marriage proceedings between those parties.

Certain payments discharging pecuniary obligations excepted

84. One of the exclusions in Subdivision D of Division 7A is contained in section 109J of the ITAA 1936, which provides that payments discharging certain pecuniary obligations do not give rise to a deemed dividend under section 109C of the ITAA 1936.

85. Section 109J of the ITAA 1936 reads as follows:

> A private company is not taken under section 109C to pay a dividend because of the payment of an amount, to the extent that the payment:
>
> (a) discharges an obligation of the private company to pay money to the entity; and
>
> (b) is not more than would have been required to discharge the obligation had the private company and entity been dealing with each other at arm's length.

Paragraph 109J(a): discharge of an obligation to pay money

Orders made against a matrimonial party – no relevant obligation

86. In order for section 109J of the ITAA 1936 to be satisfied, there needs to be an obligation of the private company to pay money to an entity. Where an order is made under section 79 of the FLA 1975 against a matrimonial party to **cause** a private company to pay money or transfer property to an associate of a shareholder, no binding requirement in law is imposed upon the private company to make a payment of money or transfer of property.

87. The binding requirement in law is imposed against the matrimonial party against whom the order is made.

88. Therefore, the requirement in paragraph 109J(a) of the ITAA 1936 that the payment 'discharges an obligation of the private company to pay money', cannot be satisfied.

89. Section 109J of the ITAA 1936 therefore cannot operate to prevent a deemed dividend from arising under section 109C of the ITAA 1936 in respect of the transfer of property or payment of money, where the transfer or payment has arisen as a result of an order against a matrimonial party to cause the company to make the payment or transfer the property to an associate of a shareholder.

Orders made against private company – no relevant obligation if order is to transfer property

90. Where the private company is made party to the proceedings such that the Family Court can impose orders directly on the private company, any subsequent order of the Family Court under section 79 of the FLA 1975 for a private company to pay money to an associate of a shareholder imposes a binding requirement in law for the payment to be made.[22] This type of obligation is 'an obligation of the private company to pay money to an entity' in terms of paragraph 109J(a) of the ITAA 1936. Where a private company makes a payment[23] to an associate of the shareholder in compliance with the obligation imposed by the order of the Family Court, this constitutes a 'discharge' of that obligation for the purposes of paragraph 109J(a).

91. However, where the obligation imposed on the private company is to transfer property, paragraph 109J(a) of the ITAA 1936 is not satisfied. Paragraph 109J(a) of the ITAA 1936 requires the obligation which is discharged to be for a payment of money. A discharge of an order of the Family Court to transfer property to an associate of a shareholder, does not involve the discharge of an obligation to make a payment of money. Therefore, where the order of the Family Court is to require a private company to transfer property to an associate of a shareholder, section 109J does not operate to stop a deemed dividend from arising under section 109C of the ITAA 1936.

Paragraph 109J(b): arm's length alternative hypothesis

92. Where the private company satisfies the requirements of paragraph 109J(a) of the ITAA 1936 (for example, an order has been made against the private company for it to pay money to a matrimonial party who is an associate of one of its shareholders), paragraph 109J(b) must also be satisfied for the section to prevent a deemed dividend arising under section 109C of the ITAA 1936.

93. Paragraph 109J(b) of the ITAA 1936 requires consideration of whether the payment made is more than would be required to discharge the obligation had the private company and the entity who received the payment (in this case, the shareholder's associate) been dealing at arm's length.

[22] The FLA 1975 enables the court to impose sanctions on parties to property settlements who fail to comply with orders made. The sanctions include under section 112AD of the FLA 1975:

- A bond (for up to 2 years);
- A sentence (not more than 12 months);
- A fine (not more than 60 penalty units).

[23] Note that an obligation imposed by the Family Court for the private company to make a payment of money, might nevertheless be discharged by later agreement between the parties for a transfer of property of equivalent value.

94. It is not sufficient to test what ought to be paid to discharge the relevant obligation. A test of what the relevant obligation would be, had the parties been dealing at arm's length, is also required. So much is evident from the Explanatory Memorandum to Taxation Laws Amendment Bill (No. 3) 1998, which inserted section 109J of the ITAA 1936, which relevantly states at paragraph 9.49:

> An amount paid to discharge a pecuniary obligation owed by a private company to a shareholder or associate will not be treated as a dividend to the extent that the payment is **not more than the amount the pecuniary obligation would have been if the private company and shareholder or associate had been dealing with each other at arm's length** *[new section 109J]*. This section ensures that such commercial dealings are not unfairly taxed and that, for example, disguised distributions are **not made by inflating the amount of a debt** owed to a shareholder or associate by a private company. (emphasis added)

95. In *Di Lorenzo Ceramics Pty Ltd & Anor v. FCT,*[24] this was confirmed as the proper construction to be placed on section 109J of the ITAA 1936, where, after quoting this section, Lindgren J said:

> Accordingly, if Ceramics purchased property from Tile and thereby incurred an obligation to pay Tile the purchase price, and if that price was no more than the price the parties would have agreed upon if they had been dealing with each other at arm's length, s 109C would not deem the payment to be a dividend.[25]

96. That is, a consideration of what would have been the payment had the parties been dealing with each other at arm's length (as paragraph 109J(b) of the ITAA 1936 directs us to do), necessarily involves an enquiry as to what would have been the obligation agreed between such parties.

97. The meaning of dealing at arm's length is well settled. In *The Trustee for the Estate of the late AW Furse No 5 Will Trust v. Federal Commissioner of Taxation*[26] (*Furse*), Hill J, in relation to the expression 'not dealing with each other at arm's length' for the purposes of subsection 102AG(3) of the ITAA 1936, said:

> What is required in determining whether parties dealt with each other in respect of a particular dealing at arm's length is an assessment whether in respect of that dealing they dealt with each other as arm's length parties would normally do, so that the outcome of their dealing is a matter of real bargaining.[27]

[24] [2007] FCA 1006; (2007) 67 ATR 42; (2007) 2007 ATC 4662.
[25] At FCA 27; ATR 47; ATC 4666;
[26] (1990) 21 ATR 1123; 91 ATC 4007.
[27] (1990) 21 ATR 1123 at 1132; 91 ATC 4007 at 4015.

98. Later in *Granby Pty Ltd v. Federal Commissioner of* Taxation (*Granby*),[28] Lee J explained:

> The expression 'dealing with each other at arm's length' involves an analysis of the manner in which the parties to a transaction conducted themselves in forming that transaction.[29] (emphasis added)

99. His Honour went on to explain that in the context of the former paragraph 160ZH(9)(c) of the ITAA 1936, the phrase 'at arm's length' means 'at least, that the parties to a transaction have acted severally and independently in forming their bargain'.[30]

100. More recently, the Full Federal Court in *Axa Asia Pacific Holdings*[31] reinforced the meaning of 'dealing' in context as one necessitating bargaining between the parties. At paragraph 105, Edmonds J and Gordon J explain:

> The reference in *Furse* 21 ATR 1123 to 'real bargaining' is significant. It focusses on actual dealing between the parties: see also *Re Hains (deceased)*; *Barnsdall v. Federal Commissioner of Taxation* (1988) 81 ALR 173. That is not surprising. It is the same mental process as that described by Griffith CJ in *Spencer v The Commonwealth* (1907) 5 CLR 418 at 423.[32]

101. Even later authority has again confirmed that to be an arm's length dealing, the conduct of the parties to the dealing must be consistent with conduct of independent third parties acting in their own interest.[33] Of course, it is the nature of the dealing itself, and not the relationship per se, that is critical.

102. In the present context, the authorities have established that the testing in paragraph 109J(b) of the ITAA 1936 requires measuring what has actually occurred against an alternative hypothesis in which the parties are dealing at arm's length.[34] That is, what pecuniary obligation would have arisen had the matrimonial parties and the private company been dealing with each other at arm's length.

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[28] (1995) 30 ATR 400; 95 ATC 4240.
[29] (1995) 30 ATR 400 at 403: 95 ATC 4240 at 4243.
[30] (1995) 30 ATR 400 at 403; 95 ATC 4240 at 4243.
[31] 2010 ATC 20-224; 81 ATR 180
[32] See *Barnsdall v. FC of T* 88 ATC 4565 per Davies J at 4568. Note also *Furse*, per Hill J at ATC 4014-4015.
[33] See for example Collier J in *Allen & Anor (As trustees for Allen's Asphalt Staff Superannuation Fund) v. FC of T* [2010] FCA 1276 at [89] to [90], whose decision other than as to penalties was upheld on appeal: See *Allen & Anor (As trustees for Allen's Asphalt Staff Superannuation Fund) v. FC of T* [2011] FCAFC 118.
[34] Refer paragraph 95 of this Ruling.

103. A similar approach was taken in *Industry Research & Development Board v. Bridgestone Australia Ltd*[35] Tamberlin, Sackville and Selway JJ said, in the context of section 39C of the *Industry Research and Development Act 1986*, that what is required is a:

> … a comparison between the actual contract and terms between the parties and the range of hypothetical transactions and contracts that might be entered into between parties dealing at arm's length [36]

104. In an earlier case of the same name,[37] Branson J said that in this context, the necessary hypothesis is what would be:

> …the result of negotiations between persons dealing with each other in circumstances which may rarely exist outside of economic theory, namely circumstances in which the result of their negotiations will be dictated purely by commercial or market considerations and not by their relationship one to the other or by appreciable disparities of power between them.[38]

105. How then do these principles apply in the context of orders made by the Family Court under section 79 of the FLA?

106. The Family Court must always exercise its own discretion on whether to make an order, and, if so what orders to make. This is so even if orders are sought by consent.[39] Section 79 orders cannot be said to be the outcome of a bargain that is struck between the matrimonial parties. Such orders, or even what transpires in comparable Family Law proceedings, do not therefore involve a dealing in the relevant sense between the private company and the associate of the shareholder.

107. The present context therefore requires an abstract hypothetical concerning what would have been settled between the parties if 'dictated purely by commercial or market considerations'.

108. The question then necessarily becomes what would a private company be obliged to pay (if anything) to a non-shareholder, outside the family law setting?

Arm's length obligation to pay associate?

109. As a practical matter, the consideration of what a private company might be obliged to pay an associate if acting at arm's length must proceed on the basis the private company would act in accordance with law, whether that be in terms of its own governing constituent documents or the *Corporations Act.*

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[35] [2004] FCAFC 56.
[36] At [39].
[37] [2001] FCA 954;
[38] At [10].
[39] *Harris v. Caladine* (1991) 172 CLR 84 at 96, 103-104, 124, 133.

110. In a commercial setting, the private company may be incapable of appropriating profits directly to a non-shareholder. Such an appropriation may be in breach of sections 181[40] or 182[41] of the *Corporations Act* and/or in breach of the director's fiduciary duty not to misuse company funds.[42]

111. In a commercial setting, for a private company to make a payment to a non-shareholder, the payment would ordinarily need to be in consideration for something of value provided in return by the non-shareholder.

112. Even if the private company is empowered to make gratuitous payments to non-shareholders,[43] this does not answer the question of what arm's length amount the company would be obliged to pay. The essence of a gratuitous payment is a voluntary appropriation of cash or property to a donee, that is, a gift. A gift involves no imposition of any obligation on the donor nor any discharge of an obligation in the making of the gift.[44]

113. In view of the foregoing, the 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. Therefore, any payment made in compliance with an order of the Family Court under section 79 of the FLA 1975 necessarily exceeds what would be paid in an arm's length dealing. Accordingly, section 109J will not apply to prevent such a payment from being treated as a deemed dividend under section 109C of the ITAA 1936.

[40] Section 181 of the *Corporations Act* establishes a statutory duty to act in good faith and for proper purposes.
[41] Section 182 of the *Corporations Act* expressly prohibits officers or employees of a company from improperly using their position to gain an advantage for any other person or cause a detriment to the company.
[42] The fiduciary duty is found in a different context in *Paul A Davies (Aust) Pty Ltd v. Davies* (1983) 1 ACLC 1091.
[43] A private company may be empowered to confer a financial benefit on a related party if full disclosure is given and approval is obtained from shareholders in the manner prescribed in Chapter 2E of the *Corporations Act*.
[44] *Federal Commissioner of Taxation v. McPhail* (1968) 117 CLR 111 at 116; *Leary v. Federal Commissioner of Taxation* (1980) 11 ATR 145 at 147; 80 ATC 4438.

114. Concluding that arm's length parties would not enter into a relevant transaction at all (so that transaction necessarily exceeds what would have occurred between arm's-length parties) is not novel. In *Allen & Anor (as trustees for Allen's Asphalt Staff Superannuation Fund) v. FC of T*[45], which concerned the former paragraph 273(7)(b) of the ITAA 1936 Collier J held:

> Had the parties been at arm's length, there is no evidence before me to support a finding that the arrangement would have occurred at all and that the Super Fund would have derived the income it received. It follows that the amount of relevant income received by the Super Fund was greater than might have been expected to have been received if the parties had been dealing with each other at arm's length.[46]

115. Moreover, reaching this conclusion in the context of section 109J of the ITAA 1936 accords with the apparent policy intent. The Explanatory Memorandum to Taxation Laws Amendment (2007 Measures No. 3) Bill 2007 which inserted section 109RC of the ITAA 1936[47] makes it clear payments made in compliance with relevant family orders are intended to be assessable as dividends. This Explanatory Memorandum relevantly states:

> 1.44 Under the current law, transfers of property and other 'payments' in respect of marriage or relationship breakdown are caught by Division 7A even though they may be non-voluntary (e.g. by court order). As such a deemed dividend may arise.
>
> 1.45 The amendment provides that deemed dividends arising from 'payments' in respect of marriage or relationship breakdowns, may be frankable by the company ...
>
> …
>
> 1.99 While these payments could be completely removed from being caught by Division 7A this would arguably be providing a tax benefit to these taxpayers which is not the intention of these provisions.

Franked deemed dividends

116. Where a private company is taken, via Division 7A, to pay a dividend to an associate of shareholder as described above, that deemed dividend is likewise frankable by virtue of section 109RC of the ITAA 1936

117. Specifically, section 109RC of the ITAA 1936 enables dividends taken to be paid by relevant private companies under section 109C because of family law obligations to be franked. The section reads as follows:

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[45] [2010] FCA 1276.

[46] At [99]. The decision of Collier J was upheld, other than as to penalties, on appeal: See *Allen & Anor (As trustees for Allen's Asphalt Staff Superannuation Fund) v. FC of T* [2011] FCAFC 118.

[47] Section 109RC of the ITAA 1936 provides that a deemed dividend that is taken to be paid because of a family law obligation may be franked. See further at paragraphs 116 and 117 of this Ruling.

> **109RC(1) [Application]** This section applies if a dividend is taken to be paid under this Division because of a family law obligation.
>
> **109RC(2) [Dividend not made unfrankable]** Subparagraph 202-45(g)(i) of the *Income Tax Assessment Act 1997* does not make the amount of the dividend unfrankable.
>
> **109RC(3) [Conditions for franking]** The dividend can be franked in accordance with Part 3-6 of the *Income Tax Assessment Act 1997* only if:
>
> **(a)** the dividend is franked at the private company's benchmark franking percentage for the franking period in which the dividend is taken to be paid; or
>
> **(b)** if the private company does not have a benchmark franking percentage for the period - the dividend is franked at a franking percentage of 100%.
>
> **109RC(4) [Recipient]** For the purposes of subsection (3), if the recipient of the dividend is not a member of the private company for the purposes of Part 3-6 of the *Income Tax Assessment Act 1997*, treat that recipient as such a member.

118. It is a question of fact whether a private company has sufficient franking credits to frank a deemed dividend in the manner contemplated by section 109RC. Further, it is also a question of fact whether the directors of the private company resolve to frank the deemed dividend, noting that there is no compulsion under section 109RC for directors to make such a resolution.

119. As discussed in paragraphs 72 and 73 of this Ruling, an entity receiving a franked dividend will, under Division 207 of the ITAA 1997, generally (though subject to certain exceptions):

- be required to include an amount equal to the franking credit on that dividend in their assessable income, and
- be entitled to a tax offset equal to the same amount.

120. One such exception is where the entity receiving the franked dividend is not a 'qualified person', as defined in Division 1A of the former Part IIIAA of the ITAA 1936, in relation to that dividend.[48] One way the entity will be so qualified, will be if they have held their shares in the private company at risk for a relevant 45 day period (or 90 days for preference shares) as described in that former Division.

121. Subsection 109RC(4) has the effect that an associate of a shareholder is treated as a shareholder for relevant purposes. However, a question arises as to how an associate of a shareholder (that is treated for certain purposes as if they were 'a' shareholder) is able to satisfy the 'qualified person' test when they are not actually a holder of the relevant shares.

122. For subsection 109RC(4) of the ITAA 1936 to be given meaningful effect, the reference to 'member' needs to be one which is imputed with such characteristics as to enable the 'qualified person' rules in Division 1A of former Part IIIAA of the ITAA 1936 to be considered.

[48] See paragraph 207-145(1)(a) of the ITAA 1997.

123. The characteristics which might most rationally be imputed to a notional shareholding are those relating to the shareholding of the actual member with whom the recipient is associated.

124. This approach is consistent with and gives effect to the intended effect of section 109RC of the ITAA 1936.

125. The Explanatory Memorandum to Taxation Laws Amendment (2007 Measures No.3) Bill 2007 which inserted section 109RC relevantly states:

> 1.45 The amendment provides that deemed dividends arising from 'payments' in respect of marriage or relationship breakdown, may be frankable by the private company taken to pay the deemed dividend. The dividend may be franked irrespective of whether it was made to a shareholder or associate of the shareholder (eg, an ex-spouse). ***[Schedule 1, items 13 and 28, section 109RC of the ITAA 1936 and subparagraph 202-45(g)(i) of the ITAA 1997]***

126. Subsection 109RC(4) of the ITAA 1936 is intended to provide the necessary deeming such that the dividend taken to be paid by a private company to an associate of a shareholder, may nevertheless be franked.

127. It is to be observed that subsection 109RC(4) of the ITAA 1936, is effectively otiose were the provision construed such that the private company may frank the deemed dividend but the associate may not claim the benefit of the associated franking credit as a tax offset. Accordingly, such construction is not to be preferred.[49]

128. As the High Court stated in *Project Blue Sky v. ABA*[50] at paragraph 71:

> …. a Court construing a statutory provision must strive to give meaning to every word of the provision. In *Commonwealth v Baume* Griffith CJ cited *R v. Berchet* to support the proposition that it was 'a known rule in the interpretation of Statutes that such a sense is to be made upon the whole as that no clause, sentence, or word shall prove superfluous, void or insignificant, if by another construction they may all be made useful and pertinent.' (footnotes excluded).

129. Absent any other obvious means to give subsection 109RC(4) of the ITAA 1936 an operation, the Commissioner considers it open to read the reference to 'a member' in subsection 109RC(4) as a reference to the member of whom the recipient of the deemed dividend is an associate. This imputes the characteristics of the actual shareholding of that member (of whom the recipient is an associate) to the notional shareholding of the associate.

130. Taking this approach, the testing contained in paragraph 207-145(1)(a) of the ITAA 1997 might be appropriately applied to the recipient's notional shareholding such that in relevant cases, the franking credit may be claimed by the associate as a tax offset.

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[49] See Pearce, DC and Geddes, RS, 2006, Statutory interpretation in Australian, 6th edn, Butterworths, Australia at 2.22 and 2.33.
[50] [1998] HCA 28; 194 CLR 355; 153 ALR 490, 72 ALJR 841.

131. Such an approach gives both a sensible and pragmatic operation to subsection 109RC(4) of the ITAA 1936 and accords with the statutory object evident from the clear words of the Explanatory Memorandum.

Subdivision 126-A rollover

132. Just as in ordinary circumstances where an in specie distribution to a shareholder might give rise to an incidence of taxation to the private company under the CGT regime and also an incidence of taxation to the shareholder under section 44 of the ITAA 1936, so too may a dividend arise upon a transfer of property in compliance with a section 79 order (under section 44, whether or not via Division 7A) and CGT consequences separately arise in respect of that transferred property.

133. Broadly, where the transfer of property from a private company to a matrimonial party in compliance with a section 79 order would otherwise have CGT consequences for the private company, Subdivision 126-A of the ITAA 1997 generally defers those consequences until such time as that matrimonial party disposes (or otherwise deals) with that property (and instead visits those consequences on that party). It does this primarily by:

- disregarding the capital gain or capital loss made by the private company upon the transfer,[51] and
- treating the matrimonial party as having the same cost base (or reduced cost base) as the private company at the transfer time (or – where the asset was acquired by the company prior to 20 September 1985 – treating the asset as having been acquired by the matrimonial party prior to that time).[52]

134. In addition to these consequences, the cost base (and reduced cost base) of the shareholder's interests in that company may also be altered under Subdivision 126-A of the ITAA 1997. Specifically, if property is transferred in compliance with a section 79 order by a private company to a shareholder, the cost base of that shareholder's shares in the private company may be both:

- reduced under subsection 126-15(3) of the ITAA 1997 (broadly by the fall in market value of those shares caused by the property transfer), and
- increased under subsection 126-15(4) of the ITAA 1997 (broadly by the dividend assessed to the shareholder).

135. If instead the property is transferred in compliance with such an order to an associate of the shareholder, the cost base of the shareholder's shares in the company may only be reduced, under

[51] See subsections 126-15(1) and 126-5(4) of the ITAA 1997.
[52] See subsections 126-15(1), 126-5(5) and 126-5(6) of the ITAA 1997.

subsection 126-15(3) of the ITAA 1997 (broadly by the fall in market value of those shares caused by the property transfer).

136. It should also be noted that Subdivision 126-A of the ITAA 1997 does not apply, and therefore the consequences described in paragraphs 133 to 135 of this Ruling do not arise, if the transfer of property is not 'because of' the section 79 order (that is, if the transfer of property is not in compliance with that order). For example, if the section 79 order requires that money be paid, and the parties separately agree to satisfy that obligation by the transfer of property, the transfer of property is not 'because of' the order in the strict sense, and Subdivision 126-A does not apply. Instead, the company will be assessed on any capital gain that arises upon that transfer.

Appendix 2 – Alternative views

This Appendix sets out alternative views and explains why they are not supported by the Commissioner. It does not form part of the binding public ruling.

Payments to associates: commercial transaction not required for Division 7A exception to apply

137. An alternative view exists that section 109J of the ITAA 1936 does not require a comparison between the payment made pursuant to the order under section 79 of the FLA 1975 and a commercial transaction.

138. This view focuses on the fact that the obligation and the amount required to discharge the obligation are determined, ultimately, by a court of law, sitting in judgement of a dispute between two parties. The proponents of this view argue that the relationship between the parties and the nature of their dealings (that is, whether or not they deal with each other at arm's length) is irrelevant to the amount of the court order, such that it cannot be said that the amount the company is obliged to pay is more or less than it would have been had the parties been dealing at arm's length.

139. But this overlooks the fact that it is only because the parties are not at arm's length, specifically because of their association with the matrimonial dispute, that the order is made against the private company in the first place.

140. Proponents of this view then argue that the amount the private company is required to pay is not more than what an arm's length party would be required to pay to satisfy such a court order. This however glosses over the technical construction of paragraph 109J(b) of the ITAA 1936 which requires a testing of what obligation would have arisen had the parties been 'dealing with each other at arm's length'.[53]

141. The Commissioner is of the view this requires a comparison between what has actually occurred and what would occur if the parties were dealing with each other in a genuine commercial setting, a context drawn in with the use of the term 'at arm's length', and not just an assumption that because the obligation was imposed by a court of law as a third party arbiter, the obligation and the amount required to satisfy the obligation are at arm's length.

142. Whilst the Family Court may impose an obligation and in turn, determine the amounts required to satisfy the obligation, the private company and matrimonial parties are not of themselves engaged in a 'dealing' such that it can be said the obligation arises from the striking of a bargain.

143. Moreover, the alternative view disregards the available construction of section 109J of the ITAA 1936 which best aligns with the apparent policy of the provision.

[53] For the reasons explained in paragraphs 92 to 104 of this Ruling.

144. The Commissioner therefore disagrees with the alternative view for these reasons.

Payments to associates: equivalent commercial transaction can be found in a family law context

145. An alternative view also exists that the hypothesis required for paragraph 109J(b) of the ITAA 1936 to operate might be found not in a commercial setting but in an alternative mechanism used by the matrimonial parties and the private company to settle the division of matrimonial property for family law purposes.

146. In this regard, Part VIIIA of the FLA 1975 enables matrimonial parties to enter into an agreement concerning the division of property on breakdown of a marriage, amongst other things. Such agreements are termed 'financial agreements'.

147. Where certain formalities are satisfied, financial agreements are binding not only on the parties but also the Courts and are termed 'binding financial agreements'.

148. Amongst other provisions, subsection 90C(1) in Part VIIIA of the FLA 1975 was amended by the Family Law Amendment (De Facto Financial Matters and Other Measures) Bill 2008 to enable third parties to be covered by financial agreements. The Explanatory Memorandum to that Bill relevantly states:

> 281. A binding financial agreement enables persons intending to marry and married couples to provide in writing for how property will be distributed between them on marriage breakdown, and can be made to give effect to a property settlement on separation or divorce.
>
> 282. The amendments in Part 1 of Schedule 3 clarify that:
>
> - binding financial agreements between spouses can include another person (a third party) as a party to the agreement, and
> - a binding financial agreement can make provision on other matters beyond those incidental or ancillary to property settlement or maintenance issues between the spouses.
>
> 283. Financial agreements can be made in contemplation of a marriage, during a marriage, or after a divorce order is made.
>
> 284. The amendments address issues that occasionally arise when the financial affairs of married couples are intermingled with other family members, including where family assets are held within a corporate or tax structure.

149. It is argued the alternative hypothesis required for paragraph 109J(b) of the ITAA 1936 to operate might be found in what might reasonably be expected to be settled as a 'financial agreement'.

150. Financial agreements are contractual.[54] It follows the necessary *indicia* of contract must be present, namely: offer, acceptance, consideration, intention to create legal relations, etcetera. The settling of such a contract thus requires a bargain to be struck between the parties and therefore, it is said, a 'dealing' in the context required by paragraph 109J(b) of the ITAA 1936.

151. It is further argued that in the same sense that a potential litigant may be best served in achieving an out of court settlement, it is in the commercial best interests of the private company to also seek to settle what might otherwise be a larger exposure under a section 79 of the FLA 1975 order by participating in a financial agreement. Similarly, it is argued it is in the commercial best interests of the private company to minimise legal costs by avoiding formal court proceedings. That is, the private company will bargain on commercial arm's length terms to achieve the best possible outcome for the private company.

152. It is thus concluded under this alternative view that the necessary ingredients for the alternative hypothesis required under paragraph 109J(b) of the ITAA 1936 are present, that is:

- an obligation is imposed in contract on the private company pursuant to the financial agreement;
- the obligation is for the payment of money; and
- the obligation would be bargained for on arm's length terms.

No arm's length dealing

153. The issue which arises here is whether, or to what degree, the assumed facts should be stripped away to construct a valid alternative hypothesis.

154. But for the special relationship between the parties and the family law context, the private company would not be expected to gratuitously convey property or make a payment of money to a non-shareholder.[55]

155. In the settling of a binding financial agreement, the promises made by a private company are undertaken as part of the broader considerations of the matrimonial parties in terms of settling the division of the matrimonial estate.

156. In agreeing to convey property or make a payment of money to a non-shareholder, the private company is conforming with these broader considerations of the matrimonial parties. To put it another way, the private company is submitting its will or promoting the interests of one or both of the matrimonial parties over itself.

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[54] See section 90KA of the FLA 1975 and *Australian Securities and Investments Commission v. Rich* (2003) 181 FLR 181; [2003] FLC 93-171 at FLR 197-198 and 203-204; FLC 746-778 and 751-752.

[55] For the reasons set out at paragraphs 109 to 115 of this Ruling.

157. The authorities are clear that such dealings are not at arm's length.

158. As Justice Lee said in *Granby*:[56]

> That is not to say, however, that parties … will be dealing with each other at arm's length in a transaction in which … one of the parties submits the exercise of its will to the dictation of the other, perhaps, to promote the interests of the other.

159. For these reasons, both the special relationship and family law context must be stripped away in casting the alternative hypothesis required by paragraph 109J(b) of the ITAA 1936. That is, what might be settled as a binding financial agreement cannot be employed as the alternative hypothesis for the purposes of testing an order under section 79 of the FLA.

160. Moreover, the alternative view disregards the available construction which best aligns with the apparent policy intent of the provision.

161. The Commissioner therefore disagrees with this alternative view for these reasons.

[56] At ATC 4244; ATR 404.

Appendix 3 – Detailed contents list

162. The following is a detailed contents list for this Ruling:

	Paragraph
What this Ruling is about	**1**
Ruling	**4**
Money or property to be paid or transferred to a shareholder	4
Money or property to be transferred to an associate of a shareholder	5
Dividends frankable	7
CGT Rollover applies	9
Examples	**11**
Money paid or property transferred to a shareholder	11
Example 1: Section 79 orders to pay money to a shareholder	11
Example 2: Section 79 orders to transfer property to a shareholder	13
Example 3: Section 79 orders against a matrimonial party to cause a private company to pay money to a shareholder	17
Example 4: Section 79 orders against a matrimonial party to cause a private company to transfer property to a shareholder	20
Money paid or property transferred to an associate of a shareholder	23
Example 5: Section 79 orders for a private company to pay money to an associate of a shareholder	23
Example 6: Section 79 orders for a private company to transfer property to an associate of a shareholder, deemed dividend franked	27
Example 7: Section 79 orders against a matrimonial party to cause a private company to pay money to an associate of a shareholder	32
Example 8: Section 79 orders against a matrimonial party to cause a private company to transfer property to an associate of a shareholder	36
Date of effect	**40**
Appendix 1 – Explanation	**43**
Summary and context	43
Family Law Context	47
Income tax laws and matrimonial property proceedings	55
Section 44 of the ITAA 1936	55
The meaning of distribution	58

Paid out profits 59
A dividend for tax purposes 61
Section 79 orders to pay money or transfer property (or cause money to be paid or property transferred) to a shareholder 62
Distribution out of profits 62
To a shareholder 66
Conclusion 68
Franked dividends 72
Division 7A 74
109C Payments to associates can be deemed to be dividends 76
Certain payments discharging pecuniary obligations excepted 84
Paragraph 109J(a): discharge of an obligation to pay money 86
Orders made against a matrimonial party – no relevant obligation 86
Orders made against private company – no relevant obligation if order is to transfer property 90
Paragraph 109J(b): arm's length alternative hypothesis 92
Arm's length obligation to pay associate? 109
Franked deemed dividends 116
Subdivision 126-A rollover 132
Appendix 2 – Alternative views **137**
Payments to associates: commercial transaction not required for Division 7A exception to apply 137
Payments to associates: equivalent commercial transaction can be found in a family law context 145
No arm's length dealing 153
Appendix 3 – Detailed contents list **162**

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Previous draft:

TR 2013/D6

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Subject references:

- court orders
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- dividends
- family law
- franked dividends
- private company distributions
- profits

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- ITAA 1936 109C(3)(c)
- ITAA 1936 109J
- ITAA 1936 109J(a)
- ITAA 1936 109J(b)
- ITAA 1936 109L
- ITAA 1936 109RC
- ITAA 1936 109RC(1)
- ITAA 1936 109RC(2)
- ITAA 1936 109RC(3)
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