White Paper - Nº 8

The hidden cost of breaking up: matrimonial settlements and tax

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Love is blind. It can also be expensive. Most people enter a new relationship with all flags flying - giving little thought to what will happen if the relationship doesn't work out. Yet when a relationship fails, the division of assets can cause some nasty headaches.

Dividing relationship property is never a black and white matter. This applies whether you adopt a legal perspective or simply consider the tax implications.

Tax, on top of everything else?

That's right. The division of assets pursuant to a Relationship Property Agreement (RPA) or a court order can cause tax issues. In this white paper, we look at some of the tax implications in relation to the division of assets as a result of a relationship coming to an end for any reason, be it dissolution, separation, or the death of one of the partners. By 'relationship', we mean a marriage, a de-facto partnership, or a civil union; and the spouses or partners we will simply call 'partners'.

The three-year rule

The relevant legislation is the Property (Relationships) Act 1976. The Act sets out a framework that applies to the assets of married couples, de-facto couples, and civil union partners. It applies to any relationships that have lasted more than three years. In cases where a de facto relationship has lasted less than three years, no order for division of relationship property under the Act can be made, unless there is a child of the relationship (whether adopted or biological) or one partner has made a significant contribution to the relationship.

What is relationship property?

The assets of the relationship are covered by the Act in cases where the relationship ends by separation, dissolution, or the death of one partner. As a general rule, the responsibility of either partner for the breakup of a relationship is unrelated to how the assets will be divided. (The Courts can take this into consideration in certain circumstances, however.)

The Act is based on the principle of the equality of the partners, from which the presumption of an equal division of relationship assets arises. The Act places an equal weighting on financial and non-financial contributions to the relationship by the partners. A fundamental principle of the Act is the assumption that both partners have contributed equally to the relationship, whether financially or by other means, such as looking after children and managing the household. The Act specifically states that there is no presumption that contribution of a monetary nature is of greater value than a contribution of a non-monetary nature. The Act may also take into account the economic disparity of both partners after the termination of the relationship, but only if this has occurred because of the effects of the division of functions within the relationship.

In case of the death of one of the partners, the rules are slightly different. The Act does not automatically apply. The surviving partner must make a decision within six months of the date after administration of the Estate is granted whether the relationship property is to be divided under the Act or whether to accept whatever provision the deceased has made for them in his or her Will. If the surviving partner does not make the choice within the six-month period, he or she is deemed to have chosen to benefit under the Will. If a valid claim is made under the Act, it will override the terms of the deceased's Will.

Taxation can play an important part in relationship proceedings, as there are special rules that often defer any tax liabilities that would otherwise arise on the transfer of assets between parties. However, that is only the start of the matter! While accountants, lawyers, and barristers are broadly aware of these provisions, many fail to make due allowance for the inherited tax obligations that fall on to the Transferee under such agreements.

Different types of property

There are four types of property that need to be considered:

- Relationship property,
- Separate property,
- Trust property, and
- Disputed property.

1 Relationship property includes some or all of the following:

- The family home, even if it was acquired by one partner before the relationship began, by inheritance, or via a trust;
- Chattels, such as furniture, cars, and boats;
- Property acquired in contemplation of a relationship or during a relationship;
- Any income that came in during the relationship;
- The proportion of the value of life insurance and superannuation entitlement that is attributable to the relationship;
- Property owned jointly, or acquired by either partner during the relationship;
- Any increase in value of or the proceeds from disposal of relationship property;
- Any separate property that is mixed with the relationship property to such an extent that it is unreasonable or impracticable to regard it as separate property or if a relationship property was used to acquire separate property;
- Debts (which are divided into personal and relationship debts). Personal debts are the responsibility of the person who incurred them, and relationship debts are the joint responsibility of the partners;
- Any increase in the value of separate property or income or gains from separate property if this is attributable to the application of relationship property or to the actions of the other spouse.

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2 Separate Property

- Separate property is property that is not relationship property. The starting point is that separate property remains the property of the partner who owned it before the relationship and will continue to be separate property if it is kept separate. As a general rule, a property acquired by a partner before the relationship will remain separate property unless it is mixed with relationship property, becomes relationship property, or becomes the family home.
- There are a number of ways by which separate property can become relationship property. There are rules about this, and their application depends on the individual circumstances of the parties. In order to achieve a great degree of certainty about what constitutes separate property, one can enter into a property-sharing agreement with the other party. These are also known as 'contracting-out agreements' or, more popularly, pre-nuptial agreements ('pre-nups'). We will deal with them in detail later in this paper.
- The family home, even if it is legally owned by one partner, not jointly owned, will never keep its status as separate property once the three-year threshold has been passed. As soon as the relationship is more than three years old, the Act must apply. The same applies to family chattels, which are considered to be relationship property unless they can be classed as heirlooms.
- Inherited property and gifts are separate property unless actions are taken that re-characterise them as mixed property.

3 Trust Property

- Family trusts are commonly used in New Zealand to protect assets. Property owned by a family trust is generally considered to be relationship property and therefore subject to the Act. However, the sale of Trust property and its distribution by agreement can not only cause tax issues but may also put the separate property status of the property at risk.
- Trusts cannot be used pre-emptively. If a partner in the relationship decides during the course of the relationship to transfer relationship property to a Trust, in order to prevent the other partner from making a claim under the Act, the Court will order compensation to be paid to the other partner, either in cash or by adjusting the relationship property.
- Recent case law has confirmed that some trusts, where settlors have significant powers to control the trust, have been invalidated. Where a settlor has significant powers to control the trust property, the Court has held that it is no different than if the settlor held the assets directly. In situations where settlors and trustees have significant powers to control the Trust property, it is therefore advisable to diversify the powers of control.

4 Disputed Property

- If one partner claims an item of property is separate and the other claims it is relationship property (or at least some part of it is relationship property), then it falls into the category of disputed property.

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The tax implications of breaking up

1 Relationship Property

Special rules in the Income Tax 2007 (ITA) cover transfers of relationship property. The fundamental principle of asset transfer provisions is that any income tax that would have ordinarily applied when assets inside the tax net are sold does not arise on settlement pursuant to the relationship property agreement or a court order.

Here are some examples in which the asset transfer rules in the Income Tax Act would apply:

- Commercial or rental property
- Land
- Shares and options
- Personal property
- Trading stock
- Business
- Pensions

Any income tax liability that would have otherwise arisen is deferred until such time the property is disposed of by the recipient (known as the Transferee) of the relationship property.

In effect, the Transferee steps into the shoes of the Transferor from the start.

This means that the Transferee is treated as having acquired the property at the original date and at the original cost (or the tax-adjusted value, which is cost less depreciation). This is particularly helpful for the purposes of the 10-year rule, in cases where the transferred property is land (or an interest in land) that is subject to income tax. No income or gain is derived from the transfer of relationship property between the Transferor and the Transferee pursuant to relationship property agreement or court order.

This is good news for the person transferring the property, as the Transferor does not derive income or gain from the transfer. The Transferor therefore has no potential income tax liability. The situation of the Transferee is slightly more unfortunate, as the Transfereemay be liable to pay income tax should the Transferee sell the property at a later date.

Asset transfers pursuant to a relationship property agreement or a court order can have an impact on shareholder continuity, depreciation, financial arrangements, and trading stock. The tax implications of these are described below:

Shareholder Continuity

Shares in a family business or any other company that are held by one partner or both partners in their personal capacity are considered to be relationship property. More often than not, shares in a family business are transferred between the Transferor and the Transferee as part of the settlement. Under normal circumstances the ITA requires that 66% shareholder continuity be maintained for the purposes of imputation credits and 49% be maintained for the purposes of loss continuity provisions from when a credit or loss arose until they are utilised. In case of family business, it is often the case that the husband and wife each own 50% of the shares or some percentage thereof.

If 66% continuity is not maintained, the company will lose its imputation credits. This will have adverse tax consequences at the time the dividends are subsequently distributed. In effect, these dividends will be double taxed. Where a company has losses carried forward, these will be lost if the shareholder continuity of 49% is not maintained from the start of the year in which the loss arose until the end of the year in which it is offset or utilised. In the absence of the asset transfer provisions in the ITA, the transfer of shares could result in the loss of shareholder continuity.

The asset transfer rules operate in a way that the transfer of shares from Transferor to Transferee as a result of relationship property settlement is ignored. No loss of continuity arises. The shares in the company are deemed to be owned from the original date by the Transferee.

If however the Transferee decides to sell the shares at later date, the respective transfer will not be protected by the asset transfer provisions and the disposal of shares may result in loss of shareholder continuity.

Depreciation Recovered

Any depreciation recovered that has been derived from the disposal of property in respect of which depreciation has been claimed is generally subject to income tax. When property is transferred pursuant to a relationship property agreement or a court order, the Transferor does not derive depreciation recovered. The depreciation recovery is ignored for the purposes of the relationship property transfer. Should the Transferee decide to dispose of this property at later date, the Transferee will have depreciation recovered, if the proceeds exceed the value at which the asset was transferred. Moreover, the real problem here is that the Transferee will also inherit the liability for depreciation recovered up to the period that the asset is transferred to them. Often this financial liability is not considered when the value of assets is reconciled upon a financial separation between the parties.

Financial Arrangements

Financial arrangements are essentially debt instruments and things similar to them. For taxation purposes they are taxed under a separate code. There is no longer any capital gain on such instruments. Instead, a simple matching of consideration given and received forms the underlying basis of the calculation of income and expenditure for taxation purposes.

Transfer of financial arrangements, in general, is subject to taxation under the accrual rules. Depending on the classification of Transferor and the Transferee, and the nature of the financial arrangement transferred, the Transferor may have to perform a base price adjustment. This is in effect a wash up calculation whereby the overall income or expense under a financial arrangement is worked out, and reconciled with the amounts returned or claimed in past years to give a final wash up income or expense figure. The result of this may either be taxable or deductible for the Transferor.

The asset transfer rules operate in the way that they specifically exclude the application of accrual rules to transfers of financial arrangements between Transferor and Transferee pursuant to the relationship property agreement or court order. Again, the Transferee inherits any difference between what the Transferor has returned or claimed for taxation purposes, and what they should have, even if it's only with the benefit of hindsight.

Trading Stock

Income derived from the disposal of trading stock is generally subject to taxation. The asset transfer rules do not ignore the transfer of trading stock, but they provide some relief when assets are transferred pursuant to relationship property agreement or a court order. The value at which the trading stock is transferred largely depends on whether the trading stock was acquired during the income year in which the trading stock is transferred or not.

In cases where the trading stock that is used in the business by the Transferor is transferred upon the settlement of relationship property in the year in which the trading stock was acquired by the Transferor, the transfer will be at cost to the Transferor. Therefore the Transferor will not have any resulting income tax liability. The Transferee will assume the original cost to Transferor.

In cases where the trading stock used in the business by the Transferor is transferred upon the settlement of relationship property and the trading stock was on hand at the start of the income year, the value at which the trading stock (other than specified livestock) is transferred is the greater of the closing value of the trading stock:

- For the Transferor at the end of the income year before the transfer, or
- For the Transferee at the end of the year of transfer

The difference in value of the trading stock may result to income of the Transferor. The Transferee is deemed to acquire the trading stock at the value specified above.

Trading stock transferred pursuant to relationship property settlement that is not used in the businesses of the Transferor is transferred to the Transferee at the original cost to the Transferor. Therefore there is no tax consequence to the Transferor. The Transferee is deemed to have acquired the trading stock at the original cost.

Personal Property

Income derived from the business of dealing in personal property, or personal property acquired with the intention of resale is taxable. The asset transfer provisions operate so that the income tax consequences that would otherwise arise are deferred when property is transferred pursuant to relationship agreement or settlement, until such time the personal property is disposed of by the Transferee. Once again the Transferee needs to take care that while they are deemed to take over the property at cost to the Transferor, they are not also taking over a taxation liability where the property has increased in value since its acquisition.

2 Separate Property

Separate property, if kept separate, remains separate. Therefore it is not transferred pursuant to relationship property agreement or a court order. As a result separate property generally does not create any income tax issues. The courts may make an order in certain circumstances for compensation to be made out of the separate property. In such cases the transfer will be treated as a transfer of relationship property with no tax consequences arising at the time of transfer.

Disposal or transfer of separate property is not a transfer pursuant to a relationship property agreement; therefore general taxation principles would apply. In simple terms, the disposal or transfer of separate property may be subject to income tax under the general principles. This will also apply where separate property is sold or transferred to for instance a trust.

3 Trust Property

Whilst some assets owned by a family trust, such as the family home and the family chattels, are always relationship property, others are not. The reason is that the trust itself is not a party to a relationship property agreement. For the relationship (matrimonial) property rules to apply, the assets would have to be owned by one or both of the partners. Assets that are subject to the relationship property rules are assets in which one or both partners have legal or equitable interest. In most cases the partners would be stipulated as one of the discretionary beneficiaries in the Trust Deed. The beneficiaries do not have legal or equitable right in the property until such time the Trustees of the Trust exercise their powers in the beneficiary's favour.

When assets other than the family home and chattels are owned by a trust, they may still have to be divided when the relationship breaks up, either by agreement or by court order. In reality these assets will either be sold by the trust and the cash distributed or the assets will be transferred from the trust to the Transferee, who will then transfer the assets into his or her new respective Trust and gift away the debt back to them.

These asset transfers can cause headaches from the tax perspective. For the purposes of the ITA, the asset transfer provisions do not extend to property owned by trusts, other than the family home and family chattels. Transfer of other trust property (even if it is transferred pursuant to agreement or court order) is treated as a disposition at market value and subject to ordinary tax provisions. This can have adverse implications in relation to

- Depreciation recovered
- Loss of shareholding continuity
- Financial arrangements

The following is a good illustration of the implications

- A Family Trust owns a couple of rental properties, in respect of which depreciation has been claimed. The trustees of the Old Trust are a husband and wife who have separated. They have agreed that the rental properties are to be divided between them equally. As a result, the Old Trust will be resettled on to new separate trusts set up by the husband and wife respectively. The rental properties will be transferred from the Old Trust to the New Trusts at market value. This will result in depreciation recovered, which will be taxable to the Old Trust. There may also be rules that limit the new trusts' cost base for depreciation purposes to the cost of the Old Trust, not the higher market value at which assets were transferred.

New Zealand no longer has Gift Duty, so gifting will not result in an additional tax impost. However, the gifting of assets into a new trust can have adverse consequences on any benefits payable by WINZ and on the rest home subsidies. Partners who think that they will need to rely on these at some point should carefully consider whether gifting is appropriate.

The Goods & Service Tax Act 1985 (GST Act)

There is no protection or roll-over relief awarded by GST Act in relation to settlements of matrimonial property. Therefore property transferred pursuant to relationship property settlement that is in the tax net (i.e. any asset that is used for purposes of taxable activity) will be subject to GST.

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Contracting-out agreements or 'pre-nups'

The partners in a new relationship sometimes enter into a contracting-out agreement, popularly known as a 'pre-nup'. Pre-nups are not just for film stars and other celebrities. A contracting-out agreement is a good starting point for protecting separate property, irrespective of whether it was acquired before or during the relationship. The agreement can be entered into at any time, whether before, during, or at the end of the relationship. However, it should be made as early as possible, as the legal entitlements of both partners under the Act will change once the relationship has lasted for three years. In a nutshell, these agreements permit the partners to deal with property differently than is prescribed by the Act. Such agreements stipulate how all the parties' property will be owned and dealt with in the event that the relationship comes to an end.

There are certain very stringent requirements that must be met before a contracting-out agreement is valid and enforceable. For instance, such agreements must be in writing, and be signed by both parties. The parties' signatures must be witnessed by a lawyer who must also certify that, before the person signed the agreement, they had explained the effect and implications of the agreement to that person. Each party must also have had the benefit of independent legal advice before they signed. An important point is that there must have been full disclosure of both parties' assets and financial matters prior to signing the agreement, otherwise the party cannot have independent legal advice and the lawyer cannot certify the agreement.

One caveat. Pre-nups are not bulletproof. A court can set aside a contracting-out agreement if it is satisfied that enforcing it would cause serious injustice.

Conclusion

The division of relationship assets is never straightforward when a relationship comes to an end. Your tax adviser can help you put the necessary structures in place at the start or during the relationship that will prevent or minimise your potential tax exposure in the event that the relationship ends.

If the end is nigh, worrying about the potential tax consequences that may arise just adds additional strain when you are already feeling vulnerable. A consultation with a good accountant or tax adviser will make all the difference. They will help you plan how to structure the division of relationship property in order to prevent or mitigate your tax exposure.

Don't carry the burden on your own. We are here to help. Just give us a call, and we will be happy to talk through the implications of your particular situation with you.

Nigel Smith

About Covisory

The Covisory Group specialise in International and Domestic Tax Services, Trust Management, Succession Planning, Strategic and Business Planning, Accounting Services and Business Valuations.

Established in 2007, The Covisory Group has grown from one business to four with a diversity of clients. Covisory clients are owners of family businesses, operating both in New Zealand and globally. Our team of specialists work either one-on-one or alongside our clients' team of professional advisers to develop appropriate short- and long-term solutions.

We build strong relationships with our clients based around trust, accessibility, and responsiveness. There is no 'one size fits all' about our services. Our solutions are bespoke to each client, drawing on our up-to-date specialist knowledge and our years of experience. providing one-on-one expert advice.

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