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Family breakdown & TBC issues

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This document is a general guide only and should not be relied on as advice. Further, we provide no advice to the parties or the person ordering unless we are requested to do so in writing. This document based on the law as at 27 January 2020. As superannuation, family law and taxation laws are subject to regular change and substantial penalties can be imposed for any contravention, expert advice should be obtained if the enclosed information is not acted upon shortly after the above date or if there is any doubt. Unless specifically instructed by you in writing, and subject to you entering into an ongoing client agreement and payment of our required yearly fee, there is no obligation whatsoever upon DBA Lawyers to notify you in respect of any changes to the law, ATO policies, etc, and how any such changes might impact upon the enclosed documentation. Except to the extent required by law, we disclaim all and any liability arising in any manner that does not relate to the documentation prepared on our specific instructions. As a law firm we are not licensed to provide financial product advice under the *Corporations Act 2001* (Cth). Copyright in this document belongs to DBA Lawyers Pty Ltd and any unauthorised use without our prior written consent may be prosecuted.

1. SMSFs and super splitting overview

1.1 Guide for advising on splitting superannuation

Superannuation is considered 'property' for the purposes of the *Family Law Act 1975* (Cth) ('FLA'), and accordingly, it can generally be split in a similar way as the parties' other assets following a relationship breakdown (see s 90XS of the FLA).

The superannuation splitting laws extend to de facto relationships including heterosexual and same sex relationships. In Western Australia, however, superannuation for de facto couples is treated as a financial resource and not as a separate splittable asset. The position in Western Australia is proposed to change once the Family Law Amendment (WA De Facto Superannuation Splitting and Bankruptcy) Bill 2019 is passed as law.

This memo provides an overview of some of the key points to consider when undertaking a super split in a self managed superannuation fund ('SMSF'). This memo provides a general guide only and is no replacement for expert advice given the complexity of the superannuation, taxation, family law and other factors that relate to an effective super split.

Indeed, expert advice by both parties is recommended to ensure the optimal outcome for each party is achieved. In particular, each party should obtain their own advice from their own family lawyer.

The focus should be on the most effective outcome after taking into account the costs, tax, commercial and overall family position. Indeed, a great deal of stress and suffering can be avoided if the parties work amicably together in achieving an effective split. Moreover, there are many benefits for a graceful split with dignity given the children to the relationship are also likely to suffer from any bickering or drawn out legal action.

DBA Lawyers provides assistance in relation to SMSF law and provides a range of services and advice to SMSF trustees and members including those needing assistance in relation to splitting their SMSF in the context of a relationship breakdown.

To be concise, we have used abbreviations throughout and for your convenience, a table of abbreviations is set out in the Annexure.

1.2 What is a Splitting Order?

A superannuation split may occur under a splitting order or a superannuation agreement, which is part of a financial agreement ('FA'). We discuss FAs and superannuation agreements under heading 10.

Unless the lawyers or advisers involved with negotiating the split have superannuation and taxation expertise in relation to SMSFs, there is the prospect for the splitting orders to be inconsistent with the legal and technical requirements. At times splitting orders need supplementary documentation and steps to achieve their desired outcome.

For your convenience, we refer to the term 'Splitting Order' below to include a split under a court order (whether a contested order or consent orders arrived at by the parties to a court action) and also to a split in accordance with a FA.

Where an SMSF trustee receives a Splitting Order certain obligations under Part 7A of the *Superannuation Industry (Supervision) Regulations 1994* (Cth) ('SISR') apply. Importantly, an SMSF trustee must comply with the *Superannuation Industry (Supervision) Act 1993* (Cth) ('SISA') and SISR following a separation as prescribed compliance requirements need to be completed.

1.3 Member and non-member spouse

This document refers to a 'member spouse' ('MS') and 'non-member spouse' ('NMS') in explaining the splitting rules. This terminology is from s 90XD of the FLA and is used throughout this document so we discuss it below.

MS = the spouse who is the member of the fund and whose superannuation interest is being split is referred to as the 'member spouse'. We also at times refer to the MS as the 'remaining member', as they typically remain in an SMSF after a payment split is finalised with the departing member being the one who exits the fund (the NMS).

NMS = the spouse who is obtaining the benefit of that split is referred to as the 'non-member spouse' in respect of that interest. The NMS is also at times referred to as the 'departing member' as they typically exit an SMSF after a payment split is finalised, with the remaining member (the MS) continuing their membership in that SMSF.

Accordingly, in a typical two member SMSF with a former couple, each is a NMS in respect of the other's interest in the fund, in addition to their status as an individual member of that fund. That is, the NMS will typically have their own interest as well as the split interest to transfer or rollover. In contrast, in a single member SMSF, there is a MS and typically a NMS in relation to that MS's interest.

2. Splitting Orders

2.1 'Splittable' interests

Where a Splitting Order is made in relation to an SMSF member, the SMSF trustee is bound to apply the terms of the Splitting Order whenever a splittable payment becomes payable.

Generally, most superannuation interests are splittable, provided they are over $5,000 in value (refer reg 11 of the *Family Law (Superannuation) Regulations 2001* ('FLSR')). Certain payments are not splittable payments, such as payments on compassionate grounds and disability payments in the first two years of payments (refer reg 12 of the *Family Law (Superannuation) Regulations 2001* ('FLSR')). Unless stated otherwise, this document will only refer to splittable superannuation interests.

The FLA defines a 'splittable payment' to include the following:

- a payment to a spouse;
- a payment to another person; or
- a payment to the legal personal representative ('LPR') of the spouse, after the death of the spouse.

Splittable payments typically occur on retirement, rollover or death. When one of these events occur and the trustee has an obligation under the SMSF deed to make a payment, that is a splittable

payment. The Splitting Order provides an additional obligation on the SMSF trustee to split the payment between the MS and the NMS under the terms of the Splitting Order.

The net amount of a Splitting Order can be determined by either the 'base amount order' or a 'percentage order' method.

2.2 Base amount order

A base amount Splitting Order can specify a specified amount or formula for determining the amount payable to the NMS.

Interest up to the time of the payment split is also ascertained and reflected in the amount payable at that time. The interest is based on a rate that is 2.5% above the percentage change in the original estimate of full-time adult ordinary time earnings ('AOTE') for all persons in Australia, as published by the Australian Bureau of Statistics during the year ending with the February quarter immediately before the beginning of the adjustment period (ie, AOTE + 2.5%).

The rate for the financial year ending 30 June 2020 is 4.8% p.a. (see: *Family Law (Superannuation) (Interest Rate for Adjustment Period) Determination 2019* (Cth)). This adjusted amount is referred to as the 'adjusted base amount' which is calculated in accordance with reg 45D of the FLSR.

The base amount provides a specified amount or formula that may provide a basis for furthering other property negotiations between the parties.

2.3 Percentage split order

Under a 'percentage interest split' the superannuation interest is generally divided by specifying a percentage or proportion of the member's splittable interest that is to be paid to the NMS.

The percentage specified in the order is generally applied to the splittable payment at the time the payment is required to take place.

Thus, a valuation and set of financial statements or management accounts are required to divide the member balances at that time. Earnings and any capital appreciation or devaluation up to that point in time should be reflected in each members' account balances at that time. Thus the actual amount that is split is not determined until the time the payment, transfer or roll over is made.

3. SISR operating standards

Part 7A of the SISR provides a series of operating standards an SMSF trustee must observe when they receive a Splitting Order. The operating standards will apply contemporaneously with the Court Order and in most cases well before the SMSF trustee is required to make a splittable payment. Where the SMSF trustee observes the operating standards under SISR, the payment splitting obligations under the FLA will be negatived (refer Division 2.2 of the FLSR).

The parties to a Splitting Order are typically the two SMSF members who are also trustees/directors and thus are generally aware of when a Splitting Order is made.

In a two-member fund, there will be two entitlements and one of the members will be departing. So, in a two-member SMSF, we refer to the 'departing member' and the 'remaining member'

As noted above, in a two member SMSF each may be a NMS in respect of the other member's interest.

3.1 Documenting the super split

SMSF trustees and advisers often do not realise that Splitting Orders do not enliven the relevant splitting provisions in the SISR, nor do they bind the SMSF trustee. Accordingly, additional documents are required to implement a legally effective superannuation split.

DBA Lawyers' suite of Family Law SuperSplitting documentation is designed to assist and provide SMSF trustees and advisers with practical guidance in relation to the steps required by Part 7A in order to implement the split.

In particular, the following documents are included which broadly cover off Steps 1–4 above:

- Detailed covering letter which contains general guidance on implementing the documents.
- Trustee resolutions that records the receipt of the Splitting Order (refer to Step 1 above).
- Notice to the trustee by the departing member providing the contact details of the NMS.
- Payment split notices from the trustee to both the NMS and the MS that the MS's superannuation interest is subject to a payment split.
- Notice of election by the NMS to the trustee.
- Notices of transfer by the trustee to both the NMS and MS in relation to the treatment of the superannuation interest.

In addition to the above, if applicable, the relevant ATO form should be completed to prepare the rollover.

4. The proportioning rule

Broadly, the proportioning rule provides that the tax free and taxable components of a benefit are taken to be paid in the same proportion as the tax free and taxable components of the member's interest from which the benefit is paid from.

The components of the departing member's transferable benefit (being the split amount under a Splitting Order) are generally in the same proportions as the remaining member's superannuation interest.

When a departing member combines all their interests into a single interest in the same SMSF, the taxation characteristics are combined in accordance with Division 307 of the ITAA 1997 for tax purposes.

Broadly, the proportioning rule states that any benefits paid from a superannuation interest have the same relative proportions of the tax-free and taxable components as the interest from which they are paid (refer s 307-125 of the ITAA 1997).

By way of background, a MS's superannuation interest may comprise both a tax-free and taxable component. When a NMS receives a transferable benefit as a result of an interest split then the relative proportions of the tax-free and taxable components of the MS's interest are transferred to the NMS's payment. Thus, when combined the 'mixed' tax free and taxable components must be recalculated to reset the amount or proportions of the tax free and taxable components.

A sound understanding of the proportioning rule is important for planning purposes.

5. What impact do the preservation rules have?

The preservation rules form a part of the payment standards in Part 6 of the SISR. The preservation status of benefits in the superannuation environment determines whether and how the benefits can be cashed (ie, paid out of an SMSF as a benefit).

A member's benefits can be comprised of one or more of the following types:

- ***Preserved benefits:*** these include all contributions and all earnings after 30 June 1999. Broadly, these cannot be cashed until a condition of release is met.

- ***Restricted non-preserved benefits:*** these broadly include benefits from employment-related contributions (other than employer contributions) made before 1 July 1999. Naturally, this type of benefit is increasingly rare.

- ***Unrestricted non-preserved benefits:*** these are benefits that can be cashed at any time, subject to the SMSF deed. Usually, these benefits become present after a member meets a condition of release with a nil cashing restriction.

The law states that all benefits in a regulated superannuation fund will be preserved benefits, except for the amount of a member's:

- restricted non-preserved benefits; or

- unrestricted non-preserved benefits (reg 6.03 of the SISR).

You should check each member's annual member statement issued by their super fund trustee to determine the preservation status of their benefits.

The preservation components of a new interest created for a NMS in relation to a payment split broadly works as follows:

- a proportion must be taken from the unrestricted non-preserved benefits, the restricted non-preserved benefits and the preserved benefits of the MS; and

- the proportion taken from each category of benefits must be the same as the category bears to the MS's interest immediately before the new interest is created.

Broadly, the preservation rules ensure that any new NMS interest has the same relative proportions of the MS's superannuation interest. Thus, if the MS had say 70% preserved and 30% unrestricted

non-preserved benefits, the NMS will receive the new interest in these proportions; there is no cherry picking available.

6. Transfer balance account issues

The $1.6 million transfer balance cap ('TBC') imposes a limit on the total amount that a member can transfer into an exempt (retirement phase) pension.

Usage of a member's personal TBC is tracked through their transfer balance account ('TBA').

Impact of a splitting order on a member's TBA

Where the remaining member of an SMSF, say Robert (the MS), is in retirement phase and his pension, that is valued at $600,000, is subject to a splitting order in favour of Mary and his SMSF transfers $300,000 to Mary's SMSF to comply with his Splitting Order, his TBA records must be adjusted by recognising the $300,000 commutation. Otherwise, his TBA will be overstated.

The question then arises as there are several key debits that can be obtained, as outlined immediately below.

Transfer balance debits

The following items count as a debit to an individual's TBA:

- A partial or full commutation of a retirement phase pension. Note that when a commutation occurs, the debit value is generally equal to the amount commuted (ie, the value of the amount transferred out of retirement phase). Note that ordinary pension payments and any decrease in the value of assets supporting a pension do not count as debits. This debit is available under item 1 of s 294-80(1) of the ITAA 1997 for typical commutations of a pension.

- There is also a specific debit available for certain splits under item 4 s 294-80(1) of the ITAA 1997 which states:

  > a *transfer balance debit arises under section 294-90 because of a payment split

  Many people when considering where to obtain a debit, mistakenly consider that item 4 is the relevant provision. However, item 4 typically only applies to certain unfunded public sector superannuation funds that continue to pay both the MS and the NMS from the same pension interest (eg, typically a defined benefit lifetime pension that may be payable say 50% to the MS and 50% to the NMS). However, where a pension is commuted and a TBA debit is needed for a payment splits involving an SMSF member, they obtain a debit under the usual commutation of a pension process under item 1 as discussed above.

This is confirmed by the ATO in LCR 2016/9 at [60A]:

> 60A. *If the payment split is achieved by the member spouse fully or partially commuting a superannuation income stream that is in the retirement phase to pay the non-member spouse a lump sum amount, a debit will arise in the member spouse's transfer balance account.48 If the non-member spouse chooses to use that lump sum amount to start a superannuation income stream, a transfer balance credit arises in their transfer balance account.49 These transfer balance credits and debits will be reported to the Commissioner by superannuation income stream providers.*

Note, that the ATO's reference to 'payment split' in paragraph 60A is not correctly correct as the payment split only applies where there is a splittable payment as that term is defined in the FLA.

7. Tax consequences

Broadly, where a new NMS interest is created in an SMSF, or the NMS's entitlement is transferred or rolled-over to another fund, no immediate income tax liabilities will arise.

For example, if say a NMS obtains a splitting order awarding $250,000 of the MS's interest in an SMSF, that $250,000 is not taxable at that stage to the member.

We do examine the tax impact to the SMSF below as tax may be incurred by an SMSF trustee in realising or in transferring or rolling over assets to another SMSF, refer to heading 8 on CGT Planning. The payment split where a new interest is created in the NMS is similar to a roll-over to another SMSF where no tax will be payable.

However, when a NMS withdraws a benefit in the future, they will be subject to the normal tax regime applicable to superannuation benefits. Importantly, the NMS's benefits will be taxed independently from the taxation of the MS's benefits. Where the member is over 60 years and has satisfied a relevant condition of release, a benefit paid from an SMSF is generally tax free.

Where a lump sum is paid, the NMS will be treated as the member of the fund. Accordingly, the NMS will be subject to normal taxation treatment, irrespective of how the MS would have been taxed had the benefits been paid to them. This can have significant implications, for example, where the MS has attained 60 years but the NMS is under 60 years of age. The NMS in this instance could be liable for tax; whereas the MS may have been able to withdraw the money and pay the NMS who could then contribute that amount to a super fund if they chose to do so.

Again, this is another example, where the parties cooperating together may achieve a better outcome.

8. CGT planning

8.1 Potential CGT relief

A splitting order could give rise to significant CGT liabilities where an SMSF is required to transfer or roll over assets to another SMSF to satisfy a payment split. At times, the SMSF may simply have to sell or realise assets to pay out a NMS's interest.

8.2 In kind rollovers and CGT relief

CGT rollover relief may be available where there is transfer of an asset in kind (ie, 'in-specie'), eg, the transfer of a real estate property from one SMSF trustee to another under s 126-140 of the ITAA 1997.

However, rollover relief is not automatic; nor is it at the election of the trustee. There are some subtle differences in the requirements to obtain rollover relief as between the split amount and rollover relief for the departing member's own entitlement.

Broadly, the requirements to obtain rollover relief for the split amount are:

- There is an interest in the first SMSF that is subject to an order (Splitting Order) for a payment split.
- As a result of that Splitting Order, the first SMSF trustee transfers or rolls over a CGT asset to another (second) SMSF for the benefit of the departing member (NMS) from the first SMSF to the second SMSF (or 'another complying superannuation fund' which is typically another SMSF).
- The transfer or roll over of the CGT asset to the second SMSF is in accordance with Part 7A of the SISR.

In simple terms, where a Splitting Order requires an SMSF trustee to transfer or roll over a CGT asset to another (second) SMSF for the benefit of the departing member (NMS), CGT relief can apply.

Appropriate advice should be sought as it may not always be worthwhile seeking CGT roll over relief as this only defers the tax on the capital gain rather than saving tax.

Therefore, it is important to factor in the potential future CGT liability when determining the value of an asset with a deferred 'unrealised' capital gain. However, if the NMS subsequently realises or disposes of the asset while in pension or retirement phase, there may not be any CGT payable in relation to that CGT asset; assuming the law does not change adversely in the future.

9. Other considerations

9.1 Flexibility when transferring assets on divorce

Broadly, an SMSF trustee of a regulated superannuation fund must not acquire assets (excluding certain assets such as money, listed securities, business real property and units in certain widely held unit trusts) from a related party of the fund (s 66(1) of the SISA). However, s 66(2B) of the SISA provides a specific exception for related party acquisitions where:

- at the time of the acquisition, the member and their spouse were separated and there is no reasonable likelihood of cohabitation being resumed;
- the acquisition occurs due to reasons directly connected to a relationship breakdown; and
- the asset represents a whole or part of the member's own interest in the fund or the member's entitlement under a payment split from their spouse or former spouse (ie, as determined by Part VIIIB of the FLA in relation to the MS or former spouse in the transferring fund).

Note that a contravention of s 66 can result in a one year jail sentence or an equivalent monetary penalty. Thus, advisers must ensure that a relevant exception is satisfied. One key factor of this rule is that the asset need only represent part of the member's entitlement.

9.2 Transferring pre-1999 unit trusts and similar assets

Broadly, the in-house asset provisions restrict SMSF trustees from investing more than 5% of a fund's assets into 'in-house assets' (see Part 8 SISA). An in-house asset is broadly defined in s 71 of the SISA to represent a loan to, or an investment in:

- a 'related party' of the fund (as broadly defined);

- an investment in a 'related trust' (as broadly defined) of the fund, or
- an asset of the fund subject to a lease or lease arrangement between a trustee of the fund and a related party of the fund.

As such, an SMSF would broadly be considered to have made an investment in an in-house asset where the fund purchased units in a related unit trust (eg, a unit trust that was controlled by a related party holding more than 50% interest, significant influence or having the ability to hire/fire the trustee).

However, there are certain exclusions to the in-house asset rules. In particular, an exclusion to the in-house asset rules applies where an SMSF acquired units in a related unit trust where the trustees of the fund acquired the units prior to 11 August 1999.

Broadly, s 71EA may provide relief in certain circumstances and may result in a transfer of an asset from one SMSF to another SMSF (as part of a relationship breakdown) retains its pre-11 August 1999 status. In particular, s 71EA (3) broadly provides that where:

- at the time of the acquisition by the new SMSF trustee, the member and their spouse were separated and there is no reasonable likelihood of cohabitation being resumed;
- the acquisition occurs due to reasons directly connected to a relationship breakdown; and
- the asset represents the whole or part of the member's own interests in the transferring fund or the member's entitlements under a payment split from their spouse or former spouse (i.e., as determined by Part VIIIB of the FLA in relation to the MS or former spouse in the transferring fund);

the asset is deemed as though the trustees of the new SMSF acquired the asset at the time that the original SMSF trustee acquired it (i.e. the exclusion from the in-house asset rules continues to apply in the new SMSF).

9.3 Contribution caps

An appropriately designed Splitting Order may provide a method to increase the overall amount that a member may able to accumulate in the superannuation environment, especially where a former spouse seeks to retain assets outside superannuation, eg, the family home and other liquid investments.

In particular, once a member exceeds more than $1.6 million in superannuation they can no longer make non-concessional contributions. For these members, obtaining more superannuation moneys from a Splitting Order is one way to boost their super!

9.4 Revise estate\succession\risk planning

Naturally, following a relationship breakdown there are a range of other documents that should be reviewed to determine whether they need to be revised including, among other things:

- The advantages and disadvantages of having a corporate trustee when a two member SMSF becomes a single member fund.
- The person's Will, powers of attorney and similar documents.

- Any death benefit nomination including any binding or non-binding death nomination relating to any SMSF or other superannuation fund including any similar document.
- Investments and bank accounts — who has authority, passwords, etc.
- Advisers who assist in relation to the SMSF may require changing.
- Any pension documents to determine whether any change is required especially regarding any reversionary nomination
- The SMSF deed may need to be updated.
- The shareholders and directors of any SMSF corporate trustee and the constitution of the company may also require updating.
- Who manages the SMSF and maintains records, etc.
- Is there any need for a flag/freezing order/caveat, etc, to protect a member's interest in the SMSF or elsewhere?
- A range of other matters that your advisers can advise on.

10. Splitting with a financial agreement

10.1 Financial agreements

We understand from family law experts that a growing number of family law disputes these days are settled by a FA. As discussed below, many couples, both married and de facto, are entering into FA to help prevent a prolonged and costly negotiation process arising at the end of a personal relationship.

There are two types of FA. The first is a "pre-nup" style of FA where the rules for splitting are set and may remain that way for some years or never be used if the relationship continues. The second type of FA is where the relationship has broken down.

One great advantage of a FA is that the parties can agree on how their assets, including their superannuation, are to be split in the event of a relationship breakdown. The inclusion of specific superannuation terms in the agreement can be drafted before, during or after the relationship breakdown.

A 'superannuation agreement' refers to the terms or part of a FA that covers the superannuation interests of a couple. That is, the terms or part of a FA that deals with superannuation interests is a 'superannuation agreement' for the purposes of Part VIIIB of the FLA. However, a superannuation agreement (which is included as part of a FA) will have no effect unless or until the spouse marries or enters into a de facto relationship even though the remainder of the FA is binding on the parties that that agreement.

The time that a de facto relationship actually begins or ends is a matter of fact to be determined on a case by case basis. A de facto relationship is generally considered to commence when a couple start 'living together on a genuine domestic basis'. However, expert advice should be obtained if there is any doubt.

10.2 Negotiating a financial agreement

Parties can specify in their FA how their superannuation interests are to be split. For instance, in accordance with a specified base amount (or formula to calculate the base amount) adjusted for growth over the years. Alternatively, parties may adopt a specified percentage value to be applied to all splittable payments made in respect of their superannuation interest.

When negotiating a split or superannuation agreement, the 'net of tax value' of the underlying assets in the SMSF should be considered. For instance, where the SMSF assets comprise shares, it is not sufficient to simply split the value of the shares on a 50/50 basis.

It is imperative that the tax liabilities arising from the assets are also contemplated. Accordingly, a prudent party will not only request that SMSF assets be independently valued, but also that a tax analysis of the assets be undertaken to ensure that the after-tax value of each asset is obtained. Significant unfairness can result where the tax liabilities associated with the splittable assets are not taken into account.

10.3 Court order versus financial agreement

If the parties to a relationship breakdown cannot agree (either via a FA or consent orders lodged with the court settling the dispute between the parties) a legal contest via the usual family court system is required.

The court system can add significant time, costs and stress with a division of property that is specified by the court which may result in both side being unsatisfied.

Moreover, the family court process will also likely order mediation to see if the parties can resolve their property and super split.

Naturally, each party should obtain their own advice from their own family lawyer.

This list is to be read subject to the disclaimer as it is not advice and is not an exhaustive list.

Annexure

Abbreviations

CGT	Capital Gains Tax
FLA	*Family Law Act 1975* (Cth)
FLSR	*Family Law (Superannuation) Regulations 2001* (Cth)
FA	Financial Agreements
ITAA 1997	*Income Tax Assessment Act 1997* (Cth)
LPR	Legal Personal Representative
MS	Member Spouse
NMS	Non-member Spouse
SMSF	Self-Managed Superannuation Fund
SISA	*Superannuation Industry (Supervision) Act 1993* (Cth)
SISR	*Superannuation Industry (Supervision) Regulations 1994* (Cth)
TBA	Transfer Balance Account
TBAR	Transfer Balance Account Reporting
TBC	Transfer Balance Cap
TRIS	Transition to retirement income stream