FORENSIC ACCOUNTING
for family law

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edition 3

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This booklet is based on our extensive personal professional knowledge and experience as specialist forensic accountants.

Since the release of our first edition of this booklet in October 2001 and our second edition in April 2004, professional standards together with the Family Law Rules 2004 have reinforced the paramount duty of the forensic accountant to the court — a duty that overrides any other duty whether acting as a single expert or a shadow expert.

We have prepared this booklet to provide solicitors, and others, involved in family law property disputes with a general understanding of forensic accounting services and the role of a forensic accountant as a single expert or shadow expert in family law matters.

In particular, we comment on the Family Law Rules 2004 and recent professional standards adopted by accounting bodies that set the standard for forensic accounting services — the basis of appointment of an expert, the work undertaken by a forensic accountant, and the structure of a forensic accountant’s expert report.

In addition, we review and comment on the role of the forensic accountant in family law matters including document discovery, investigations and the valuation of interests in businesses, companies, trusts and partnerships. We also raise other issues that a forensic accountant can assist in such as potential taxation issues arising from the settlement, maintenance agreements, dealing with loan accounts to/from shareholders and superannuation.

We wish to thank Mr Peter Szabo of Moores Legal for reviewing this booklet to ensure the accuracy and relevance of the quoted case law.

We trust this booklet is informative, interesting and assists you with your work with forensic accountants.

Russell J Munday

P Bruce Wilkinson
1 | INTRODUCTION

The Family Court and the Federal Magistrates Court have jurisdiction under Part VIII of the *Family Law Act 1975* (Cth) (“Family Law Act”) to settle property and maintenance matters between the parties to a marriage or former marriage.

On 1 March 2009, the Family Law Act was amended to make provision for the regulation of financial matters between people in de facto relationships (including same-sex couples).

Under s. 4 of the Family Law Act, the property the court considers must “arise out of the marital relationship” and includes all property owned by either spouse, with each other, or with any other person or entity.

Property that the court can deal with includes:

- property purchased during the marriage;
- property owned by the parties before the marriage;
- superannuation;
- gifts and inheritances received by either party;
- assets and goodwill that a party has built up in a business;
- compensation awards;
- lottery winnings; and
- redundancy packages.

Property that generally cannot be dealt with by the courts includes:

- future expectations under wills or trusts (except in circumstances where the facts indicate a level of certainty of inheritance or benefit);
- long service leave entitlements; and
- actions for personal injury damages (unless the other party nursed the injured spouse through their injuries).

Broadly, the courts’ approach to the alteration of the parties’ property interests includes:

- Identification and valuation of the parties’ assets, liabilities and financial resources. The valuation, generally, being at the date of hearing or date of settlement.
- Assessment of contributions (financial and non-financial) of each party towards the acquisition, conservation or improvement of any such property is determined and assets are divided in accordance with those contributions.
- Assessment as to whether or not one party needs a further adjustment of capital in their favour for their future needs or for the purposes of correcting a substantial disparity in the earning capacity or financial resources of the parties.
- An assessment is then made as to whether or not the division of assets and financial resources (as determined in the above two points) is just and equitable.
INTRODUCTION

In marriages where the matrimonial pool of assets is comprised of only real estate and personal items, there is little difficulty in determining a value. However, valuation becomes an important issue where one or both of the parties of the marriage are involved in the ownership of a business or have an entitlement to an income stream.

The role of an accountant in family law matters is governed by the Family Law Rules 2004 and is primarily to assist the court by providing independent expert opinion in relation to valuation and other financial and accounting matters.

Knowledge of the principles and practice of how businesses are valued and how the court views this in the context of family law proceedings is important.

The purpose of this booklet is to briefly:

• explain the requirements of the Family Law Rules 2004 as they pertain to accountants acting as expert witnesses;
• illustrate what is included in a single expert valuation report;
• discuss the various business valuation methods, and consider issues such as minority interest holdings, small business valuations, and the valuation of professional practices;
• explain the role of a shadow expert;
• consider the impact of taxation issues;
• identify what information is required when conducting a valuation and investigation;
• consider specific issues in respect of superannuation entitlements and loan account balances;
• outline the various approaches to investigation;
• outline other activities undertaken by forensic accountants in the context of family law matters.
2 | APPOINTMENT & ROLE OF AN EXPERT WITNESS

Accountants involved in family law proceedings must be fully aware of the requirements of the court and of the professional codes of practice and guidelines issued jointly by the Accounting Professional & Ethical Standards Board Limited (APESB) and adopted by the Institute of Chartered Accountants in Australia and CPA Australia. In particular:

- Part 15.5 of the Family Law Rules 2004
- APES 215 — Forensic Accounting Standards
- APES 225 — Valuation Services.

Part 15.5 of the Family Law Rules 2004

The purpose of Part 15.5 of the Family Law Rules 2004 is to:

- ensure that parties obtain expert evidence only in relation to a significant issue in dispute;
- restrict expert evidence to that which is necessary to resolve or determine a case;
- ensure that, if practicable and without compromising the interests of justice, expert evidence is given on an issue by a single expert witness;
- avoid unnecessary costs arising from the appointment of more than one expert witness; and
- enable a party to apply for permission to tender a report or adduce evidence from an expert witness appointed by that party, if necessary in the interests of justice.

Part 15.5 of Family Law Rules 2004 sets out the following definitions:

- **expert** means an independent person who has relevant specialised knowledge, based on the person's training, study or experience;
- **expert's report** means a report by an expert witness, including a notice under subrule 15.59(5);
- **expert witness** means an expert witness who has been instructed to give or prepare independent evidence for the purpose of a case;
- **single expert witness** means an expert witness who is appointed by agreement between the parties or by the court to give evidence or prepare a report on an issue.
APPOINTMENT & ROLE OF AN EXPERT WITNESS

Appointment of a single expert witness

If the parties agree that expert evidence may help to resolve a substantial issue in a case, they may agree to jointly appoint a single expert witness to prepare a report in relation to the issue. The parties do not need the court’s permission to tender a report or adduce evidence from a single expert witness.

The court may, on application or on its own initiative, order that expert evidence be given by a single expert witness. When considering whether to make an order, the court may take into account factors relevant to making the order including:

- the main purpose of the expert evidence rules and in particular Part 15.5 of the Family Law Rules 2004;
- whether expert evidence on a particular issue is necessary;
- the nature of the issue in dispute;
- whether the issue falls within a substantially established area of knowledge; and
- whether it is necessary for the court to have a range of opinions.

Orders the court may make regarding a single expert witness

The court may — in relation to the appointment of, instruction of, or conduct of a case involving a single expert witness — make an order:

- requiring the parties to confer for the purpose of agreeing on a person to be appointed as a single expert witness;
- that if the parties cannot agree on who should be the single expert witness, the parties give the court a list stating:
  — the names of people who are expert on the relevant issue and have consented to being appointed as an expert; and
  — the fee each expert will accept for preparing a report and attending court to give evidence;
- appointing a single expert witness from the list prepared by the parties or in some other way;
- determining any issue in dispute between the parties to ensure that clear instructions are given to the expert;
- that the parties;
  — confer for the purpose of preparing an agreed letter of instruction to the expert; and
  — submit a draft letter of instruction for settling by the court;
- settling the instructions to be given to the expert;
- authorising and giving instructions about any inspection, test or experiment to be carried out for the purpose of the report; or
- that a report not be released to a person or that access to the report be restricted.
**APPOINTMENT & ROLE OF AN EXPERT WITNESS**

**Single expert witness’s fees and expenses**

Unless the court orders otherwise, the parties are equally liable to pay a single expert witness’s reasonable fees and expenses incurred in preparing a report.

A single expert witness is not required to undertake any work in relation to his or her appointment until the fees and expenses are paid or secured. If there is a dispute about fees, a party or the expert witness may request the court to determine the dispute.

It is common practice for a single expert witness not to issue his or her report until full payment has been received.

**Single expert witness’s report**

A single expert witness must prepare a written report.

If the single expert witness was appointed by the parties, the expert witness must give each party a copy at the same time.

If the single expert witness was appointed by the court, the expert witness must give the report to the Registry Manager.

**Appointing another expert witness**

If a single expert witness has been appointed to prepare a report or give evidence in relation to an issue, a party must not tender a report or adduce evidence from another expert witness on the same issue without the court’s permission.

The court may allow a party to tender a report or adduce evidence from another expert witness on the same issue if it is satisfied that:

- there is a substantial body of opinion contrary to any opinion given by the single expert witness and that the contrary opinion is or may be necessary for determining the issue;
- another expert witness knows of matters, not known to the single expert witness, that may be necessary for determining the issue; or
- there is another special reason for adducing evidence from another expert witness.

**Cross-examination of single expert witness**

A party wanting to cross-examine a single expert witness at a hearing or trial must inform the expert witness, in writing at least 14 days before the date fixed for the hearing or trial, that the expert witness is required to attend.

The court may limit the nature and length of cross-examination of a single expert witness.
APPOINTMENT & ROLE OF AN EXPERT WITNESS

Instructions to an expert witness

All instructions to an expert witness must be in writing and must include:

- a request for a written report;
- advice that the report may be used in an anticipated or actual case;
- the issue about which the opinion is sought;
- a description of the matter to be investigated, any experiment to be undertaken or issue to be reported on; and
- full and frank disclosure of information and documents that will help the expert witness to perform their function.

Expert witness’s duty to the court

The duty of the expert witness is to the court, and in particular to impartially assist the court with matters that are within the expert witness’s knowledge and capability.

The expert witness’s duty to the court prevails over the obligation of the expert witness to the person instructing, or paying the fees and expenses of, the expert witness.

The expert witness has a duty to:

- give an objective and unbiased opinion that is also independent and impartial on matters that are within the expert witness’s knowledge and capability;
- conduct the expert witness’s functions in a timely manner;
- avoid acting on an instruction or request to withhold or avoid agreement when attending a conference of experts;
- consider all material facts, including those that may detract from the expert witness’s opinion;
- tell the court:
  — if a particular question or issue falls outside the expert witness’s expertise; and
  — if the expert witness believes that the report prepared by the expert witness is based on incomplete research or inaccurate or incomplete information, or is incomplete or may be inaccurate, for any reason.

Form and content of expert’s report

An expert’s report is required to be addressed to the court and the party(ies) who are instructing the expert witness. It must have attached to it a summary of the instructions given to the expert witness and a list of documents relied upon in preparing the report, and be verified by an affidavit of the expert witness.

An expert’s report must also:

- state the reasons for the expert witness’s conclusions;
- include a statement about the methodology used in the production of the report;
• include the following in support of the expert witness’s conclusions:
  — the expert witness’s qualifications;
  — the literature or other material used in making the report;
  — the relevant facts, matters and assumptions on which the opinions in the report are based;
  — a statement about the facts in the report that are within the expert witness’s knowledge;
  — details of any tests, experiments or investigations relied on by the expert witness and, if they were carried out by another person, details of that person’s qualifications and experience;
  — if there is a range of opinion on the matters dealt with in the report, a summary of the range of opinion and the basis of the expert witness’s opinion;
  — a summary of the conclusions reached;
  — if necessary, a disclosure that:
  – a particular question or issue falls outside the expert witness’s expertise;
  – the report may be incomplete or inaccurate without some qualification and the details of any qualification; or
  – the expert witness’s opinion is not a concluded opinion because further research or data is required or because of any other reason.

**Consequences of noncompliance**

If an expert witness does not comply with the Family Law Rules 2004, the court may:
• order the expert witness to attend court;
• refuse to allow the expert’s report or any answers to questions to be relied on;
• allow the report to be relied on but take the noncompliance into account when considering the weight to be given to the expert witness’s evidence; and
• take the noncompliance into account when making orders for:
  — an extension or abridgment of a time limit;
  — a stay of the case;
  — interest payable on a sum ordered to be paid; or
  — costs.

**Single expert witness’s answers**

A single expert witness must answer a question within 21 days after receiving it.

An answer to a question:
• must be in writing;
• must specifically refer to the question; and
• must answer the substance of the question or object to answering the question.
**APPOINTMENT & ROLE OF AN EXPERT WITNESS**

If the single expert witness objects to answering a question or is unable to answer a question, the single expert witness must state the reason for the objection or inability in the document containing the answers.

The single expert witness’s answers must be:
- attached to an affidavit;
- sent by the single expert witness to all parties at the same time;
- filed by the party asking the question; and
- taken to be part of the expert’s report.

The single expert witness’s reasonable fees and expenses incurred in answering any question are to be paid by the party asking the questions. A single expert witness is not required to answer any questions until the fees and expenses for answering them are paid.

**Appointment of a “shadow” expert**

Either party may choose to appoint their own shadow expert to review the report of a single expert witness and prepare questions.

The activities of a shadow expert range from reviewing the valuation, the methodology adopted and reliability of documentation relied upon, evaluating the reasonableness of any assumptions and the correctness of all arithmetic calculations.

**Conference**

Within 21 days after receipt of a single expert witness report, the parties may enter into an agreement about conferring with the expert witness for the purpose of clarifying the report. The agreement may provide for the parties, or for one or more of them, to confer with the expert witness.

The parties must agree on arrangements for the conference and are free to make any arrangements for the conference that are consistent with the purpose of clarifying a report prepared by a single expert. For example, arrangements for a conference might include the attendance of another expert, or the provision of a supplementary report.

Before participating in the conference, the expert witness must be advised of arrangements for the conference.

In seeking to clarify the report of the expert witness, the parties must not interrogate the expert witness.

If the parties do not agree about conferring with a single expert witness, the court, on application by a party, may order that a conference be held in accordance with any conditions the court determines.
Questions to single expert witness

A party seeking to clarify the report of a single expert witness may ask questions of the single expert witness within 7 days after a conference is held or if no conference is held, within 21 days after receipt of the single expert witness’s report by the party.

The questions must:
• be in writing and be put once only;
• be only for the purpose of clarifying the single expert witness’s report; and
• not be vexatious or oppressive, or require the single expert witness to undertake an unreasonable amount of work to answer.

The party raising the questions must give a copy of the questions to the other side.

Independence

An accountant acting in the role of expert witness must be independent to be a credible witness. Hence, the accountant should avoid being appointed by either party, or jointly, where they have acted for either or both parties in another capacity, e.g. as tax agent, accountant or auditor.

APES 215 paragraph 3.5 states that:
“When a Member in Public Practice is engaged to perform a Forensic Accounting Service which requires Independence or where a Member in Public Practice purports to be independent when performing a Forensic Accounting Service, the Member shall comply with Independence as defined in this Standard.”

APES 215 paragraph 2 defines “independence” as:
“Independence means:
(a) Independence of mind - the state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional scepticism; and

(b) Independence in appearance - the avoidance of facts and circumstances that are so significant a reasonable and informed third party, having knowledge of all relevant information, including any safeguards applied, would reasonably conclude a Firm’s, or a member’s, integrity, objectivity or professional scepticism had been compromised.”
APPOINTMENT & ROLE OF AN EXPERT WITNESS

Professional standards

APES 215 paragraph 5.4 states that:

“A Member who is acting as an Expert Witness shall comply with the following:

(a) the paramount duty to the Court which overrides any duty to the Client or Employer;
(b) a duty to assist the Court on matters relevant to the Member’s area of expertise in an objective and unbiased manner;
(c) a duty not to be an advocate for a party;
(d) a duty to make it clear to the Court when a particular question or issue falls outside the Member’s expertise.”

Remuneration

APES 215 paragraph 8.2 states that:

“A Member in Public Practice shall not enter into a Contingent Fee arrangement or receive a Contingent Fee for:

(a) an Expert Witness Service; or
(b) a Forensic Accounting Service, other than an Expert Witness Service, that requires Independence or where the Member purports to be independent.”
Under Chapter 13 of the Family Law Rules 2004, all parties have a general duty of disclosure and are required to make full and frank disclosure of the party’s financial circumstances.

Typical information required to value a business includes:

- brief history of the business, including details of its legal structure
- historical financial statements for last 3 to 5 years
- income tax returns of the business and parties for last 3 years
- management reports (if available)
- budgets (if available)
- Business Activity Statements and working papers (current year)
- business plan (if available)
- details of investments (as shown on balance sheet)
- details of properties (as shown on balance sheet)
- depreciation schedule for plant and equipment
- aged debtors and creditors listing at balance date or year to date
- staffing details: role, hours, wages
- details of lease on business premises
- key events in business’s history
- details of major competition
- summary of major customers during last 3 years
- details of main products/services sold
- any other information considered relevant.

Typically, the forensic accountant has a checklist of information required.

If the accounts of the business appear unreliable (compared to industry statistical information, etc.) then further examination of source records may be required including:

- general ledger (usually a MYOB or Quicken system in small businesses)
- bank statements
- sales journals
- cash payments/cash receipts journal
- purchases journal
- stock records
- wages records
- general journal
- register rolls
- recent finance applications
- owner’s credit card statements.

It is best if the forensic accountant is given the opportunity to visit the business and interview the owner.
A good starting point for a forensic accountant when asked to investigate the financial affairs of a party in a family law matter is the Form 17 Financial Statement, as required by each party to a financial case (rule 13.04 of the Family Law Rules 2004).

The Form 17 sets out the party’s income, expenses, assets, liabilities, superannuation details, interests in trusts or deceased estates.

The forensic accountant’s objective then is to ensure there is no understatement of assets or income from what is included in the Form 17. Occasionally there is a motivation for the spouse to hide assets, resources from this Form 17 (although it is illegal to do so).

Other records to review include:

- The spouses’ income tax returns for the last 3 years. These should include dividends/trust distributions from the investments listed in the Form 17 and expenses such as interest on liabilities.
- A search of the Australian Securities & Investments Commission’s database for details of the companies that the spouse has been involved as a public officer and/or shareholder (historic and current).
- Titles Office search of properties owned by the spouse and by the companies in which the spouse has an interest.
- Recent finance applications — while there may be an incentive to understate assets and income in the Form 17, the opposite usually applies to applications for finance.

Indicators that a person has more assets than declared can be determined from a review of their lifestyle and from financial analysis.

Lifestyle indicators may show that the spouse’s reported income cannot support their current lifestyle. It involves identifying expenditures (on items such as designer clothes, jewellery, entertainment, art collections, expensive house and furnishings, luxury cars, expensive vacations, etc.) and comparing to current reported income.

A financial profile can be developed on the spouse to illustrate that reported earnings from a business are being understated and therefore the actual value of that business is higher than reported by the spouse and it is generating greater income than disclosed. Of course, this has implications with income tax authorities.

An “asset betterment” analysis can identify that the family has accumulated wealth with non-reported income.
INVESTIGATIONS FOR UNDISCLOSED ASSETS / INCOME

This analysis involves:

- identifying the assets and liabilities of the parties at a point in time (say start of the marriage). It is important to consider assets at the cost rather than market value and therefore exclude any appreciation or depreciation in value);
- identifying income sources (including salary, business profit, investment income, inheritances, gifts, insurance proceeds and asset sales);
- identifying expenditures (on interest, credit card payments, travel, clothing, food, heat, light and power, children’s education, insurances, entertainment, jewellery, art, furniture, etc.);
- identifying significant asset purchases, sales, investments and borrowings during this period;
- estimating what the income/expenses should derive;
- comparing with known assets and liabilities.

Example

James owns a small business which reportedly shows him earning $70,000 per annum. He is married to Jane and has 2 young children. Jane does not work.

An estimate of the family’s worth at the start of the marriage is:

<table>
<thead>
<tr>
<th>Assets</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash on Hand</td>
<td>2,000</td>
</tr>
<tr>
<td>Cash at Bank</td>
<td>12,000</td>
</tr>
<tr>
<td>Share Investment</td>
<td>15,000</td>
</tr>
<tr>
<td>House</td>
<td>240,000</td>
</tr>
<tr>
<td>Motor Vehicle</td>
<td>25,000</td>
</tr>
<tr>
<td>Business</td>
<td>200,000</td>
</tr>
<tr>
<td></td>
<td><strong>$494,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Home Mortgage</td>
<td>140,000</td>
</tr>
<tr>
<td>Business Loan</td>
<td>85,000</td>
</tr>
<tr>
<td>Motor Vehicle Lease</td>
<td>15,000</td>
</tr>
<tr>
<td></td>
<td><strong>$240,000</strong></td>
</tr>
</tbody>
</table>

Net Worth $254,000

Three years later, the home mortgage had been reduced to $100,000 and the business loan reduced to $55,000. The motor vehicle lease was $5,000. Sharebroker records indicate that the cost of share investments were now $45,000 and the parties had $25,000 in the bank.

During the period it is estimated that James had spent $30,000 on art.

Based on the above it is apparent that the net worth of the family had increased.
### Example (continued)

<table>
<thead>
<tr>
<th>Assets</th>
<th>Start</th>
<th>End</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash on Hand</td>
<td>2,000</td>
<td>2,000</td>
</tr>
<tr>
<td>Cash at Bank</td>
<td>12,000</td>
<td>25,000</td>
</tr>
<tr>
<td>Share Investment</td>
<td>15,000</td>
<td>45,000</td>
</tr>
<tr>
<td>House</td>
<td>240,000</td>
<td>240,000</td>
</tr>
<tr>
<td>Motor Vehicle</td>
<td>25,000</td>
<td>25,000</td>
</tr>
<tr>
<td>Art</td>
<td>–</td>
<td>30,000</td>
</tr>
<tr>
<td>Business</td>
<td>200,000</td>
<td>200,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$494,000</strong></td>
<td><strong>$567,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>Start</th>
<th>End</th>
</tr>
</thead>
<tbody>
<tr>
<td>Home Mortgage</td>
<td>140,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Business Loan</td>
<td>85,000</td>
<td>55,000</td>
</tr>
<tr>
<td>Motor Vehicle— Lease</td>
<td>15,000</td>
<td>5,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$240,000</strong></td>
<td><strong>$160,000</strong></td>
</tr>
</tbody>
</table>

**Net Worth**

<table>
<thead>
<tr>
<th>Start</th>
<th>End</th>
</tr>
</thead>
<tbody>
<tr>
<td>$254,000</td>
<td>$407,000</td>
</tr>
</tbody>
</table>

**Estimate of the family’s annual expenses**

| Credit Card | 18,000 |
| Interest    | 20,000 |
| Living Expenses | 35,000 |
| **Total**   | **$73,000** |

**Income from Known Sources**

| Business | 70,000 |
| Interest | 700    |
| Dividends | 1,300 |
| **Total** | **$72,000** |

**Analysis**

| Movement in Net Worth | $153,000 |
| Add Expenses for 3 years | 3 x $73,000 | 219,000 |
| Total Spent/Saved | $372,000 |
| Income from Known Sources | 3 x $72,000 | 216,000 |
| Estimated Unreported Earnings | $156,000 |
| or $52,000 per annum |

The above indicates that the family received, on average, an extra $52,000 per annum from the business, or other sources, than is being declared. It may mean that the business is therefore worth much more than is being stated in the Form 17 (although a separate valuation exercise is required).
5 | VALUATION OF BUSINESSES, ENTITIES & SHARES

Basis of valuation

The Family Law Act 2004 does not specify how assets that form part of the matrimonial pool are valued. The Family Court will be influenced by case law that has established guidelines to follow in determining the appropriate value of a particular asset, given the circumstances of the case. Where there is an issue as to what is the appropriate value of an asset that forms part of the matrimonial pool, the Family Court has an obligation to hear and determine the issue.

In order for the court to make a determination as to the appropriate value, the parties have a clear obligation to make a full and frank disclosure of all relevant financial circumstances. Once the value of the assets that make up the matrimonial pool are determined, the Family Court may make such orders as it considers appropriate when altering the interests of that property among the parties.

The Family Law Act does not define the term “value”.

Given the lack of legislative guidelines, the courts have developed their own definitions. Most of these definitions evolved from interpretation of state and federal taxation statutes. The courts in both Australia and England have discussed whether valuation is a theoretical discipline or whether it is merely guesswork. For instance, in Myer v. Commission of Taxes [1937] VLR 106, the Victorian Supreme Court determined that the process of valuation is essentially an art which involves an element of guesswork. In Gold Coast Selection Trust v. Humphrey [1948] AC 459, the court stated that valuation is an art, not a science.

The concept of “market value” which was developed by the High Court, has become a widely accepted definition of “value”.

In Spencer v. Commonwealth [1907] 5 CLR 418, Griffith CJ stated the definition of value as:

‘In my judgement the test of value of land is to be determined not by inquiring what price a man desiring to sell could actually have obtained for it on a given day, that is, whether there was in fact on that day a willing buyer, but by inquiring: “What would a man desiring to buy the land have had to pay for it on that day to a vendor willing to sell it for a fair price but not anxious to sell?”...to ascertain what, according to the then current opinion of land values, a purchaser would have had to offer for the land to induce such a willing vendor to sell it, or, in other words, to inquire at what point a desirous purchaser and not a unwilling vendor would come together.’

1 In the Marriage of Shaw (1989) 12 Fam LR 806
2 In the Marriage of Lenahan (1987) 11 Fam LR 615
3 Orilio v. Orilio (1985) 10 Fam LR 642
4 S.79 Family Law Act 1975 (Cth)
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This definition, by implication, involves the notion of the hypothetical willing but not anxious purchaser and the willing but not anxious vendor. This concept has been further developed as:

“the price that would be negotiated in an open and unrestricted market between a knowledgeable, willing but not anxious buyer and a knowledgeable, willing but not anxious seller at arm’s length.”

Application of “market value” by the Family Court

The Family Court has utilised the definition of “market value” in certain circumstances.

In the Marriage of Dunbar (1987) 11 Fam LR 901, the Full Court accepted the test as established in Spencer’s case and interpreted it as the following:

“The object of any valuation exercise is to establish what a willing but not anxious purchaser would be prepared to pay and a willing but not anxious seller would be prepared to accept.”

However, the Family Court has held that such tests of valuation can only be applied where there is a ready and available market. Shares in listed public companies are an example of where the market value can be determined by reference to the latest prices for that particular share as quoted by the stock exchange. Real property could also be easily valued according to its market value. Personal items such as artwork and jewellery, may also be readily valued by reference to the market value.

There are particular assets and circumstances where a “special value” or “value to the owner” is utilised instead of “market value”.

Adamson makes the following observations in relation to the definition of “value”:

‘The word “value” cannot be defined in a decisive sense which will meet all purposes. Although property must at any given time have the same value for the same purpose, it is evident that it could have differing values on the same day according to the reason for which it is necessary to establish a value. Market value established by actual sales does not necessarily represent the value to a holder who does not wish to sell; neither is the value to a holder necessarily coincident with the value to a prospective purchaser. Then we speak of intrinsic value, market value, holding value, fair value, tangible assets value, value as a going concern, and realisation value.’

This statement recognises the differing concepts of value: that of market value and value to the owner. It is this distinction which becomes crucial in many family law property cases where assets that belong to the parties of the marriage may not necessarily be of significant value to the hypothetical purchaser but will be of significant value in the hands

6 Adamson, MS, The Valuation of Company Shares and Businesses The Law Book Company Ltd, Sydney, 1986, p. 10
of the owner of that asset. In these circumstances the Family Court may exercise its discretion under s. 79 of the Family Law Act and value the asset according to some other basis, which in the circumstances would be more appropriate. A “special” or “intrinsic” value may be used which reflects the worth of that particular asset to the party or parties to the proceedings.

The “market value” may not be an appropriate method for valuing shares in a private family company.

In the Marriage of Hull (1983) 9 Fam LR 241, the particular assets to be valued were shares in a private family company. The wife held almost the entire equity capital of the company. The wife’s mother held a small parcel of shares which pursuant to the Articles of Association enabled her to exercise the entire voting rights in the company. The court held that it would be inappropriate in these circumstances to use the tests laid down in Spencer v. Commonwealth (1907) 5 CLR 418, that is, the application of a market value to the wife’s shares would in these circumstances result in a unrealistically low amount. This would be due to the fact that although the wife held a vast majority of the equity in the company, she could not exercise any control over the affairs of the company as her mother controlled all the voting shares in the company. In these circumstances the wife’s parcel of shares would not be an attractive investment to a hypothetical purchaser, thus reducing their commercial value. Nygh J stated the following in respect to this proposition:

“It cannot be said in all seriousness that Mrs Hull’s interest in the company is valueless. The test laid down in Spencer’s case can only be applied where there is a ready and available market. It is of no application in a case such as this where such a market is lacking.”

In the Marriage of Reynolds (1984) 10 Fam LR 388, the Full Court said:

“We are doubtful, however, whether valuation methods which have been developed for commercial purposes are entirely appropriate for the purposes of family law. The present commercial value of shares in a proprietary company may not reflect their value to the spouse who either has control after divorce or who stands ultimately to benefit from them or control them after the death of generous parents, as appears to be the case here.”

In AJW v. JMW (2002) FLC 93-103, Warnick J held:

“There could be no doubt that the objective of valuations should be to assess the value of shares to the husband (owner) ... where there were “special benefits” or not, though if there were special benefits, they must be valued in achieving the objective. However, the use of the term “value to the owner” in Family Law property cases, should not be dependent on the existence of special benefits, but rather, be descriptive of the objective of the valuation exercise.

“Where there is a market for the shares, evidence of market value may well be the same as “value to the owner” ... But where there is no market, it is something of a “non-sequitur” to seek to ascertain market value.
‘But the mischoice of “fair market value” as the objective of the valuation may lead the valuer to adopt a methodology which may not wholly suit a circumstance where there is no market. So, for example, there may be impetus to deduct realisation costs, as if shares were going to be sold, when in fact, because there is no market, they are not, and cannot be sold.’

However, there appears to be a practical application to the distinction between “market value” and “value to owner”. In Dalziel & Weinstein (2008) Fam CA 777, Coleman J stated:

‘To the extent that there is a distinction between market value and value to the owner, the Court would understand the distinction in practical terms to relate more to minority interests in an entity than to a case such as this. Where there is a minority interest which the evidence does not suggest is likely to be realised, or sought to be realised, there is arguably a degree of uncertainty in discounting simply because the interest is a minority interest. In those circumstances, the “value to the owner” is arguably the value of the interest in the market place.’

Discount rates have been applied by the Family Court when determining the value of shares in a family company. In Sapir v. Sapir (No. 2) (1989) 13 Fam LR 362 and In the Marriage of Turnbull (1990) 15 Fam LR 81, the simple discount rate was applied whereas in Georgeson v. Georgeson (1995) FLC 92-618 a discounted cash flow was approved.

An area where the “value to owner” approach may be inappropriately applied relates to the determination of the value of a business which has significant personal goodwill of the spouse attached to it, rather than alienable commercial goodwill.

In Wall and Wall (Unreported No. EA 83/99) Fam CA 257, the Full Court held that the trial judge had erred in treating the personal goodwill of the parties as commercial goodwill. Once the personal goodwill was excluded the shares had little value. The Full Court explained that the personal goodwill was an element of the husband’s earning capacity which represented a significant factor to be taken into account in determining spousal maintenance (s. 75(2) of the Family Law Act 1975).

**Court to determine value**

The Family Court may take expert evidence as to the valuation of assets, but the ultimate determination of value is a matter for the court.

Expert witnesses may provide evidence as to the value of certain assets that make up the matrimonial pool. The court’s obligation is to resolve valuation issues was stated In the Marriage of Lenehan (1987) 11 Fam LR 615 as:

“A trial judge, as part of his ultimate responsibility under s. 79 or other wise is normally required to determine a number of issues. Some of those issues may properly attract the evidence of expert witnesses. In appropriate circumstances their opinions are admissible to assist in the determination of such an issue. It is the responsibility of the trial judge to take into account the opinions of such witnesses. However the ultimate duty of the judge is to determine the issue on the whole of the material before him including such opinions.”
When the Family Court is faced with the situation of having two alternative valuations, it may come to its own conclusions as to the appropriate valuation.\(^7\)

**While the Family Court may reject the opinion of one or more expert witnesses in determining the value of assets, the court’s valuation should not be arbitrarily determined.**

If the court hears evidence from two witnesses who present alternative opinions as to the value of an asset, it must not merely select the average of these two values when determining the value of the asset. *In the Marriage of Dunbar* (1987) 11 Fam LR 901, two expert valuations of certain assets were given. In order to resolve the valuation issue, the trial judge merely calculated the average of the two valuations when determining the appropriate value.

The Full Court of the Family Court rejected this approach and stated that it is open for the trial judge to reject the opinions of the two experts, and it was inappropriate to determine the value by arbitrarily taking the average of the two alternatives.

The trial judge may find that one expert’s evidence is more credible than the other’s, due to problems or faults in the reasoning of one of the experts.\(^8\) These flaws in the expert’s opinion may be revealed in cross-examination and it is open for the trial judge to reject or accept the opinions of an expert on such grounds.

**The Family Court cannot conduct its own investigations as to the value of matrimonial assets.**

The Family Court can, however, have regard to expert opinions. *In the Marriage of Dean* (1988) 12 Fam LR 633, the trial judge had to determine a value for the goodwill of a company. The judge consulted a textbook to determine what figure the profit of the company should be multiplied by, in order to calculate the value of the company. No evidence was called at the trial on this issue. The trial judge did not inform the parties that the value would be determined by this method.

The Full Court held that the trial judge should have informed the parties of his intention to determine the issue in this particular manner as he was not an expert in valuations, and the scope of judicial knowledge did not extend to valuations thus he could not rely on his own knowledge.

The Full Court also raised doubts as to whether it was within the judicial powers of the court to conduct its own investigations on such an issue. The Full Court referred to the case of *Cavanett v. Chambers* [1968] SASR 97 where Bray CJ made the following comments:

“It would be preposterous to suppose, for example, that in a claim for damages or workmen’s compensation where divergent medical opinions have been expressed by expert witnesses on each side, the court should be at liberty without consent to pursue independent inquiries of its own on the point through medical journals or text books not referred to by witnesses.”

\(^7\) *In the Marriage of Chick* (1987) 12 Fam LR 64  
\(^8\) *In the Marriage of Chick* (1987) 12 Fam LR 64
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Relevant time of valuation

The date of hearing is generally regarded by the Family Court as the relevant date to value property.

This date has been emphasised in a number of cases and appears to be inherent in the provisions of s. 79 of the Family Law Act. For instance, in *Warne v. Warne* (1982) FLC 91–247 where nine years had elapsed between the date of separation and the date of hearing. The court held that due to the practical problems in valuing property at some point in the distant past, the date of hearing was the more appropriate time to value to the property.

In some circumstances, the Family Court may regard the date of separation as the most appropriate date to value property.

If there has been a significant lapse of time since the date of separation and the date of hearing the property proceedings, the date of separation may be relevant. For instance, *In the Marriage of Cozantis* (1979) 4 Fam LR 709, the parties had separated shortly after purchasing a business. The husband had taken control of the business subsequent to separating from his wife. By the time the property proceedings were heard, the value of the business had increased substantially due to the efforts of the husband. The court found that since separation, the husband had made sole contributions to the asset and this should be taken into account in the discretionary factors in s. 79 of the Family Law Act.

Therefore the Full Court held that due to the special circumstances of the case, the date of separation was the most appropriate date to value the business. However the Full Court took an opposite view as to the more appropriate time to value the property.

Definition of business valuation

It is important to understand what is meant by business valuation.

A business valuation refers to the value of the net operating assets, which are involved in the operations of the business in question, and could include:

- debtors
- stock
- plant and equipment
- goodwill
- other intangible assets such as patents, brands, customer lists, business name, etc.
- creditors
- employee entitlements.

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9 See also *In the Marriage of Currie* (1976) 26 FLR 469; *In the Marriage of Hayne* (1977) 30 FLR 533 at 534; *In the Marriage of Healy* [1977] FLC 90-295 at 76,565; *In the Marriage of Lange and Moores* [1979] FLC 90-651 at 76,437; *In the Marriage of Mackie* [1981] FLC 91–69.

10 See also *In the Marriage of P* (1985) FLC 91–605; *In the Marriage of Faraone and Shablah* (1988) FLC91–956.
A business is funded by a mixture of equity and debt. Debt could be from an interest-bearing financier such as a bank or from the owners of the business in the form of loans rather than equity capital. Businesses are generally sold without their associated funding, be it equity or debt.

It follows then that an entity such as a company is worth:

- the value of the business it operates (net operating assets); and
- the value of non-operating assets and liabilities such as investments, loans, debts to financiers, etc.

**Applicable standards**

APES 225 Valuation Services issued by the Accounting Professional & Ethical Standards Board (APESB) in July 2008 sets professional standards for the provision of quality and ethical valuation services by members.

It is a mandatory requirement of APES 225 that in circumstances where a member prepares a written valuation report in respect of a valuation service, the valuation report clearly communicates:

- the name of the party engaging the Member;
- a description of the business, business ownership interest, security or intangible asset being valued;
- the date at which the value has been determined;
- the date on which the valuation report has been issued;
- the purpose for which the valuation report has been prepared;
- the name and qualifications of the Member(s) responsible for the valuation;
- the scope of the valuation, including any limitations or restrictions;
- the basis of the valuation;
- a statement whether the valuation was undertaken by the Member acting independently or not;
- the valuation approaches adopted in determining the estimate of value and a description of how they were applied;
- the specific information on which the Member has relied and the extent to which it has been reviewed;
- a description of the material assumptions applied in the valuation and the basis for those assumptions;
- a conclusion of value for a valuation engagement or a limited scope valuation engagement, or a calculated value for a calculated value engagement;
- all qualifications that materially affect the conclusion of value or calculated value;
- for a limited scope valuation engagement, a statement that if a valuation engagement had been performed the results may have been different;
- for a calculation engagement, a statement that if a valuation engagement had been performed the results may have been different;


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- where a Member has prepared a valuation report that requires independence or purports to be independent, a statement that the compensation to be paid to the member is not contingent on the conclusion, content or future use of the valuation report; and
- a statement that the valuation service was conducted in accordance with this Standard.

**Main methods of valuing a business**

The main method utilised to value an interest in a business will depend on whether the business is operated by a listed public company, or whether it is a private business owned under a sole tradership, partnership, trust or company structure.

Where the parties to the marriage have share holdings in listed entities, the valuation of those shares is relatively straightforward. In the majority of cases, the share price is determined by consulting the quoted prices for those companies listed on the stock exchange.

However, the position with interests in unlisted businesses is more complicated. When valuing a person's interest in a private company, the shareholding of that company must be valued and not the assets of that company.\(^{11}\)

There are three basic types of valuation methods for businesses. The first is based on the earnings of the business, the second is based on the assets of the business and the third is a rule of thumb. In summary these methods may be broken down into these categories of valuation methods:

**Earnings based**
- capitalisation of maintainable earnings
- discounted cash flows

**Assets based**
- going concern
- realisation of assets or liquidation value

**Market based**
- rule of thumb
- comparative sales

The Family Law Act does not prescribe guidelines for valuing an interest in a business for a property hearing.

When determining the most appropriate method for valuing a person's interest in a business, a number of factors need to be considered. The High Court in *Mallet v. Mallet* (1984) 156 CLR 605 considered the issue of valuation of shares in an unlisted private

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\(^{11}\) *In the Marriage of Gamer* (1988) 12 Fam LR 73, the Full Court at 79
company in the context of property proceedings pursuant to s. 79 of the Family Law Act. Mason J stated the following in regard to valuing shares in a private company:

“What is the most appropriate method of estimating the value of shares in a proprietary company depends upon a variety of factors. They include the purpose for which the valuation is made, the nature of the share holdings, the character of the company’s business, its capacity to earn profits and the net value of its assets.”

The Australian Securities & Investments Commission’s Regulatory Guide 111 issued in March 2011 provides some guidance as to the appropriate valuation methodology to be utilised.

This Regulatory Guide “Content of expert reports” prescribes standards to be followed in the valuation of a corporation or the preparation of profit forecasts which are intended for publication to a section of the public. Specifically, such reports would be used for share buy-backs, selective capital reductions, schemes of arrangement, takeovers and prospectuses.

Although not directly applicable to valuing interests for family law purposes, the Regulatory Guide provides a guide as to what sort of information would be included in a valuation report. It also provides guidance on the appropriate valuation methodology that should be considered.

Regulatory Guide 111 details the following methodologies which the expert should consider:

- (a) the discounted cash flow method and the estimated realisable value of any surplus assets;
- (b) the application of earnings multiples (appropriate to the businesses or industries in which the entity operates) to the estimated future maintainable earnings or cash flows of the entity, added to the estimated realisable value of any surplus assets;
- (c) the amount that would be available for distribution to security holders on an orderly realisation;
- (d) the quoted price for listed securities, when there is a liquid and active market and allowing for the fact that the quoted price may not reflect their value, should 100% of the securities be available for sales; and
- (e) any recent genuine offers received by the target for the entire business, or any business units or assets as a basis for valuation of those business units or assets.

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12 ASIC Regulatory Guide 111: Content of expert reports, para. RG111.69
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Capitalisation of future maintainable earnings method

Capitalisation of earnings is the most commonly used method for the valuation of businesses with a consistent earnings trend that is indicative of ongoing earnings potential.

It is not suitable for start-up businesses, businesses with erratic earning patterns, or those which have large capital expenditure requirements in the near future.

A capitalisation of earnings requires consideration of:

- the estimated future maintainable earnings of the business;
- the appropriate capitalisation rate (or price earnings multiple) which will reflect the purchaser’s required rate of return, risk inherent in the business, future growth opportunities and alternative opportunities; and
- a separate assessment of surplus or unrelated assets and liabilities, i.e. those not essential to producing the estimated future earnings which are then added or deducted from the capitalised earnings.

The capitalisation of future maintainable earnings method of valuation requires an estimate of the maintainable level of earnings of a business.

This estimate is based on available information. In practice, a review of historical results will provide a guide to the entity’s future performance. The result is adjusted to remove any extraneous or abnormal items that are not recurrent to the typical operations of the company. Once the future maintainable earnings is determined, it is then multiplied by an appropriate price earnings multiple (or the inverse where it is divided by the capitalisation rate) to arrive at the value of the business. This rate will allow for elements such as risk, the time value of money, and future growth prospects.

The use of an earnings-based method of valuing an interest in a company for the purpose of s. 79 property hearing was discussed by Mason J in Mallet v. Mallet 156 CLR 605:

“It has been said that a valuation based on earning capacity is generally most appropriate because the hypothetical purchaser of shares in a company which is a going concern is looking, not to a winding up, but to the profits which will ensue from the company continuing to trade: McCathie v. FC of T (1944) 69 CLR 1; Abrahams v. FC of T (1944) 70 CLR 23; Commissioner of Succession Duties (SA) v. Executor Trustee and Agency Co. of SA Ltd (1947) 74 CLR 358.”

In contrast, the Family Court in Ramsey v. Ramsey (1997) FLC 92-742 followed the decision in Turnbull v. Turnbull (1991) FLC 92-258 where it was held that the purpose of the valuation is to ascertain the value to the individual shareholder, not the commercial or market value of the shares to the hypothetical purchaser. The value to be assigned must be realistic. Warnick J in Ramsey’s case pointed out that there is a need to recognise the point at which the difference between value to the shareholder and the market value becomes relevant.
The level of future maintainable earnings will not necessarily be the same as present or past earnings, although these figures may serve as a guide.

In considering the relevance of past results as a guide to expected future maintainable earnings, several factors have to be critically examined. For instance, changes that have or are likely to occur to the type of business activity conducted (such as product lines) and the structure of the industry and marketplace (level of protection, competition and growth), should be considered. The financial results for a number of years should be reviewed to determine the frequency of trade or season cycles and the pattern or trend in profitability.

Past accounting policies must be evaluated as they may have been inconsistent or may be inappropriate for the purpose of valuation.

There are several areas where accounting methods that have been utilised by a business may have been inappropriate. It will be necessary to select the most appropriate accounting policies to adopt. Where this differs from the method used, the effect of this difference should be calculated and the prior results recast on the new basis.

In particular, the following should be reviewed:

- criterion for determining the timing of income recognition;
- basis of depreciation;
- method and consistency of stock and work-in-progress valuations;
- the timing of expenditure and period-end accruals;
- uses of provisions for losses and expenditure;
- income tax accounting (tax effect or not);
- accounting for unearned income (e.g. construction contracts);
- extraordinary items included in past earnings;
- discontinued business;
- commercial rentals; and
- new businesses.

The recasting of current and past results must also have regard to the potential impact of a change in ownership or management of the business as well as changes in legislation.

The current management and its level of remuneration (in particular, the sufficiency or excessiveness of owner’s remuneration packages) have to be critically examined. The change of management may impact on the clientele of the business, the relationship with suppliers or the costs of finance (if low interest loan funds of present owners are withdrawn).
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The impact of changes in income tax and other laws such as superannuation, payroll tax, sales tax, GST and trade practices, may affect future earnings. It is ultimately a question of degree as to whether or not past results can be recast to reflect these types of changes in order that they are representative of a trend in expected future maintainable earnings.

The “Price Earnings Multiple” or its inverse, the “Capitalisation Rate” must be determined. Once this figure is determined and applied to future earnings, it will reflect the expected rate of return from the business.

Factors to be taken into consideration in determining such a rate include:

- **Degree of risk associated with this type of activity** owing to:
  - external factors, economic indicators
  - the industry or business sector
  - the level of competition
  - risk of obsolescence
  - degree of control and regulation
  - degree of protection or assistance by governments
  - seasonal and trade cycle variability
  - changes in tax rate, allowances for tax losses or changes in the status of the entity.

- **Growth expectations of investment**
  - changes in the product cycle
  - expected life of the product
  - industry outlook for future growth.

- **Degree of negotiability**
  The degree of negotiability of an investment affects the required rate of return. The readily negotiable nature of publicly listed shares is one of the contributing reasons as to why the expected rate of return on such shares would be much lower than a parcel of shares in a proprietary company which, pursuant to its Constitution, places restriction on transfers.

  The relevant constituent documents must be examined carefully by the valuer. This procedure is not only important in the area of negotiability, but more importantly in regard to the rights or entitlements of the interest being valued (e.g. preference versus ordinary shares).

- **Control**
  The lesser degree of control over one’s investment the higher the required return (e.g. non-voting shares as against voting shares or minority interest not enabling a directorship).

- **Multiples achieved for other investments**
  Reference to the multiples achieved for other investments may assist in determining an appropriate level of return for the risk involved.
Surplus assets which do not contribute to the operations of a business should be separately valued and then added to the business valuation which has been obtained from the capitalisation of maintainable earnings.

Surplus assets would include excess cash, non-core investments or property not used in the operations of the business. Such non-core assets should be isolated from the core assets of the business as these non-core assets will generate a different return and represent a different risk profile than those core assets that are central to the business.

Property that is used in the business can be considered a “surplus asset” by adjusting the estimated maintainable earnings to reflect a fair commercial property charge. Property has a different risk profile to that of a business and therefore should be assessed separately.

In the determination of maintainable earnings, the valuer needs to consider whether to use profit after interest and tax (NPAT) or earnings before interest and tax (EBIT).

The capitalisation rate or multiple must, of course, be based on what is being capitalised. Clearly a higher multiple is applied to NPAT than EBIT.

Current trends in valuation indicate that there is more emphasis on valuing businesses on an ungeared basis (that is, on a multiple of estimated maintainable EBIT), and then deducting the debt and adding any surplus assets, to determine the value of the entity.

**Discounted cash flow**

The discounted cash flow (DCF) method of valuation of a business is a measure of the expected future value of the flow of cash both in absolute terms and during the time period over which it is derived.

Discounting of future cash flows has a strong theoretical foundation. It involves assessing the present value of future cash inflows and outflows which are then discounted to determine what they are worth in “today’s” dollars. The discount rate chosen should reflect the required rate of return, given the risk associated with generating those cash flows.

Considerable judgement is required in estimating future cash flows. Usually the net present value is extremely sensitive to small changes in underlying assumptions, few of which are capable of being predicted with accuracy especially after the first 2 to 3 years. It also requires calculation of a terminal value at the end of the forecast period. These factors impose their own difficulties and this is why the capitalisation of earnings is the most commonly used method to value established industrial businesses.

Adopting the discounted cash flow approach to a valuation of a business or interest in a business requires:

- an assessment of the cash flows to the business for a period of say five years;
- an assessment of the termination value at the end of the period;
- an assessment of an appropriate discount rate to apply to the projected cash flows to reflect the time value of money and the risks associated with actually achieving the potential future earnings of the company.
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The basic principles behind a DCF are that a dollar today is worth more than a dollar received in the future (due to the effects of inflation), and that the availability of cash is limited, as it has an opportunity cost (i.e. a cost of other opportunities foregone).

The value of a business is determined by assessing the present value of the cash flows which are expected to occur in the future. This process involves determining the likely future receipts and expenditure of cash, expected to be received/incurred over a number of years, these are then discounted to determine what they are worth in today’s dollars, or their “present value”.

The discount rate chosen to determine the present value should reflect the required rate of return given the risk associated with generating those cash flows. The discount rate used should reflect the opportunity cost of capital.

The DCF method will not be suitable for valuing all businesses and there are some risks associated with its application.

Because the method is dependent on future cash flows which a project or business is expected to generate, an estimate of both the amount and timing of these cash flows must be made.

A further issue is determining the appropriate discount rate to use. It needs to accurately reflect the risk and expected return of the project or business.

For instance, substantially differing valuations can be achieved when discounting an amount of $10,000 to be received in 10 years time by using differing discount rates. $10,000 in 10 years time is worth $6,139 if discounted by 5%, $3,855 if discounted by 10% and $1,073 if discounted by 25%.

Typically, the types of businesses or investments to which DCF valuations are most applicable are those with:

- finite lives;
- new investments with high growth until maturity;
- existing investments requiring high levels of additional capital expenditure or entering growth stages; and
- long-term lease arrangements where a residual value is anticipated.

There are a number of potential advantages to using a DCF method for valuing as compared to a capitalisation of maintainable earnings. The potential benefits are:

- the DCF method is focused on cash, which is how investors and bankers evaluate an investment;
- by being focused on cash the DCF method eliminates any distortions that may arise due to the use of creative accounting or differing accounting procedures; and
- the DCF method places emphasis on the time value of money which is important in evaluating investments over a number of years.

For the above reasons, it could be said that the DCF method is more objective when compared to the capitalisation of maintainable earnings which is more open to manipulation by the use of differing accounting policies. In determining which is
the preferable earnings-based method of valuing a business, the circumstances of that particular valuation will be crucial in determining which method is the most suitable.

Generally where the cash flows are predictable and not expected to vary, the DCF method will be applicable. However, it may be difficult to accurately predict cash flows due to factors such as the variable nature of interest rates and other economic conditions. Thus in circumstances where the cash flows are predictable and the investment life is finite, the DCF method would be appropriate. However, in reality there may not be many circumstances where these conditions will be met.

**Asset-based valuations**

**An asset-based valuation, on both a “going concern” and “realisation of assets” basis may be an appropriate method of valuing a business.**

An asset-based valuation of a business is normally used as a secondary method of valuation as a crosscheck on the reasonableness of the capitalisation of maintainable earnings method. That is, after valuing the business on an earnings basis, does the “Price to Asset Ratio” appear reasonable in the circumstances? The Price to Asset Ratio measures the value of the business as derived divided by the Net Tangible Operating Assets of the business. Generally, this would derive a value of between 1 and 2 for most businesses, perhaps higher for service/professional businesses.

However, it is a primary method of valuation for businesses that are underperforming or not making a sufficient economic return to derive a value, on a capitalisation of earnings basis, greater than an asset-based valuation.

Where a business is profitable, an asset-based method should not be used unless the maintainable earnings provide an inadequate return on the net tangible operating assets utilised in the business.

There are two asset-based valuation approaches: going concern or realisation of assets.

In both instances it is necessary to critically examine and adjust, where necessary, the recorded book value of assets. Therefore, in many instances this would require the assistance of independent experts for items such as real estate and plant valuations.

A valuation on a going concern basis would have regard to the value of assets on the assumption that they would be realised in the normal course of business.

The realisation of assets or a liquidation basis of valuation assumes that the business will cease operations and as a result may give rise to certain adjustments to values compiled on the going concern method referred to above, namely:

- a reduction in certain asset values, e.g. machinery, stock and work-in-progress owing to the need to discount prices for discontinuance of trading;
- the incurring of additional liabilities, e.g. lease payouts, income tax, capital gains tax liability, redundancy, retrenchment and liquidation costs; and
- the loss of non-transferable industrial rights, franchises, leases etc.

The realisation basis in most instances is more a measure of security of an investment rather than valuation unless liquidation is contemplated in the near future.
VALUATION OF BUSINESSES, ENTITIES & SHARES

Rules of thumb valuations

A “rule of thumb” method of valuing a business is widely used in certain industries such as childcare centres (value per child), nursing homes (value per bed), professional practices (value per $ of gross fees), small retail outlets, etc.

Rule of thumb valuations are not a primary valuation method and have, over a period of time, developed as a result of market transactions. They are mainly prevalent in the valuation of small businesses or readily comparable businesses.

This method is often criticised as being too simplistic and ignoring the financial results of the business. Care should be taken when using the rule of thumb method, as a value may be difficult to substantiate in court. The method often leads to over-valuation and therefore inadequate returns on investment.

However the method is widely used to value a number of small (or comparable) businesses such as:

- professional practices such as accounting firms, medical practices
- newsagencies
- real estate rent rolls
- childcare centres
- nursing homes
- hotels
- restaurants/cafes
- small retail businesses.

Comparative sales

This method of valuation, as the name implies, is based on a comparison of sales achieved in the market place for similar businesses.

Although a comparison may be made, it is necessary to consider the various factors that can and do affect individual businesses.

Factors such as years of operation, systems adopted, staffing, location, demographics, competition, position in the marketplace, quality of the business equipment, security of tenure, reputation, relationship with customers, etc. may affect the expected future profitability and hence the value of the business.

Selection of appropriate valuation method

Differing valuations will result from using the earnings-based, the asset-based or market-based methods.

The valuer has to decide which is the most appropriate methodology. If the business has high earnings and low net assets, an earnings-based method may be appropriate, whereas an asset-based method may be appropriate where the business has significant assets but relatively poor earnings. At the end of the day, the value must reflect what a rational
person would be willing to pay or to receive in light of the circumstances surrounding the business or entity under consideration. Valuers must presume a market and place themselves in the position of a rational purchaser and seller.

Typically:

- The capitalisation of earnings method is adopted for performing, mature businesses with no major changes envisaged in the medium term.
- The DCF method is appropriate for finite life projects, businesses with predictable cash flows, start-up businesses (which may incur losses initially and then turn to profit), existing businesses entering an expansion phase, resource companies.
- Asset-based methods are normally a secondary method (check the “Price Asset Ratio” for reasonableness), but are suitable for non-performing businesses or entities which have passive investments in equities and property.
- Market-based methods are also normally a secondary method but have relevance to small business and comparable businesses.

**Minority interest holdings**

Where one of the parties to the proceedings has a minority interest in a company, a discount will be applied to that interest to compensate for the restriction on the transfer of the shares and for the lack of control over the business.

The discount reduces the pro rata value of the entire business to reflect the absence of control and lack of negotiability. This discount generally varies at between 10% and 30%.


This principle has been judicially accepted in revenue cases such as *Gregory v. Commissioner of Taxation* (1971) 123 CLR 547 and *Commissioner of Taxation v. Sagar* (1946) 71 CLR 421.

**The Family Court may apply a discount for valuing a minority interest in a private company.**

In revenue cases, where the interest to be valued is a minority holding, a discount rate should be applied to that interest to compensate for restriction of transfer and a lack of control over the business. The Family Court has also recognised that in certain circumstances it is appropriate to apply a discount.

In *Sapir v. Sapir (No. 2)* (1989) 13 Fam LR 362 the wife had a 48% interest in various family companies. The wife’s shares were subordinate in rights compared to her parents’ shares, however, it was intended that the wife would inherit the parents’ interest in shares on their death. The husband’s valuer adopted a discount rate on the value of the shares of 4–6%, essentially discounting the shares at a minimal rate for the benefit of receiving cash now rather than in the future.
Further, the husband’s valuer argued that as the only realistic purchaser of the minority share holding would be the wife’s parents they would not be concerned with the fact that they were purchasing a minority interest. The wife’s valuer applied a discount rate of between 12–16%, on the basis that it was a minority interest and that while the parents were still alive it would be difficult to realise the full capital value of the shares.

It was held that the commercial value of the shares was not appropriate as there was no ready and available market and it did not reflect the value to the wife. The court essentially accepted the husband’s valuation, applying a discount rate to the minority share holding of 6.5%.

The Family Court has valued shares in private family companies based on the worth of the shares to the shareholder.

In the Marriage of Turnbull (1990) 15 Fam LR 81, the husband held a minority interest in two family companies controlled by his father. The transfer of the shares was restricted as the directors had to approve such a transfer. Both the husband and the wife called accountants to give evidence. The wife’s valuer testified that the husband’s interest was valued at several million dollars which in his opinion should be discounted by 20% to take into account of the father’s ultimate control over the affairs of the company and the lack of negotiability of the shares caused by the restriction on their transfer.

The husband’s expert gave evidence that the husband’s interest was only worth the par value of the shares because of the restrictions on their transfer, the fact that the husband’s father had effective control, and only a controlling interest would attract a purchaser who was willing to pay a premium.

Before making a determination as to the appropriate basis for valuing the husband’s shares, Baker J reviewed relevant authorities. One of the cases cited was In the Marriage of Reynolds (1984) 10 Fam LR 388, where the Full Court said:

“[w]e are doubtful, however, whether valuation methods which have been developed for commercial purposes are entirely appropriate for the purposes of family.”

Baker J agreed with the Full Court in Reynolds case and stated that in the context of valuing shares in private companies for the purposes of the Family Law Act, the shares should be valued on the basis of their worth to the shareholders. In determining that the appropriate basis for valuing shares was what they were worth to the husband and not to a hypothetical purchaser, Baker J rejected both accountants’ evidence. In regard to the wife’s accountant who advocated a discount rate of 20%, Baker J was very critical and believed his evidence was unsustainable. Baker J rejected the valuation of the husband’s accountant on the basis that the par value was a ridiculously low figure compared to the overall net worth of the companies and it ignored the husband’s intentions for the companies.
After making these observations about the respective accountants, the Full Court found that despite the existing complicated ownership structure, ultimately the husband would retain ownership of one of the companies and consequently there should be a modest discount rate applied in the interest of that particular company. With respect to the second company, the court found that ultimately the husband and his four sisters would gain ownership of this entity and so a slightly higher discount rate was adopted.

In *Ramsey v. Ramsey* (1997) FLC 92-742, Warnick J held that expert evidence may be adduced as to the proper valuation methodology to be applied in a particular case. However, it was for the court to come to its own conclusions as to whether the suggested approach is appropriate in all the circumstances of the case.

Matters such as the probability of a current minority shareholder gaining control, the difference between value to one spouse as assessed by accountants and the realisable value are the types of matters to be determined by the court, not the expert witness. Where there is a lack of realisable value of a shareholding, the court should consider:

- whether there is a market for the shareholding;
- if there is a market, then the market value will be highly relevant even if there is no intention to sell;
- any allowance for lack of realisable value is best made by the court particularly if there are other disposable assets on hand;
- where there are no realisable assets, the lack of market value of the shareholding will be critical not only to the division of the property but the orders made; and
- the possibility of the minority shareholding gaining control of the company.
VALUATION OF BUSINESSES, ENTITIES & SHARES

Small business valuations

Business valuation theory tends to insist that an allowance be made for the owner/operator to receive a fair wage before estimating maintainable earnings of the business.

Business brokers, on the other hand, generally do not allow for a commercial wage to the owner/operator. Small businesses are generally sold in the market place on the basis of a multiple of earnings before an allowance for the owner/operator’s wage.

Example

- A takeaway food shop was sold for $50,000.
- The business was making $40,000 profit before owner wages.
- The price consisted of $15,000 for plant and equipment, $12,000 stock, and $23,000 for goodwill.
- A fair annual wage for the owner would be $36,000 ($12/hour @ 60 hours/week).

If a fair wage was included, the real profit of the business was $4,000. On this basis the price of $50,000 appears high. Yet the purchaser was prepared to pay this price.

Reasons for this include:
- The purchaser was buying an income.
- The purchaser can live from the business (if food business).
- The purchaser is his own boss.
- “Cash” aspect of the business.
- The purchaser can split his income with his spouse.
- Purchasers of small businesses do not differentiate between profit and wage.

These factors are not considered in general “return on investment” business valuation theory.

Other factors making small business valuations difficult include:
- availability of records
- poor reliability of records
- profits can fluctuate
- private expenses (such as motor vehicle, telephone, etc.) may be included in the accounts.

The above factors are reasons why more than one method should be considered when valuing small businesses (capitalisation of earnings, rule of thumb).
Valuation of professional practices

The same methods apply in valuing an interest in a professional practice as those applied in valuing any other type of business.

Some partnerships have formulae for ingoing and outgoing individual partners. Indeed, many of the larger legal and accountancy practices now operate on a “no goodwill” basis. That is incoming partners pay no goodwill when they are admitted to the partnership and receive no goodwill payout when they leave. The individual partners cannot sell their interest.

These formulae rarely reflect all considerations that should be factored into either valuing the practice in total or one partner’s interest in the practice.

Professional goodwill is the difference between the value of the practice as a whole and its net tangible operating assets. It relates to the recognition of the firm’s name, its established clientele and connections, its services, databases, systems, etc.

The key is to differentiate between goodwill pertaining to the practice and that pertaining to the individual. Personal goodwill relates to the person’s own contacts, experience, and reputation.

A derivative of the capitalisation of earnings method, that is, the capitalisation of super profits is often applied to the valuation of a partner’s interest in large professional practices.

Super profits are the profits in excess of those required to provide an economic rate of remuneration for all labour and capital used in the practice.

To assess profitability of a practice, the previous year’s results are reviewed. These should be adjusted for:

- non-recurring items (abnormal bad debts, client losses, etc.);
- accrual accounting (many small practices are on a cash basis and exclude work-in-progress, trade debtors and trade creditors); and
- a commercial salary for the partners.

The assessed maintainable profit is then capitalised at an appropriate rate to reflect associated risks.
VALUATION OF BUSINESSES, ENTITIES & SHARES

Example 1: Two partner practice – Capitalisation of earnings approach

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Fees</td>
<td>$1,200,000</td>
</tr>
<tr>
<td>Assessed Maintainable Profit</td>
<td>500,000</td>
</tr>
<tr>
<td>Less Assessed Commercial Salaries</td>
<td>300,000</td>
</tr>
<tr>
<td>Partnership Profit Before Tax</td>
<td>200,000</td>
</tr>
<tr>
<td>Less Tax at say 50%</td>
<td>100,000</td>
</tr>
<tr>
<td>Earnings after Tax</td>
<td>$100,000</td>
</tr>
<tr>
<td>Capitalisation Rate, say</td>
<td>20%</td>
</tr>
<tr>
<td>Value of Practice</td>
<td>$500,000</td>
</tr>
<tr>
<td>Less Net Tangible Operating Assets</td>
<td>200,000</td>
</tr>
<tr>
<td>Derived Goodwill</td>
<td>$300,000</td>
</tr>
</tbody>
</table>

One partner’s interest in the practice may therefore be assessed at $250,000 ($500,000/2).

Example 2: One partner’s interest (aged 50) in a no goodwill practice – Super profits approach

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Assessed Maintainable Profit</td>
<td>$500,000</td>
</tr>
<tr>
<td>Less Assessed Commercial Salary</td>
<td>300,000</td>
</tr>
<tr>
<td></td>
<td>200,000</td>
</tr>
<tr>
<td>Less Interest on Capital &amp; Current Accounts ($350,000 at say 8%)</td>
<td>28,000</td>
</tr>
<tr>
<td>Super Profits</td>
<td>172,000</td>
</tr>
<tr>
<td>Less Tax at say 50%</td>
<td>86,000</td>
</tr>
<tr>
<td>Super Profits after Tax</td>
<td>$86,000</td>
</tr>
</tbody>
</table>

These may be earned until the partner retires (say, age 60). However, the possibility of death should also be factored in.
Based on this, the Net Present Value of the Super Profits may be calculated as:

<table>
<thead>
<tr>
<th>Age</th>
<th>Super Profits After Tax</th>
<th>Mortality Factor\textsuperscript{a}</th>
<th>Discount Rate\textsuperscript{b}</th>
<th>Present Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>51</td>
<td>86,000</td>
<td>0.99091</td>
<td>0.7561</td>
<td>64,437</td>
</tr>
<tr>
<td>52</td>
<td>86,000</td>
<td>0.98737</td>
<td>0.6575</td>
<td>55,832</td>
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<tr>
<td>53</td>
<td>86,000</td>
<td>0.98356</td>
<td>0.5718</td>
<td>48,362</td>
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<tr>
<td>54</td>
<td>86,000</td>
<td>0.97944</td>
<td>0.4972</td>
<td>41,878</td>
</tr>
<tr>
<td>55</td>
<td>86,000</td>
<td>0.97499</td>
<td>0.4323</td>
<td>36,250</td>
</tr>
<tr>
<td>56</td>
<td>86,000</td>
<td>0.97018</td>
<td>0.3759</td>
<td>31,367</td>
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<tr>
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<td>86,000</td>
<td>0.96496</td>
<td>0.3269</td>
<td>27,129</td>
</tr>
<tr>
<td>58</td>
<td>86,000</td>
<td>0.95926</td>
<td>0.2843</td>
<td>23,451</td>
</tr>
<tr>
<td>59</td>
<td>86,000</td>
<td>0.95301</td>
<td>0.2472</td>
<td>20,259</td>
</tr>
<tr>
<td>60</td>
<td>86,000</td>
<td>0.94614</td>
<td>0.2149</td>
<td>17,489</td>
</tr>
</tbody>
</table>

\textbf{Net Present Value of Super Profits} \quad $440,801$

\textsuperscript{a} From Australian Life Tables 2005–07. Probability of reaching age at year end based on start of age 50.

\textsuperscript{b} Discount rate of 15% per annum real. Higher rates may apply.

In the family law context, care needs to be taken not to double count as having substantial capital value and at the same time making further orders for maintenance under s. 75(2) of the \textit{Family Law Act 1975} due to significant difference in earning capacity. The court therefore tends to make an adjustment under s. 75(2) rather than to attribute a substantial capital value to the super profits income stream.

At the end of the day, each practice is different and careful analysis of each situation is required to assess whether the valuation is based on value to the owner or fair market value. It is important to be familiar with what is actually happening in the commercial world concerning payment of goodwill on the admission/retirement of partners/sale of practices, how specialised the practice is, the availability of staff, etc.
6 | VALUE OF REAL ESTATE

The theory of land valuation is a specialist area and is beyond the parameters of this discussion on family law.

The evidence from a licensed property valuer is accepted by the Family Court as the appropriate value for real property. The value placed on real property will have regard to recent sales in the area. The estimated rental yield from the property will be taken into consideration, if applicable, in determining the earnings before interest and taxes (EBIT).

If the property is used for a specialised purpose, such as agricultural or primary production, an appropriate valuer who has the relevant experience in valuing these properties should be engaged.

7 | VALUE OF PERSONAL PROPERTY AND CHATTELS

Personal property includes items such as artwork, antiques, furniture and motor vehicles.

In the Marriage of Antmann (1980) 6 Fam LR 560, the court was faced with two alternative methods of valuing jewellery. One valuer adopted a replacement value and the other had adopted a realisation value. The court stated that there is no fixed rule in regard to what is the proper method of valuation for property. However the selection of a method depended on a number of factors such as the type of personal property, the purpose for which the property was acquired and whether the property needs to be realised in the short term or whether the property is intended to be retained by one of the parties.

In the Marriage of Shaw (1989) 12 Fam LR 806, the Full Court stated that a significant consideration when selecting the method of valuing personal property is whether or not the property was to be realised in the short or long term. The Full Court considered that if there is a real likelihood that the property will be realised in the short term then the appropriate method of valuation would be a realisation value. However if one of the parties intends to retain the property, then a value based on replacement cost would be more appropriate.
REALISATION COSTS

8 | REALISATION COSTS

Where specific assets are to be sold and the proceeds are to be split among the parties, a deduction may be made for realisation costs. However, In the Marriage of Kelly (No. 2) (1981) 7 Fam LR 762, the Full Court upheld the decision of the trial judge, who had declined to deduct the realisation costs associated with property owned by the husband.

The Full Court went on to state that where it is anticipated that specific items of property are to be sold and the proceeds are to be split among the parties it would be appropriate to deduct the costs of realisation. It would not be appropriate to deduct realisation costs where the sale of that property is not contemplated.

Where specific assets are to be sold and the proceeds split between the parties, a deduction may be allowed from the valuation figure for any capital gains tax liability.

A settlement of property or cash on a spouse or former spouse may be liable to capital gains tax. In the Marriage of Rothwell (1993) 18 Fam LR 454, the issue for consideration was whether capital gains tax should be deducted from the value of the husband’s interest in a company and a unit trust. The trial judge held that it would be appropriate to deduct the notional capital gains tax liability that would result from the sale of the shares in the company, but there would be no deduction for capital gains tax from the units in the unit trust as it was not clear in which country the sale proceeds would be realised so the Australian capital gains tax rules may not apply. The shares had been valued on a “net realisable value” which by definition implied that the value should have allowed for the capital gains tax liability.

Further, the trial judge held that it would be unfair to award a cash sum to the wife without taking into consideration the capital gains tax liability of that particular asset as the husband would be unable to dispose of that asset without incurring the liability for capital gains tax.

The decision of Nicholson CJ in Carruthers v. Carruthers (1996) FLC 92-707 sets out the widely adopted practice to make allowance for tax and other realisation costs where the asset is likely to be disposed of or orders of the court will cause a disposal.

Revaluation of surplus assets, such as property, should ordinarily include an allowance for tax and realisation costs.

The Full Court in Rosati v. Rosati (1998) Fam CA 38 affirmed the trial judge’s approach of not making an allowance for capital gains tax when determining the value of the property pool, but taking it into account as a s. 75(2) factor (as there was no evidence of a sale of the business in the short term).
Rosati’s case sets out the following general principles:

“(1) Whether the incidence of Capital Gains Tax should be taken into account in valuing a particular asset varies according to the circumstances of the case, including the method of valuation applied to the particular asset, the likelihood or otherwise of that asset being realised in the foreseeable future, the circumstances of its acquisition and the evidence of the parties as to their intentions in relation to that asset.

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

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

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

Various taxation consequences may arise upon the breakdown of a relationship. The main taxation issues that arise are in the areas of capital gains tax (“CGT”), stamp duty and income tax.

There may be significant tax advantages to be gained with careful planning and consideration of the issues that are relevant to the breakdown of relationships. This chapter aims to provide the family law practitioner with knowledge of the relevant taxation issues that may arise in the context of family law proceedings.

Capital gains tax

A wide variety of assets are subject to CGT.

Section 8 on Realisation Costs discussed whether notional CGT should be taken into account in the assessment of the family’s net assets.

In calculating notional CGT, details of the following are required:

- the relevant party’s current taxable income
- the acquisition cost of the asset and date of acquisition
- stamp duty and other transfer costs
- costs of any improvement to the asset
- current market value less notional disposal costs.

The capital gain (for assets acquired post September 1985) is generally 50% of (the net sales price less cost). This is taxed at the taxpayer’s marginal rate of tax (assuming there are no offsetting capital losses).

The Income Tax Assessment Act 1997 (Cth) (“ITAA 1997”) provides roll-over relief from the imposition of CGT where there is a disposal of an asset upon the breakdown of a relationship.

Roll-over relief is effectively a deferral of liability to pay CGT. The transferee of the asset takes the asset with the CGT characteristics it had in the hands of the transferor. ITAA 1997 allows the deemed sale or transfer of assets in certain circumstances to be ignored for CGT purposes until the asset is disposed to a third party.

Automatic roll-over relief is available where there is a transfer of an asset pursuant to an order of a court under the Family Law Act or a corresponding foreign law, a maintenance agreement made pursuant to s. 87 of the Family Law Act or an order of a court made after 2 April 1992 under a law dealing with de facto marriages. Roll-over relief may be granted for assets transferred between spouses and de facto spouses, and assets transferred from a company or a trust to a spouse or de facto spouse.
This relief is provided by way of either s. 126-5 which deals with assets transferred between spouses and de facto spouses; or s.126-15 which deals with assets transferred from a company or a trust to a spouse or de facto spouse. It should be noted that for orders made prior to 2 April 1992 the definition of “spouse” in s. 126-5 referred only to married spouses.

The roll-over relief afforded by this section to a transferee spouse will be as follows:

- Where the asset was acquired prior to 20 September 1985, the transferee spouse is deemed to have acquired the asset before that date (s. 126-5); and thus the CGT-free status of the asset is preserved for any future disposal of the asset to third parties.

- For assets acquired on or after 20 September 1985, the transferee spouse is deemed to have paid as consideration for the acquisition of the asset an amount equal to the indexed cost base or the reduced cost base to the transferor spouse at the time of the transfer (s.126-5). Where the market value of the asset being transferred exceeds the indexed cost base, the transferee spouse will assume a potential CGT liability, being the difference between the market value and the indexed cost base. The transferee spouse will be able to utilise the expenses incurred by the transferor spouse in that spouse’s period of ownership, as these expenses will form part of the transferee spouse’s cost base on acquisition.

- If the asset was a “personal use asset” to the transferor spouse, it retains its character after transfer to the transferee spouse (s. 126-5). Any subsequent disposal will be subject to the special provisions relating to such assets. Personal use assets are assets for the personal use or enjoyment of the taxpayer and/or associates. These assets are either listed or non-listed personal use assets.

The implications of roll-over relief should be given careful consideration before any court-based orders are executed.

There may be an advantage in avoiding the roll-over relief. For instance, depending on the financial circumstances of the transferee and transferor spouses, it may be beneficial to realise a capital loss on the transfer of the asset. To avoid the automatic grant of roll-over relief, the parties should transfer the assets outside the Family Law Act regime so that the transfer is not pursuant to a court order.

There is some uncertainty as to whether a cash settlement pursuant to the Family Law Act is liable to CGT.

Taxation Ruling TR 95/35 sets out the Commissioner of Taxation’s views on how CGT is levied on the receipt of a compensation payment arising out of a litigious settlement. The ruling provides the right to sue or seek compensation is an asset for CGT purposes. This asset is “disposed” when the litigious matter is settled by an award of compensation, thus the compensation may be assessable as a capital gain. The ruling does not specifically address the consequences of family law matters. It is likely that family law settlements were beyond the original intention of the legislation. Consequently it would appear unlikely that the Commissioner will pursue these litigious settlements for CGT.
**TAXATION ISSUES**

**Binding Financial agreements**

Binding Financial agreements ("BFA") became effective from 27 December 2000 as a new Part VIIIA of the Family Law Act. Valid BFAs can deal with property matters and therefore the Family Court will have no power to make orders altering those property interests.

Currently s. 126-5 and s. 126-15 of the *Income Tax Assessment Act 1997* provide CGT roll-over relief for dispositions of assets between husband and wife and involving family companies and trusts. Since 12 December 2006, relief also applies to BFA’s.

**Income tax**

Some issues to consider include:

- Outstanding tax assessments need to be factored into the family pool of assets.
- Trust distributions pending settlement – these also need to be considered in negotiating a settlement.
- Capital and income tax carry forward losses may be of benefit to the owner who retains such.
- Retained earnings in companies – should the tax (difference between shareholder’s marginal income tax rate and the amount franked) be considered
- Treatment of loan accounts in private companies

**Stamp duty**

*Certain documents which deal with Financial matters pursuant to the Family Law Act are exempt from Commonwealth, state or territory duties and charges.*

Section 90 was inserted into the Family Law Act in 1983 after the High Court had ruled that the previous s. 90 was invalid for constitutional reasons. After this decision, state parliaments enacted legislation that provided exemptions or concessions from stamp duty for transfers of property arising out of matrimonial proceedings. Each state still has their own exemptions contained in their respective Acts:

- **NSW** s.74CB *Stamp Duties Act 1920*
- **Queensland** ss 59A – D, s. 112UA *Stamp Act 1894*
- **South Australia** s.71CA, CB *Stamp Duties Act 1923*
- **Tasmania** Sch. 3 Part III *Stamp Duties Act 1931*
- **Victoria** Sch. 3 Clause 20 *Stamps Act 1958*

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14 Gazzo *v.* Comptroller of Stamps (Vic); *Ex parte* Attorney-General for Victoria (1981) 7 Fam LR 675

44 | Forensic Accounting for Family Law
TAXATION ISSUES

There appears to be no specific exemption in the Northern Territory or the Australian Capital Territory, however in *Liveris v. Commissioner of Taxes* (NT) 90 ATC 4943, the Court of Appeal held that s. 90 of the Family Law Act was a valid law in the Northern Territory.

The current s. 90 of the Family Law Act exempts the following instruments:

- a maintenance agreement made in connection with the dissolution of the marriage which is registered under s. 86 or approved under s. 87 of the Family Law Act;
- a maintenance agreement made in contemplation of the dissolution of the marriage which is registered under s. 86 or approved under s. 87 of the Family Law Act;
- a maintenance agreement registered under s. 86 or approved under s. 87 made in connection with the breakdown of the marriage;
- a deed or other instrument executed under Part VIII of the Family Law Act;
- a maintenance agreement executed by a person as a deed or instrument under s. 86 or s. 87 of the Family Law Act;
- a deed or instrument executed pursuant to an order under Part VII of the Family Law Act.

**Goods & services tax**


GST is a consumption tax that is borne by the end user. It applies to goods sold and services provided in Australia.

Ordinarily, a registered business and individual suppliers (with sales greater than $75,000 per annum) are required to:

- pay GST on each acquisition of goods and services;
- charge GST on each supply made; and
- remit the net of GST charged on supplies and paid on acquisitions.

The GST Act provides no explicit exemption for taxable supplies made during the alteration of property interests between spouses separating.

As a general rule however, transactions between husband and wife will not attract GST primarily due to the fact that they are not “enterprises” for the purposes of the legislation.

The matrimonial home retained by a spouse is a residential building occupied as a residence. Section 40.65 of the GST Act provides that residential premises are “input taxed” and therefore are not a taxable supply.

The transfer of the shares in the family company by one spouse is also not a taxable supply (due to financial supplies such as shares being input taxed).
TAXATION ISSUES

Section 38.325 of the GST Act provides that the supply of a going concern business is GST-free if the supplier and recipient have agreed in writing that the supply is of a going-concern. In all probability it would be difficult to argue that a transfer of a motor vehicle to the wife from a business comes as part of a going concern. It would therefore attract GST in the hands of the company.

GST issues will only occur where the parties have been involved in “business activities”. The matrimonial home, holiday houses and residential investments are exempt, as are shares, unit trusts, monies in savings and investment accounts, and superannuation.

The cost of legal advice, accounting and other professional advice will include GST. As the divorcing parties are the end users of these services, they will not be able to offset the GST component of the professionals’ fees.

Costs associated with the transfer of assets such as real estate agent fees and legal fees will include a non-recoverable GST component.
Historically, the Family Court treated superannuation as a financial resource rather than as property (refer In the Marriage of Harrison (1996) FLC 92–682). If there were other assets they would generally be adjusted to take into account the fact that one party may receive significantly more superannuation in the future.

The Family Law Legislation Amendment (Superannuation) Act 2001 significantly revised the treatment of superannuation on the breakdown of a marriage.

Superannuation entitlements are now treated as property under the s. 19MC of the Family Law Act 1975 and can be either divided or flagged for future division between the parties.

Before the court is able to order the division of superannuation entitlements in property settlement proceedings, s. 90MT(2) of the Family Law Act 1975 requires that the entitlements be valued.

Broadly, there are two types of superannuation schemes that operate in Australia:

- **Accumulation Schemes** — these are able to be divided relatively easily as the amount in the fund can be readily determined at any point in time.

- **Defined Benefit Funds** — entitlements are based on years of service with an employer, salary levels prior to retirement, level of contributions, investment earnings, etc.

Complex valuation issues arise in relation to Defined Benefit Funds (because the final benefit will depend upon events (retirement age, vesting rules, etc.). The Family Law Regulations 1984 and the Superannuation Industry (Supervision) Regulations 1994 provide for different methods of valuing a superannuation interest depending on the nature of the fund.

The court is required to value a superannuation interest in accordance with any method set out in the Family Law (Superannuation) Regulations 2001. These Regulations provide methods for determining the value of defined benefit superannuation interests in the growth phase (rules 28, 29 and Schedule 2).

The Family Law Legislation Amendment (Superannuation) Act 2001 allows divorced or separated couples to make binding agreements about their superannuation interests in the same way that they can with other matrimonial assets.

Parties are able to “flag” or “split” superannuation interests provided that a s. 79 Property Order or a s. 87 Maintenance Agreement under the Family Law Act are not in place.

A “flagging” agreement will prevent any payment for a superannuation interest until the “flag” is lifted by court order or the parties’ agreement. It can be used to defer a payment until a more suitable time, such as when the actual value of the superannuation interest would become known.

A superannuation interest held by a member’s spouse can be “split”, unless it gives rise to a withdrawal benefit of less than $5,000.

There is CGT relief for “splitting”.

Taxation issues with respect to loan entitlements can be complex particularly in relation to private companies.

Division 7A of the *Income Tax Assessment Act 1936* (Cth) (“ITAA 1936”) may apply if a private company pays or credits an amount to a shareholder or associate, or forgives an amount owed by a shareholder or associate to the company. Should the deemed dividend provisions apply, then the amount will be considered to be an unfranked dividend in the hands of the shareholder or the associate. Section 109C(1) states:

“a private company is taken to pay a dividend to an entity at the end of the private company’s year of income and if the private company pays an amount to the entity during the year and either:

(a) the payment is made when the entity is a shareholder in the private company or an associate of such a shareholder; or

(b) a reasonable person would conclude (having regard to all the circumstances) that the payment is made because the entity has been such a shareholder or associate at some time.”

Division 7A applies to loans made after 4 December 1997. Section 108 relates to loans before that date. The key difference between s. 108 and Division 7A is that s. 108 requires a determination by the Commission of Taxation that the loans made to the parties by the company shall constitute a deemed dividend, whereas Division 7A is more clear-cut.

Income Tax Ruling IT2637 (1991) under the former s. 108 of ITAA 1936 makes no mention of exemptions for forgiveness of loans resulting from family law property settlements. Exceptions relate to written agreement loans that adopt minimum terms for interest rates, security, repayments and terms.

It is common for a private company to lend to a shareholder in order to meet obligations under a proposed property settlement.

Also, with private companies it is common to find companies that have reinvested profits over the years and therefore have significant retained earnings (whether franked or unfranked). Should an allowance be made to recognise that upon winding up (or payment of dividends) for the difference between the franked amount and the marginal tax rate of the shareholder? It is common practice to recognise the potential tax liability in the hands of a shareholder after considering whether debit loan accounts need to be cleared, the marginal tax rate of the shareholder, the time value of the tax liability if it can be deferred for some years.

In *Campbell and Kuskey* [1998] FamCA 10, the court dealt with the issue of potential tax liability under the former s. 108. The trial judge declined to deduct from the overall property of the parties any amount in respect of the income tax payable pursuant to a determination by the Commission of Taxation that the loans made to the parties by the
company shall constitute a deemed dividend per s. 108 of ITAA 1936. Nevertheless this possible liability of the husband was taken into account as a s. 75(2) factor in the husband’s favour. The court held that:

“in most cases it would not be appropriate to treat a contingent taxation liability in this fashion. As a general rule trial judges should make a finding, on the balance of probabilities, as to whether or not such a liability exists, and if so in what amount. If it be found that such a liability exists, the Court should take it into account when calculating the net amount available for distribution between the parties, but in an appropriate case discounting the amount of such liability if circumstances warrant, for example, through uncertainty as to the time of payment.”

The parties’ two expert accountants addressed the issue of the potential s. 108 problem during the expert conference and recommenced that a dividend be declared to clear the loan accounts. The tax implications of this (after allowing for franking credits associated with the dividend and the tax payable at the marginal tax rates of the shareholders) was that income tax would still be payable.

Clearly, the loan account positions need to be carefully analysed prior to finalising any property settlement. Issues such as ramifications of debt forgiveness, unfranked deemed dividends, fringe benefits tax, etc. need to be considered.
Payments made for spousal or child maintenance are not assessable income in the hands of the recipients and are not allowable deductions for the maintenance payer.

If payments are made to a person who is or was a spouse of the maintenance payer or for the benefit of a child of the maintenance payer, they will not be assessable as income in the hands of the recipient. A spouse includes a de facto spouse and a child includes a stepchild, an adopted child or an ex-nuptial child.

The exemption from income tax is applicable regardless of whether the payments are made directly by the maintenance payer or through a body such as the Child Support Agency. Maintenance payments are not allowable deductions in the hands of the maintenance payer, regardless of whether the expenditure was incurred in the production of assessable income.

**Tax-effective maintenance payments may be achieved through the use of a child maintenance trust.**

A child maintenance trust may be utilised by a non-custodial parent to meet maintenance obligations. The attraction of these structures is that the high rates of income tax which ordinarily apply to the unearned income of minors under Division 6AA of the *Income Tax Assessment Act 1936* (“ITAA 1936”), do not apply to income which is derived from property transferred to a trustee for the benefit of a child to the marriage (s. 102AG(2)(c)(viii) ITAA 1936). That is ordinarily minors who have unearned income over $416 per annum will be taxed on that income at the top marginal rate of income tax. However under a valid child maintenance trust, the unearned income of the children or beneficiaries of the trust will be subject to the normal tax rates of an individual.

To be effective a child maintenance trust needs to be set up as a “result of a family breakdown”, and not necessarily as a result of an order or decree pursuant to the Family Law Act as was previously the requirement under the original legislation which was amended in 1994.

Additionally there must be a transfer of property from the non-custodial parent to the child maintenance trust, and the beneficiaries (the children) must be exclusively entitled to the trust property on vesting of the trust.

Further, the concessional tax treatment will only apply to arm’s length transactions, that is, the property which is transferred to the trust must be invested at commercial terms in order for this test to be met.

These structures may also be used where there is an obligation to pay maintenance although the parties never resided together, these are referred to as the “one night stand” cases (s. 102AGA(3) ITAA 1936).
Russell John Munday

Russell is a chartered accountant and holds a Bachelor of Commerce degree obtained from the University of Melbourne and a Graduate Diploma in Finance & Investment from the Securities Institute of Australia.

He is a Fellow of the Institute of Chartered Accountants in Australia, a Fellow of the Financial Services Institute of Australasia, an Associate of the Australian Institute of Management and an Associate of the Australian Institute of Company Directors.

He has over 30 years experience in chartered accounting being employed in many areas of accounting including auditing, business and taxation services and corporate finance.

As a forensic accountant he undertakes investigations, assessment of loss of earnings, expert determinations, professional opinions (of the actions of accountants, auditors and advisers) and the valuation of businesses for compliance (CGT, stamp duty, probate, etc.), mergers and acquisition (business acquisitions, sales, mergers, partnership admissions/retirements, etc.) and dispute (matrimonial disputes, shareholder disputes, etc.) reasons.

Russell has appeared as an expert witness in a variety of matters in the Supreme Court, Federal Court, County Court and Family Court.

He was the founding chair of the Melbourne branch of the Forensic Accounting Special Interest Group of the Institute of Chartered Accountants in Australia and is a member of the Business Valuation Special Interest Group.

He has presented on the subject of Business Valuations on numerous occasions such as at the CPA Australia’s Congress, for Legal & Accounting Management Seminars Pty Ltd and at the Leo Cussen Institute.
P Bruce Wilkinson

Since 1989, Bruce has specialised in forensic accounting, undertaking investigations, assessment of loss of profits, expert determinations, professional opinions (concerning actions of accountants, auditors and advisers) and valuation of businesses for a variety of purposes.

Bruce is a Fellow of the Institute of Chartered Accountants in Australia and holds a Bachelor of Business (Accounting) obtained from the Royal Melbourne Institute of Technology in 1979.

He is a Fellow of the Taxation Institute of Australia, a Registered Company Auditor, and a Registered Tax Agent.

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Having over 35 years experience in both commercial and professional accounting services, Bruce has been employed in many areas of accounting including auditing, business services and taxation services and in commerce.

Bruce has prepared expert witness reports for matters before most major jurisdictions in Australia and has provided a deposition for a matter before the Eastern District Court of New York. In support of reports prepared Bruce has appeared as an expert witness in Supreme Court of Victoria, Federal Court of Australia, Family Court of Australia, County Court of Victoria, Magistrates’ Court of Victoria, Victorian Civil and Administrative Tribunal and in various arbitrations.

With extensive experience as a specialist forensic accountant, Bruce is able to readily advise on the commercial reality underlying a dispute and provide invaluable guidance on the accounting evidence.

Bruce also provides more traditional corporate service consulting work including consulting to State Government authorities, and claimants, on the financial impact on businesses affected by the compulsory acquisition of property from which they operate and the level of compensation payable on the destruction or relocation of the business.
Munday Wilkinson is a boutique forensic accounting firm established in July 2000 by Russell Munday and Bruce Wilkinson.

We offer the legal profession and others quality service and technical proficiency commensurate with the larger accounting firms. At the same time, we are able to provide a more personalised service as we operate in a framework that enables us to be very responsive to our clients in a cost-effective manner.

The directors, Russell Munday, Bruce Wilkinson and Paul Spence, jointly have over 85 years accounting experience including over 45 years specialising in forensic accounting. We have extensive experience in:

- business and company valuations
- family law investigations, valuations and tax advice on settlements
- quantification of economic losses
- fraud audits and reviews
- loss of earnings assessments for personal injury matters
- business relocation or compulsory acquisition — claims assistance
- due diligence reviews
- professional negligence matters concerning professional advisors
- solvency reviews
- expert determinations
- expert witness.

The firm produces a regular newsletter *MW Forensic*, an information bulletin on topical forensic accounting or expert witness matters pertinent to the legal profession.