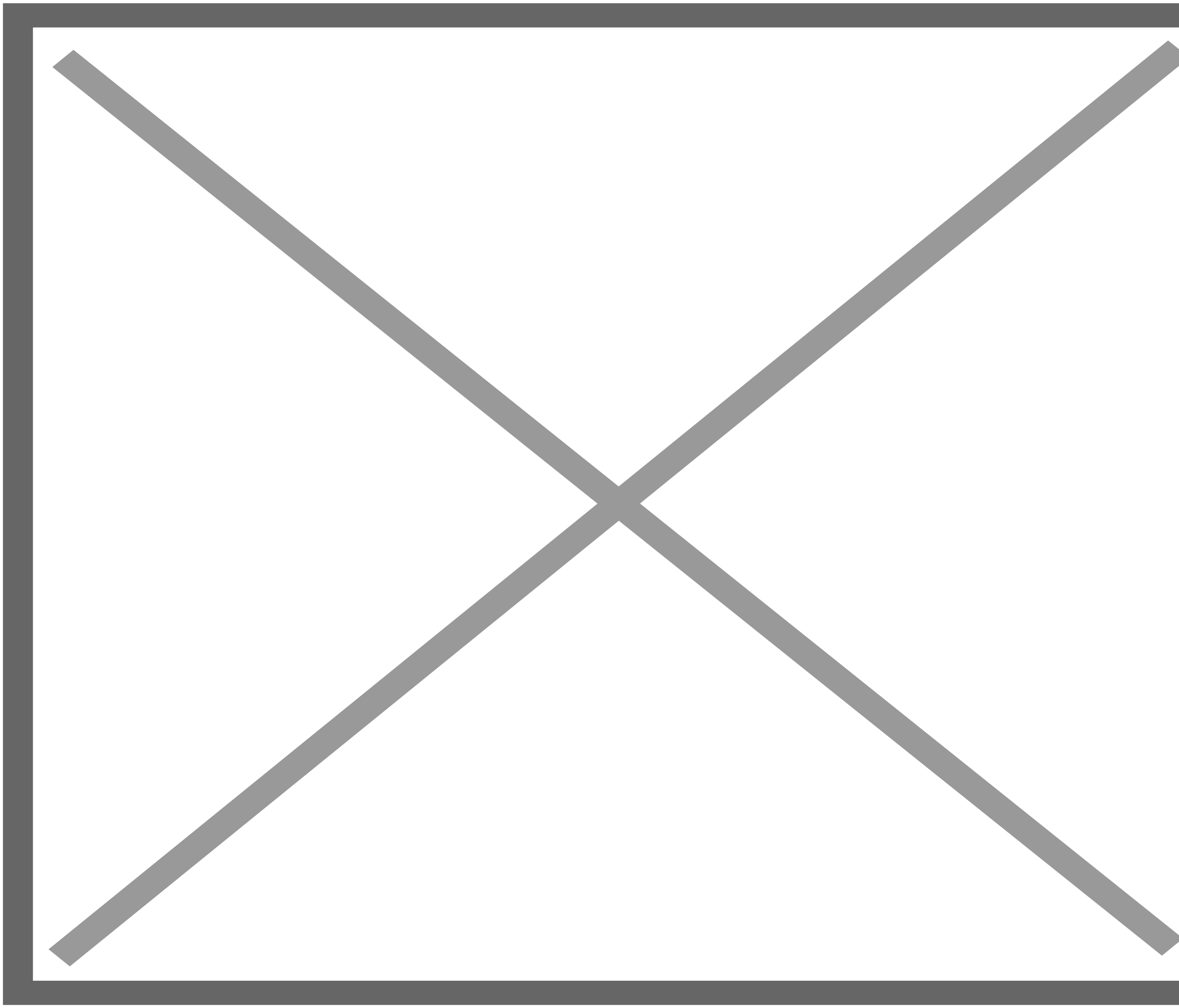
When Harry divorced Sally

Personal tax



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Anton Lane looks at the tax issues that may need to be considered when a couple is divorcing

Key Points

What is the issue?

Divorce is never easy and the timing and method to sell assets or give assets to the other spouse requires careful consideration.

What does it mean to me?

An adviser should make their clients aware that consideration needs to be given early on, after the date of separation to ensure the best possible tax outcome. Clients may not wish to because they may believe separation may not result in divorce.

What can I take away?

It is important to consider multiple perspectives when representing clients.

2017 saw a decrease in divorces of opposite-sex couples in England and Wales. It was the lowest divorce rate for opposite sex couples since 1973. The average duration of marriage for opposite sex couples was 12.2 years and divorce rates were highest among men aged 45 to 49 and women aged 40 to 44. 52% of wives and 37% of husbands petitioned for divorce on grounds of unreasonable behaviour: the most common reason for opposite-sex couples divorcing.

The amount of divorces for same-sex couples was more than three times that in 2016 and more than three quarters were female. 83% of divorces among women and 73% among men were for unreasonable behaviour.

Given these statistics: Harry is 47 and Sally is 42. They are an opposite sex couple and have been married for just over 12 years. They separated on 14 December 2018. It was Sally who wanted to separate due to Harry's unreasonable behaviour and she will petition for divorce. Sally's solicitor has indicated it may take nine months to divorce and she therefore considers she will be free by September 2019. The couple have two children aged 11 and 8.

Sally bought the family home on 6 April 2005.

Harry and Sally are equal shareholders in Style Ltd, which is a Savile Row tailor. Harry studied fashion at college and Style Ltd has been remarkably successful designing clothes for the rich and famous since its establishment in 2014. Harry works mainly from home whilst his team of tailors run the client facing shop. Sally is a lawyer and is a partner in a newly formed legal practice which has yet to generate any significant fees. Sally receives employment income from Style Ltd as well as dividends. It is estimated that Style Ltd is worth £1m. Harry and Sally also own an investment portfolio of shares worth £0.25m, cash ISAs £0.1m and four unencumbered rental properties worth £0.6m.

The family home

Although the property is registered in one name, it does not prevent Harry from having a beneficial interest if he had directly or indirectly contributed in money or money's worth towards the cost of the purchase. Sally is the legal owner, although Harry will have entitlement to capital and therefore it is likely that either an interest in the property or proceeds from its sale will be divided between the two.

Ordinarily, if Sally transferred the property to Harry, it would be a disposal for CGT purposes. However, legislation provides that a transfer occurring in the tax year of separation takes place at neither a gain nor a loss (TCGA 1992 s 58). Harry would receive the property at Sally's disposal value.

However, Sally might let Harry reside in the property, live elsewhere, and then transfer the property to him at say 30 September 2019. The transfer would not be protected by section 58 TCGA 1992 because it is not within the tax year of separation. The transfer would be a disposal for CGT purposes; although Harry until recently resided in the property, it should be regarded as his principal private residence (TCGA 1992 s 222). The last 18 months will be a period of deemed occupancy. There is also further protection where a spouse ceases to live with the other and subsequently disposes of an interest in the dwelling to them (TCGA 1992 s 225B). If certain conditions are met, the property will continue to be the transferor's main residence for the purposes of sections 222 to 224 TCGA. However, one of the conditions is that Sally has not provided notice of another residence to be her main residence.

As the year of potential freedom unfolds, Sally has rented alternative accommodation whilst Harry remains at the property. Harry became the children's primary carer. Sally and Harry divorced in December 2020. A court order in January 2021 provided that Sally holds the property on trust for Harry and their children until all the children had attained maturity (18 years old). All the children will be 18 years old or older by August 2028. The property will be sold in September 2028.

It may be in this situation that a Mesher order is appropriate (*Mesher v Mesher* 1980). The court order postpones the sale of the home and gives a charge back to a spouse exercisable on the occurrence of specified events. These orders originated to permit a spouse to remain in the home with the children until maturity or a further order of the court. The order can still be made if there are no children. The orders were more common 30 or more years ago. More commonly today, agreements are reached between spouses which may still contain similar provisions.

If Harry and Sally enter into such an agreement or if made by order of the court, the property would be transferred to a trust at the date of that order or agreement. The trustee is likely to be Sally, who would hold the interest subject to that order or agreement. Sally would have made a disposal for CGT purposes although, provided the property meets the conditions for a private residence, the gain should be exempt at the time the settlement is formed.

The deferred period ends when the children reach maturity and at that time Harry would become the outright owner. There would be a deemed disposal although, if Harry occupied the property as the only or main residence, the trustee would benefit from private residence relief for the trust period.

Sally, as the non-occupying spouse, would reacquire the share in the property at its current market value. and this value is taken into account when calculating a gain on a subsequent disposal (TCGA 1992 ss 70, 71, 225).

Style Ltd

Sally is rather keen to ensure she maintains an income stream, which currently comes from Style Ltd. However, she doesn't do much (if anything) in the business other than critique Harry's designs, often with little empathy. Conversely, Harry is quite keen to secure title over Sally's shares.

It feels unlikely, but Sally could give her shares to Harry. If that gift is made after the tax year of separation the gift would be a disposal for CGT purposes. It may be possible to make a claim to hold-over gains. Hold-over Relief may be claimed for gifts of unlisted shares in trading companies (TCGA 1992 s 165).

Sally isn't going to give up the shares easily but would do so in exchange for Harry's interest in the rental properties. Since Sally would be receiving something in return for the asset, a liability to CGT could arise on the excess of the value over the base cost. The balance could be held-over although in this situation it is likely the value received exceeds the value of the shares held in Style Ltd. If, however, the transfer was under the provisions of a court order or a consent order, there is no surrender of rights constituting actual consideration. Sally and Harry don't agree about the properties and an alternative may be for Harry to buy Sally's shares using the proceeds from ISAs. The receipt of funds from the ISAs is tax free. Sally would sell her shares so would in turn realise a gain. Sally may be able to benefit from roll-over relief if she replaces it with another qualifying asset.

The relief allows CGT to be deferred on the sale of a business asset when replacing it with another business asset within a period. Furnished holiday lettings are a business asset/trade for roll-over relief purposes provided the income tax conditions are met. Sally contemplates acquiring assets for use within her business. She also contemplates putting the funds into her business to get the relief but subsequently drawing them for her own personal use. The new asset must be used within a business. The rules are relaxed slightly where capital expenditure is first incurred for the purposes of enhancing it. The asset must be used within a trade and is not used for non-trading purposes at any time. Sally is a little disappointed that she has to use the funds for trading purposes but is pleased she doesn't have to decide straight away.

Sally can make a claim within four years after the end of the later of the tax year of:

- The disposal of the old assets; and
- The acquisition of the new assets.

Assuming Sally does not invest in qualifying assets, entrepreneurs' relief will be available for the disposal of qualifying assets. Entrepreneurs' relief is available where there is:

- A material disposal of business assets;
- A disposal which is associated with a material disposal (i.e. business premises owned personally and used by the business); or
- A disposal of trust business assets.

Gains on qualifying assets attract CGT at an effective rate of 10 per cent up to the lifetime limit in force at the time the gain is realised (currently £10m).

Since Sally has owned the shares throughout one-year prior to the disposal, the company is a trading company, her shareholding is greater than 5% of the ordinary shares and she is an employee the shares will qualify.

An alternative to Sally selling to Harry would be a company buy back. Firstly, the buyback needs to be wholly or mainly for the benefit of the trade and secondly not for the avoidance of tax. Sally not wishing to be in the business and the demise of the relationship with other shareholders or director may be regarded as for the benefit of the trade.

There are then four conditions that need to be met:

1. Sally (the seller) must be UK resident in the tax year of the purchase.
2. Sally must have held the shares for five years prior to the purchase. If the shares were received from a spouse or civil partner, provisions allow for the length of ownership to be considered in aggregate. This period is reduced to three years if the shares were acquired by will or intestacy.

3. The purchase of shares must substantially reduce Sally’s interest in the company. An interest is taken to be substantially reduced if it is not more than 75% of the seller’s interest prior to the transaction taking place.
4. Immediately after the transaction, Sally must not be connected with the company making the purchase, or any other company in the same group.

At the date of separation, Sally would not have owned the shares for five years. However, at some time in 2019, she would have owned them for five years and it is therefore important to consider the timing of a company buyback.

The day after Harry receives the shares, he terminates Sally’s employment for gross misconduct. Apparently, she was never in attendance.
It is quite possible that HMRC will become aware of the employment either through the employment tribunal or the court process for the divorce. The salary could be within the scope of the settlements legislation and taxable on Harry or it may be regarded as not wholly and exclusively for the purposes of the business for corporation tax purposes.

Maybe Harry should have been more diplomatic in his approach.