Capital split

Personal tax

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In the first of a two-part series, Emma Chamberlain considers the capital gains tax issues arising on divorce

Key Points

What is the issue?

Are payments by foreign domiciliaries to civil partners or spouses on divorce a taxable remittance? How best can they be funded?

What does it mean for me?

How best to structure divorce settlements and traps to watch

What can I take away?

Timing of payments and indemnity issues

On divorce, the assets must be divided up as the couple agree or, if no agreement is reached, as the Family Court ultimately determines. Let’s say that H has to pay W some cash or property in final settlement of her claims.

If the couple are resident and domiciled in the UK, the main point to consider on any transfer of assets is capital gains tax. If the transfer is done during the tax year of separation, even if they are no longer living together, it is treated as taking place on a no-gain, no-loss basis (TCGA 1992 s 58); otherwise it is treated as taking place at market value and capital gains tax may arise. There are various reliefs that may applicable but the safest option is to transfer assets in the same tax year as the couple separate.

If the paying party (assume H) is not UK domiciled he may have large amounts of untaxed relevant foreign income or foreign chargeable gains that have been carefully kept abroad and not remitted. His matrimonial adviser tells him that these assets have to be included in the total resources available to the couple and that he may need to pay W by using some of these funds. H objects that he will have to pay tax on these funds if they are brought to the UK. Is there a better solution?

Position for UK resident and domiciled persons

Income Tax

This is not a major consideration as the allowance for married couples and civil partners, which is lost on divorce, can only be claimed anyway by a restricted class of taxpayers born before 6 April 1935. There is no income tax relief on maintenance payments which are tax free in the hands of the recipient and paid out of taxed income of the payer.

On separation the presumption in ITA 2007 s836 that a married couple/civil partners are equally entitled to the income from jointly owned assets ceases unless it has already been rebutted by a declaration under ITA 2007 s837. After separation each party is taxed on the income arising from the asset according to his or her beneficial ownership.

If husband has claimed any EIS income tax relief and transfers such investments to the wife after they have separated but within three years of acquiring them, whether or not the transfer is in the same tax year the income tax relief is clawed back. See ITA 2008 s209. The rule is different on EIS deferral relief where there is no clawback of capital gains tax deferral relief if the transfer of EIS investments occurs in the year of separation.

Capital Gains Tax

As noted above, transfers between spouses/civil partners should generally take place in a tax year in which they are living together: the assets then being transferred at no gain no loss. The date of disposal is usually the date of agreement (TCGA 1992 s28) but if the transfer takes place pursuant to a court order then it is the date of the court order unless the order precedes decree absolute in which case it is the date of decree absolute (CGTM22410-22423). However, if the transfer of property takes place immediately without waiting for decree absolute or the order to take effect then it is the date of the actual transfer.

Example

1. H and W separate in May 2006. Provided that any transfers take place between them before April 6, 2007 they are treated as taking place on a no gain no loss basis. After April 5, 2007 the transfers are at market value.

2. H and W obtain a court order in year 1 requiring transfer of property to W on decree absolute (year 2). The date of disposal is year 2. If the parties want the disposal to take place in year 1 they must accelerate the transfer into year 1.

3. H and W have a court order after decree absolute requiring transfer of property. The date of transfer for CGT purposes is the date of the court order.

Business assets and capital gains tax

It is sometimes necessary to transfer business assets to a former spouse as part of the matrimonial settlement. As the transfer normally takes place after the year of separation, CGT may be an issue. Following decree absolute a former husband and wife are no longer connected persons by virtue of their former marital relationship and the subsequent sale of an asset by one to the other is normally a transaction at arm's length. Even if the disposal between them is in pursuance of a court order, TCGA 1992 s17(1) will still apply to the transaction to deem the disposal consideration to be equal to the market value of the asset at the date of disposal. This is because a court order is not a 'bargain' between the parties; it is the court who decides on the terms, not the parties to the order. Coleridge J confirms this interpretation in his comments in *G v G* ([2002] EWHC 1339 (Fam)):

"*In an ancillary relief hearing neither party has any rights as such at all: all the powers are vested in the court which may or may not exercise them. The parties may make suggestions as to how those powers are to be exercised. That is all. So when I order a transfer of shares in favour of the wife on a clean break basis she is not "giving up" her claim for maintenance as a quid pro quo. I am simply exercising my statutory powers in the way I consider to be fair. This would be equally the case where the court was making a consent order, for although the parties may have made their agreement it is for the court independently to adjudge its fairness.*"

G v G confirms that hold over relief under TCGA 1992 s165 can apply if all other conditions are satisfied. However, if the transfer takes place by agreement between the parties without the court’s involvement, no hold-over relief can be claimed. See CGTM67192.

If a hold-over relief claim is made pursuant to a transfer made under a court order the donee will, of course, acquire the shares or business assets at a lower base cost than market value but on a later sale may be able to mitigate the tax, for instance by use of entrepreneurs' relief.

SDLT

Transfers under court orders in divorce and dissolution proceedings are exempt from SDLT including transactions agreed by the parties in contemplation or otherwise in connection with dissolution of the marriage or civil partnership or on the separation of the parties. This is the case even if the transfer takes place by agreement between the parties without a court order (FA 2003 Sch 3(3) and (3A)).

Example 2

Rachel and Martyn separate and Martyn is ordered to transfer his share of the main residence to Rachel. His share is worth £3m. There is no SDLT payable.

The matrimonial home and capital gains tax

For many divorcing couples the matrimonial home is their most significant asset. As part of the divorce settlement, it is usual for it to be sold and the proceeds split or for one spouse to transfer his interest in it to the other. In order for full main residence relief to be available the disposal must take place within 18 months of the property ceasing to be the main residence of the transferor. Section 225B provides further limited relief. The transferred property may continue to be treated as the departing spouse's only or main residence until the date of actual disposal if all the following conditions are met:

(i) the disposal of the interest is pursuant to an agreement made in connection with the separation or dissolution of the marriage or under a court order;
(ii) in the period between the date when the disponer leaves and the disposal occurs, the other spouse occupies the house as his or her main residence;
(iii) the transferor has not elected to treat another dwelling as his main residence for any part of the period concerned. He can acquire another house but cannot claim any main residence relief on it. Thus potential problems are stored up in the future.

No relief is available under s 225B if the property is sold to a third party and the proceeds split between the couple. The house has to be transferred to the other spouse.

What happens when a marriage breaks down and one spouse wishes to remain in residence in the former marital home? Usually this will occur when there are young children and W wants to stay there but has insufficient assets to buy H out. Over the years, two main approaches have been used to enable W to remain in the family home with the children of the marriage while H's interest is protected until eventual sale. The first is by means of a trust, commonly called a Mesher Order, and the second is by means of a deferred charge order. Each has different tax effects.

***Mesher v Mesher* orders**

The former marital home is ordered to be held by H and W with the wife at liberty to live in the house rent-free paying all outgoings and then on eventual sale (e.g. when a child reaches 18) the house is sold and the sale proceeds are split in specified proportions. This order creates a lifetime settlement for CGT and IHT purposes. There is a disposal into trust by H and W to themselves in their capacity as trustees. This disposal is deemed to take place at market value. Provided that not more than 18 months has passed since the departing spouse has left the house then main residence relief should be available in respect of any gain that may arise. When the Mesher Order terminates (e.g. on the children reaching a specified age) the trust ends and there is a deemed disposal and reacquisition under TCGA 1992 s71. Alternatively the order may provide that the house is then to be sold by the trustees. The trustees are entitled to principal private residence relief under TCGA 1992 s225 on the entire gain because one spouse (usually the wife) has occupied the house as a beneficiary throughout the period of the settlement. However, Mesher trusts raise inheritance tax issues discussed in the next article.

Deferred charge order

An alternative option is a deferred charge order stipulating that a spouse receives a capital sum on eventual sale when the children leave the home. Usually H is ordered to transfer his share in the home to W and given a deferred charge on the sale proceeds. There is main residence relief on his disposal to W if it occurs within 18 months. The charge will not be realisable before a specified date such as the date upon which the youngest of the couple’s children turns 18. The amount which is charged might be for a fixed amount with interest or some additional return. On the eventual sale of the home, W will be entitled to main residence relief. On repayment of the debt to H as original creditor no CGT arises although W cannot claim a deduction and H may have to pay tax on any interest element.

Position for foreign domiciliaries

Domicile

H’s tax adviser must first check that his client’s foreign domicile status is secure, otherwise H may find that what he thought was a tax-free fund is in fact one on which past tax is already due. HMRC are under pressure to challenge foreign domicile claims so the adviser must take a sceptical attitude and not just assume that H is foreign domiciled simply because the Revenue have never challenged the

position. HMRC seem particularly interested in cases in which the individual had a UK domicile of origin and is now claiming a foreign domicile of choice. If the individual has been resident in the UK for any length of time a foreign domicile claim may be difficult to sustain.

Any settlement between H and W may need to provide that, in the event H's foreign domicile status is successfully challenged by HMRC for any tax year when past foreign income or gains are still potentially assessable, she will indemnify him for a share of tax arising. This will be particularly important if W's settlement has been calculated on a gross basis without allowance for tax that may arise on H for past events.

Paying W abroad voluntarily before decree absolute

In 2012 there was correspondence between the CIOT and HMRC that confirmed the postion when payment took place after the decree absolute pursuant to court order. Where H pays W to her sole account abroad and W gives no benefit to H or to any relevant person in relation to H, there will be no taxable remittance by H. So W must not use the funds in the UK to benefit minor children or grandchildren of H or settle them into a trust for the benefit of his issue in case that trust remits the funds here.

However, what is the position if H voluntarily gives W funds abroad before the decree absolute in the hope that the court will then order him to pay less later? In short, this is a gift to W when she is still a relevant person in relation to H.

Under ITA 2007 s 809L, remittance occurs if either the general terms of Conditions A and B are met or if the specific terms of the anti-avoidance Conditions C and D are met. Conditions C and D are not relevant if the transfer is made before the decree absolute because a gift to a relevant person cannot be treated as a gift to a gift recipient just because W ceases to be a relevant person after the decree absolute. Conditions A and B *are* potentially relevant since W remains a relevant person in relation to H at the date she receives the monies. However, no problems arise if W does not bring the money to the UK before the decree absolute.

General remittance under Conditions A and B occurs if money or other property 'is brought to, or received or used in, the UK by or for the benefit of a relevant person' (Condition A) and such funds derive from foreign chargeable gains or relevant foreign income (Condition B). H, W (while still married to H) and any minor children or grandchildren, as well as any trust that benefits them, are all relevant persons.

See ITA 2007 s 809M. Both conditions must be satisfied if a taxable remittance is to arise on H.

Therefore, if H voluntarily pays W abroad before the decree absolute when she is a relevant person in relation to H it is vital that she retains the funds abroad until after decree absolute. *Prima facie* Condition A is not satisfied. W will not remit until after the decree absolute, at which point she will cease to be a relevant person. It is important, however, that W does not set up a trust that can benefit the minor children or grandchildren of H (or H) if that trust remits the funds. This requirement is in effect unlimited in time at least while H is alive and UK resident. So W should not give the minor children an allowance out of these funds. H will have to pay maintenance for the children out of clean capital.

W should therefore undertake in a separate deed not to remit the funds in such a way as to benefit any relevant person in relation to H and to indemnify H for all tax, interest and penalties arising if she does so. H may not know until much later whether W has used the funds in a way that causes him a taxable remittance. The penalty, therefore, has to lie firmly on W in all respects. However, even with an indemnity this route is not free from practical problems because H will have to collect the money from W if she does breach the conditions and she may not tell him the right figures. In fact, if she repays him some money that he gave her abroad pursuant to the indemnity, that could itself be treated as a further taxable remittance by H because W has used the funds to benefit him and trigger grossing up!

It should be noted that the legislation does not prohibit all benefits to relevant persons. For example, if W is given the funds abroad and then later uses them to buy a house here in which the minor children live, although that technically benefits them in the UK it does not constitute a taxable remittance by a relevant person. This is because s 809L(3)(b) (ii) makes it clear that, in relation to derived funds (those that have been gifted), the property must, at the relevant date of remittance, be property of a relevant person. Although W maybe benefiting relevant persons at the date the funds are in the UK, she is not putting the funds into the minor children’s own hands.

Payment to W abroad under court order before or after decree absolute

It may not always be possible for H to pay W under a voluntary agreement and instead H has to be ordered to pay W pursuant to a court order or as part of heads of agreement ratified in a court order. Clearly, then, a debt has arisen, being an obligation imposed by the court which is satisfied by H's payment to W.

The issue therefore becomes whether H's debt to W is a relevant debt. That term is defined in s 809L(7) as a debt that relates to property brought to or received or used in the UK for the relevant person. What, then, does H's debt to W relate to? Normally we would assume it relates to the property that the borrowed money is used to purchase – for example, borrowing abroad to fund the purchase of UK houses or chattels brought to the UK. Here, H's debt to W was not incurred to buy any item of property. If there is a debt that relates to anything it must be to W's rights under UK matrimonial law.

It is difficult to see that such rights are 'property' received or brought to or used in the UK by a relevant person. In *Haines v Hill* [2007] EWCA Civ 1284, Sir Andrew Morritt indicated at para 29 that entitlement under matrimonial law was not a proprietary right. Until a court makes an order, W has no interest at all in H's property. Can W's rights under matrimonial law be said to be 'brought to, or received or used in, the UK by or for the benefit of a relevant person'? It is difficult to see how a right of action can be 'used'.

In the CIOT-HMRC correspondence on remittance and divorce in 2012, HMRC emphasise that their conclusion there is no taxable remittance is based on the payment from husband to wife being made after the decree absolute, perhaps on the basis that W is not using anything at a time when she is a relevant person and therefore no debt issue arises.

If W is paid after the decree absolute, is there a risk that Condition C in s 809L would be engaged because W is a gift recipient? In that event any benefit to the minor children might need to be avoided. In the author's view, W is not a gift recipient. Section 809N(5) states that an individual makes a gift of property if he disposes of the property either for no consideration or 'for consideration less than the full consideration in money or money's worth that would be given if the disposal were by way of bargain at arm's length'. In *Haines v Hill* the husband had been ordered in matrimonial proceedings to transfer an asset to his wife. The issue was whether this asset was available to the creditors in his bankruptcy. The Court of Appeal held not, on the ground the wife had given full consideration. This would appear to contradict

G v G [2002] EWHC 306 (Fam), which held in the context of hold over relief that there was no consideration. However, as the judge noted at para 30 of *Haines*, the fact the transfer ordered by the court does not give rise to a payment of consideration between the parties so as to reduce the value of holdover relief for capital gains tax does not entail a conclusion that a property adjustment order must be regarded as being made for no consideration within the meaning of the Insolvency Act. It is not a voluntary transaction between the parties but ordered by the court.

Conclusions on remittance question

There is no clear answer as to whether H is better to pay W the sum abroad before or after the decree absolute. It is not thought that either option causes a problem. But if he can pay her as a voluntary payment to her sole account abroad, with W undertaking not to remit until after the decree absolute and in any event not to let the funds be used in such a way that they are remitted by a relevant person that will be the best option. If he cannot do this, the payment is probably best done to W's account after the decree absolute. However, W should sign a deed pursuant to which she undertakes not to use the funds in such a way that could cause H a taxable remittance and to indemnify him for any tax that may arise (including any grossed up tax) if she does so.

Indemnities

Either party may want an indemnity from the other in relation to points of uncertainty particularly in relation to tax – for example, if H was involved in a tax scheme and has yet to establish whether this is accepted by HMRC. Possibly H is undergoing a tax enquiry in relation to his domicile status and therefore tax may turn out to be payable on past foreign income and gains. It would be unfair if H received no discount for his risk and yet ended up paying the full amount of tax that may turn out to be due. Equally, deducting the full potential amount of tax would be unfair to W if the tax never materialises.

The court may decide to deal with tax risks in one of two ways:

- Assess the realistic tax risk and then discount the amount that has to be paid by H to W. That is a rough and ready approach because the risk may end up materialising or disappearing, and one side has gained. However, it achieves a

clean break.

- Order W, as transferee, to indemnify H and pay him a reverse contingent lump sum if such a risk materialises. Of course, if H has paid W a sum abroad and she later has to pay some of that back to him under the terms of an indemnity, this could constitute a further taxable remittance by H of foreign untaxed income leading to that sum having to be grossed up. Moreover, he is clearly then receiving a benefit, leading to potential double grossing up. These issues, although generally resolvable, will have to be considered carefully in drawing up the terms of any divorce settlement.

The time limits that are relevant in relation to any tax indemnity are as follows:

(a) If full disclosure is made when H submits his tax return and the inspector's attention is specifically directed to the relevance and completeness of all the information provided with the return, including where relevant his domicile status and divorce remittance issues, then after 12 months from filing HMRC should not be able to raise any further challenge.

(b) It is unlikely that H will be able to make a sufficient disclosure on all tax risks to preclude any possibility of a discovery assessment into his return. In these circumstances a discovery assessment can be made at any time up to four years after the end of the year of assessment. If H fails to take reasonable care, this can be extended to six years from the end of the year of assessment. A small failure by H on one point could allow HMRC to extend any discovery assessment more widely. This would enable HMRC to challenge the tax position on payments by H made in this tax year for some time to come. So W's indemnity might need to cover any tax challenge made for at least four tax years from the end of the year in which the relevant tax risk arises. Of course, W's indemnity may have to last considerably longer than this if the tax challenge is made within these time limits but not resolved quickly.

Further information

A fuller consideration of these issues can be found in *Trust Taxation and Estate Planning – 4th Edition* (Sweet & Maxwell) by Chamberlain and Whitehouse.