Cross border divorce

International Tax Personal tax

01 August 2017

Meg Saksida considers the tax aspects of cross border expatriate divorce

Key Points

What is the issue?

Taxation of individuals during a divorce can be potentially complicated by one or both of the parties being classified as non UK resident.

What does it mean to me?

The time of the separation is crucial to the subsequent tax implications of the settlement in the divorce, as is the residence of the parties. Knowing the situation and advising the client at the beginning of the proceedings is crucial to avoid costly tax implications especially if a move back to the UK is planned for one of the parties.

What can I take away?

Divorcing clients living abroad should seek tax advice sooner rather than later, to ensure any financial settlement between them is free from any unexpected tax surprises.

Divorce is never pleasant, and one imagines the last thing on the mind of a divorcing couple is tax. However, the impact of tax on a divorcing individual can be financially critical, and this is exacerbated when considered in the light of the British expat and a cross border divorce.

Tax residence

The first and crucial thing to consider when advising a divorcing couple of the tax implication of divorce is the tax residence of the parties, and for capital gains tax, how long they have been non-resident. Whether one or both of the parties wish to return to the UK after the divorce is also important information.

Tax residence may not always be the same as 'where you live'. For an expat non-working spouse living in Europe for example, they may find on a day count basis that they are tax resident in the UK despite 'living' in Europe, if they spend a lot of time back and forth to the UK. An individual can also be tax resident in more than one country at the same time and in that case it is necessary to consider the Double Tax Treaty between the countries to determine the treaty residence status which takes precedence.

UK tax residents are taxed on their *worldwide* income and gains. Non UK tax residents are only taxed on income generated in the UK, and ignoring residential property and UK business assets, are not taxed on capital gains, unless they become 'temporarily non resident'.

The statutory residence test is a vast piece of legislation, but it is clear cut in its findings; one is either on the facts, a UK resident or not. There is no degree of subjective interpretation; tax residence is concluded using day counts, working hours, a home available in the UK, or factual ties to the UK. A non-working spouse, for instance living in France, with a house in the UK, minor children at boarding school, and accustomed to spending the school holidays and half terms in the UK with family, may well be – on the facts – a UK tax resident. This may not impact their lives whatsoever if they do not have any income. However in the case of a divorce, such a UK tax resident would then be liable in the UK to all worldwide income and gains, and as such, their tax residence may then become extremely important.

If the expat is on the facts, during the marriage, a non UK resident, in the aftermath of a marriage breakdown, they may wish to return to live in the UK thus becoming a UK resident again. Depending on how long the expat has been out of the UK and non UK tax resident, and the timing of when the marital assets are sold or transferred, will depend on the tax position of the individual. For example, as mentioned above, usually a non UK tax resident living outside the UK is not taxed on their personal capital gains unless they become 'temporarily non-resident'. Temporary non residence is where an individual is living outside the UK for less than five full years, having been UK tax resident for at least four of the previous seven tax years before they left. If it applies, any capital gains that were realised during the period of non-residence CGT free (on assets held when the couple departed), would become chargeable in the year of return to the UK, even though at the time of the sale they were not chargeable.

Timing of separation

The timing of the separation is also a crucial matter. A trial separation is not relevant to HMRC, but the date the separation becomes permanent is, for both income tax and capital gains tax legislation.

But when is a couple officially separated? The income tax legislation definition, which is also used for capital gains tax, and is part of the official statutory definition of 'living together' defines one of three dates, which are the date they are separated;

1. under an order of a court,
2. by a deed of separation, or
3. they are in fact separated in circumstances in which the separation is likely to be permanent.

Clearly the first and second situations are clear cut, but the third is more subjective. It will depend on the facts of the case, and evidence will need to be provided by the tax payer that shows when the decision was made to permanently separate. Sometimes a decision may be made by one partner and not communicated to the other. It may not be the date in which one party leaves the marital home that decides the date of permanent separation. As we will see, this date is crucial, especially for capital gains tax liability.

UK tax resident permanently separated in year of asset distribution

Income tax

For income tax purposes, the UK has independent taxation for married couples. Both parties will be taxed on the income they earn in the UK and worldwide, and both parties will enjoy their own personal allowance. The courts have wide powers to divide marital assets as they see fit irrespective of who legally owns them, so even if the income from assets was being shared in an unequal percentage between the parties to maximise tax efficiency, the assets may be split equally or in other ways in the financial settlement. It is worth also noting that any such declaration of beneficial interests made to HMRC ceases to have effect after the permanent separation, and as such the individuals will then be taxed according to their actual beneficial ownership proportions in the asset.

Capital gains tax

If the couple transferred assets to each other under the financial settlement in the tax year of the permanent separation, this would be done on a 'no gain no loss' basis as it would have been throughout the marriage. The legislation refers to the couple having been living together ***at some time*** in a tax year.

UK tax resident permanently separated in subsequent years

Capital gains tax

If the assets are exchanged in a tax year during which the couple were not at any point living together, but before any dissolution order or decree absolute, the assets will be deemed to be transferred at market value. This is the case even if no money has been exchanged as during a marriage or civil partnership, the couple are connected parties for CGT purposes.

Non UK tax resident permanently separated in year of asset distribution

Income tax

Non UK tax residents are only liable to income generated in the UK.

Capital gains tax

The non-resident individual is outside the UK capital gains tax regime for all capital disposals except residential property (see below) and business assets. Any transfers made to the spouse in the tax year of separation would thus be exempt from capital gains tax on the basis of the non UK residence, while the couple remain abroad. Even if either party chose to relocate to the UK subsequent to or during the divorce, the rules for 'temporary non-residence' would not be invoked, as they would have the transfer of the assets excluded as a result of the 'no gain no loss' rules, just as if they were in the UK, as explained above.

Non UK tax resident permanently separated in subsequent years

Capital gains tax

If the individuals remain non UK resident, any assets transferred to each other in a tax year during which the couple were not at any point living together, but before any dissolution order or decree absolute would be non chargeable for the non UK resident. This is on the basis of their non-residency, being outside the scope of UK capital gains tax (except for residential property). As explained above these transfers would be considered chargeable transfers if the parties were resident in the UK. There could however be a tax charge in the country in which the couple live, and local tax advice should be sought. The only time capital gains tax would be chargeable, would be if they chose to return to the UK and if that return rendered them 'temporarily non-resident'.

Residential property

Although much has been written above on the expat being outside UK capital gains tax by virtue of being non UK resident, this exclusion does not apply to residential property, which is likely to be the major asset changing hands in a divorce settlement. Non-resident capital gains tax 'NRGCT' is charged on gains accruing on a disposal of a UK residential property if the individual is not resident in the UK in the tax year in which the transfer occurs. The NRCGT rules take precedence over the temporary non-residence rules. The tax rates are

18% and 28% (depending on the individual's personal circumstances).

Essentially the NRCGT legislation sought to tax residential property in the UK on the basis of the location of the property, not the location of the owners of the property. As the legislation came in from 6 April 2015, only gains made on the property *from this date* need be taxed. There are three methods for calculating any NRCGT gains and the default method (which is rebasing the asset to the market value on 6 April 2015) will apply unless the taxpayer elects otherwise. The other methods are to time apportion the whole of the gain/loss over the time the property was owned or to take the whole gain or loss (which would clearly only be advantageous for a loss).

There are in addition, complex rules on whether or not the UK property can be elected as the non-resident couple's main residence in order to mitigate some of this charge. Usually there is a two year deadline for making a main residence election (where the individual has more than one residence), but this no longer applies to the non-resident. Instead they can make an irrevocable main residence notification on the NRCGT Return, which can apply retrospectively to any period of previous ownership of the UK residential property. Furthermore if there is already an existing nomination, the nomination on the NRCGT Return is treated as superseding it. In a marriage or civil partnership it is essential that both parties to the relationship affirm this nomination to HMRC, irrespective of which party actually legally owns the property. If one party is not required to file a Return (say the property is owned in only one name) then the individual reporting must attach a written notification from the spouse or civil partner to the NRCGT Return confirming their agreement to the terms of the nomination. If this is not done then the nomination is not valid and the calculation of the NRCGT gain will be incorrect. This is because the existing main residence rules state that a couple can only have one main residence between them.

In order to be considered as the couple's main residence, the dwelling needs to be occupied as their residence. If the individual is not resident in the territory in which the property is, this will only be possible if the individual reaches the day count test set out in the legislation. The day count test is whether the individual was present in the dwelling at midnight (or in real life, was present in the house at some point in the day and stayed overnight in the house) for at least 90 midnights in a year. If the spouse or civil partner was in the property instead, this will count towards the total for the individual, but one can't double count the night if both were in the property. If there is more than one residence in the territory, for the purposes of the 90 day test, all stays at both dwellings count towards the 90 day test. If the day count test is reached and the home is eligible for main residence relief, no chargeable gain arises for UK tax purposes irrespective of the couple's residence at the time of the divorce. The tax position of the couple's country of residence would also need to be considered.

Note that if the property was the couple's former main residence for CGT and it continues to be owned by one of the parties more than 18 months after they leave the property, then a taxable period will be applicable when the property is subsequently disposed of by that party. The leaving spouse should thus definitely take tax advice if they are to continue to own the former marital home while no longer living there.

An important practical point to note, is that an individual making a NRCGT disposal must make a special return reporting the disposal to HMRC within 30 days following the day of the completion of the sale, and in addition, tax on NRCGT gains is generally due 30 days after completion of sale.

Inheritance tax

Unlike income tax and capital gains tax which rely on the date of permanent separation, inheritance tax relies on the date of the decree absolute in the case of a divorce. If the divorce is in the UK, until this date, legally, transfers between the divorcing partners are not chargeable transfers for IHT. However, even after this date, transfers pursuant to court orders made in divorce proceedings between divorcing couples are considered by HMRC to be exempt from IHT as long as there is no intent to confer gratuitous benefit on the transferee. Be careful however if one spouse is domiciled UK and one not. There are restrictions on how much can be transferred and so tax advice needs to be taken in these situations.

If a party to the marriage or civil partnership dies after the divorce, any unused nil rate band on their death is not available to their former spouse or civil partner. Unless the divorcee or former civil partner remarries or enters a new civil partnership, any nil rate band that was unused on their death will remain unused.

Maintenance to both children and former spouses is exempt from IHT, but gifts to children that are not for their education, maintenance or training could be chargeable if not habitual and out of income, and as such, decisions on these type of gifts should be considered with tax advice.