MINIMISING COSTS

Which 6 questions should you always ask your client's tax adviser (e.g. before extracting assets out of a private business)?

Introduction

These notes support the talk by David Kilshaw of Rawlinson & Hunter on 26 November 2019. They are for guidance purposes only and no action or omission should be taken by reference to them without specific advice.

The talk considers the six key questions which you should ask a client's tax adviser (with a view to minimising costs) at the time of a breakdown in a marriage. While for ease the notes refer to 'spouses' in most cases the same position will apply to civil partners.

Question One. What is the family's tax history?

This is probably the most important question. In recent years, HMRC have been successful and persistent in tackling tax avoidance and it is important to know the parties' tax history. In particular, have they participated in mass marketed tax schemes which could have (or have) resulted in large tax demands or which carry reputational issues? Where the family assets include shares in a private company, it is also necessary to consider the history of the Company. Importantly, recent HMRC challenges have been across all types of taxpayer, not just those who might have been expected to have participated in tailored or expensive tax planning. This makes it far more likely that your clients may face unexpected tax liabilities. You do not want to waste time and therefore costs in calculating and agreeing the value of the assets to be divided, if the taxman is about to take a large chunk of them.

Areas of potential concern to review with the tax adviser include (but are not limited to):-

(a) The 2019 loan charge. Has the breadwinner (s) in the family participated in any disguised remuneration planning? For example, many in the IT sector have structured their employment via 'umbrella' companies where the bulk of their pay is received by a loan. HMRC are arguing the loan is taxable as employment income and the legislation from 6th April 2019 will tax the loan as income and as one lump sum amount. Tax may need to be paid by 31st January 2020.

(b) Film partnerships or similar planning. These are still being challenged by HMRC and HMRC now has power:-

   (i) to require payment of tax or NICs upfront before the success or otherwise of a tax scheme has been settled by the courts;

   (ii) to require tax from an individual where HMRC has been successful on that scheme in the courts against other taxpayers.

   If the client has participated in such planning, the tax adviser needs to help you identify how likely a tax bill is and what its impact will be on the pot of available assets (and, if there has been an 'advance' payment to HMRC, what will happen to the funds if the planning ultimately proves to be successful with the consequence that funds are returned to one party by HMRC). This uncertainty may require the parties to seek to adjust the future position via an indemnity, unless the court is prepared to assess the tax risk and then discount the amount to be paid accordingly (an approach which, it is suggested, is increasingly difficult although it does achieve a clean break).

(c) Offshore funds or trusts. These are of particular concern, although perhaps the tax adviser can henceforth be of greater help in the old problem of ''hidden'' assets. As a result of tax transparency, including the Common Reporting Standard (CRS) and beneficial ownership registers HMRC are much more likely to spot non-reported income and gains. In addition, the Requirement to Correct required taxpayers to correct their UK tax position by 30th September last year. For those who did not do so, we are now within the Failure to Correct regime with penalties between 100% and 200% of the tax not corrected. This may impact on many divorces –for example, the parties may have owned a holiday cottage in Spain but have not declared the seasonal rental income to HMRC. Given that trustees and others were subject to the CRS, they and the tax adviser may hold helpful information when trying to establish whether the assets disclosed as part of the divorce process are the iceberg or only its tip.

(d) The family home. This will often be the most significant asset in the marriage. CGT will normally be the main tax in issue. In many cases while the parties are living together, any gain will be sheltered from tax by the Principle Private Residence (PPR) Relief in section 222 TCGA 1992. But what if (by way of example) the husband owns the house but moves out. A sale within 18 months of moving out will be covered still by the PPR Relief but note that this period is to be reduced to 9 months from 6 April 2020. Outside this period the relief in section 225B TCGA 1992 may assist. This provision applies where a married couple cease to live together and the marriage is to be dissolved or annulled and one party moves out of the main residence. If that individual subsequently sells the home to the other spouse, as part of the financial settlement, the home then can be regarded for the purpose of PPR relief as continuing to be a residence of the transferring partner from the date his or her occupation ceased until the date of transfer provide that it has been the partners only or main residence throughout that period. Note, however, the husband must not have elected for some other house to be treated for capital gains tax purposes as his main residence for this period. Note also that section 225B is not available if the house is sold on the market.

Question Two. What is the tax status of each party?

It is imperative to establish the tax status of each party to the marriage and the tax profile (e.g. base costs) of the assets they own. In many cases, the parties will both be resident and domiciled in the UK. However, if they are not this may lead both to tax traps and planning opportunities.

You need to ask too about the'' tax rules'' on transfers between the parties. These rules will be crucial in helping decide the form and timing of any actions This may need you to share factual information with the tax adviser (e.g. the date when one party left the matrimonial home) and help determine when, for example, the home should be transferred. Where the parties are both UK resident and domiciled the rules are as follows:-

(a) For CGT purposes transfers between the spouses while living together as husband and wife are not subject to CGT (section 58 TCGA 1992) and the transfer is treated as if the asset was acquired from the spouse making the disposal for a consideration which would secure that on the disposal neither a gain nor a loss accrues. This rule applies even if the donee is not tax resident in the UK. This ''no gain, no loss'' rule continues to apply until the end of the tax year of permanent separation. Thereafter, the ''no gain, no loss '' rule is displaced and while the parties remain married they are 'connected' for tax purposes with the consequence that any CGT charge is computed by reference to the market value of the asset transferred and not the actual consideration (if any) given for the transfer. The timing of asset transfers thus becomes critical. This may be of particular importance as we are approaching the end of a tax year. Note that HMRC have published detailed notes on the timing of a disposal in the context of a marriage breakdown (see CG MANUAL 22423). In many cases, the CGT position will be very important in relation to the matrimonial home.

(b) For IHT the parties remain as spouses (and hence eligible for the spouse exemption in section 18 IHTA 1984) until decree absolute. In the context of divorce, section 10 IHTA 1984 is also of importance. This exempts from IHT transfers which arise from arm's length negotiations where they are not intended to confer a gratuitous benefit. Business property relief (BPR) which exempts from IHT certain business assets can also be important as discussed below (section 102 et seq. IHTA 1984).

(c) For income tax the spouses will have been separate taxpayers throughout the marriage. The assignment of rights under a life assurance policy does not prompt an income tax charge if made between spouses living together (section 187 ITTOIA 2005). EIS relief is not lost on a disposal of shares to which EIS relief is attached between spouses living together.

Income arising from jointly-held property of spouses or civil partners who are living together is treated as beneficially arising to the parties in equal shares unless an exception applies. In this context, reference should be made to section 836 ITA 2007. This "50/50" rule ceases to apply immediately upon a permanent separation. In any event, the "50/50" rule can be disapplied by the parties completing a joint declaration to the effect that they are beneficially entitled to the income in unequal shares.

The lecturer (while not being an expert on Scottish taxation) understands that Scottish taxpayers receiving Marriage Allowance will lose their eligibility under the Scottish higher rate threshold, whereas if they were in the UK they would not.

Take care too to ask the tax adviser about the residence of any company or trust. An 'overseas' company may in fact be UK tax resident (and therefore within the charge to corporation tax) if it is managed and controlled from the U.K. Sometimes, as the example on the slide illustrates, the marriage breakdown can place tax concerns under the spotlight for the first time. In this case, the parties had established what they considered to be an offshore company and had not paid any UK tax. However, the company was effectively run from the UK and subject to corporation tax.

If one of the parties is non-UK domiciled, this may have a considerable impact on the tax landscape, especially where the taxpayer has been filing on the remittance basis. In addition, there is then an increased likelihood of an offshore trust being involved. Examples of issues which may arise include the following –

(a) From 6th April 2017, the concept of deemed domicile has been introduced. This means that once an individual has been resident for 15 out of the preceding 20 tax years, (s)he can no longer access the remittance basis of taxation (under which offshore income and gains are only subject to tax when remitted to the UK). Tax bills may therefore rise, with a corresponding reduction in the income pot to be allocated. Particular care is required where the taxpayer own shares in an offshore company which receives non-UK source income, since unless the bona fide commercial defence applies this may , for the first time, be taxed on the arising basis under section 720 ITA 2007;

(b) Funding of payments. If a spouse pays tax on the remittance basis, then (s)he will have a tax charge when monies are brought to the UK by or for the benefit of him (her) or a ‘’relevant person’’. Following decree absolute, a spouse ceases to be a relevant person. This can have consequences for funding. For example, if a payment is made outside the UK to a spouse by the non-dom taxpayer, there will be no tax charge on the non-dom if the recipient spouse remits the monies after (s)he has ceased to be a spouse and hence a relevant person. (although the precise factual history must always be reviewed).

(c) If (say) a husband has created an offshore trust for himself and his wife, he may agree to be excluded from benefit under the trust as part of the divorce process. It is very likely that the trust fell within the ambit of section 720 ITA 2007 which is an income tax anti-avoidance provision designed (broadly) to attribute the income to the settlor of the trust. Having been excluded, the husband might have expected that he would also henceforth have been excused from any tax bills in relation to the trust income. However, the definition of spouse in section 720 means that this will not be the case until the legal end of the marriage.

Ask your tax adviser to look to the future as well. You need to know of any mooted or pending changes which may reduce the value of assets. One example, is the charge to tax on non- residents and UK property. The charge has from 6 April 2019 been extended to almost all non-resident owners of U.K. land including indirect disposals (such as sale of shares in an offshore company which owns UK land) (albeit that where assets were owned before April 2019 there will be a form of re-basing although for residential property, the rebasing normally takes effect from 6 April 2015).

Question Three. How should payments be funded?

The next big question is – ‘how to pay?’ This will depend on the nature of the Order and whether there is to be a cash or asset transfer. Where the main asset is shares in a family trading company, the questions to the tax adviser will be around how to transfer the value inherent in that company in the most cost- effective manner.

If there is to be a cash transfer, it may be necessary for the party making the payment to fund it via an extraction from the family company. The question to the tax adviser is then ‘’what is the most efficient way of funding this?’’

A common question is should funds be paid out as a dividend or a bonus? The answer will depend on the precise facts but often the difference will not be as material as anticipated. For 2018/19 onwards, the dividend allowance has been reduced to £2,000 and where dividends exceed this allowance the rates of tax are 7.5%, 32.5% and 38.1%. Remember too that distribution is widely defined and will cover selling an asset to a company at an overvalue and a distribution in specie (where there may also be a corporation tax charge on the company if the asset distributed stands at a gain). It is understood that the different Scottish rates and thresholds apply to earned income only. As a consequence, a Scottish taxpayer in the circumstances under review may have to consider both the UK rates and thresholds and the Scottish rates and thresholds in order to work out their income tax liability.

Where possible, it will obviously be beneficial for the parties to structure the transaction so it benefits from CGT rates and reliefs rather than the higher income tax rates.

Where both spouses are shareholders consider a share buy- back, especially if this can qualify for CGT treatment. The conditions to be satisfied for CGT treatment are in section 1033 CTA 2010 and for present purposes the key ones comprise the following:-

(a) The company must be an unquoted trading company;

(b) The shareholder spouse must be UK resident and owned the shares for five years (although transfers from a spouse can include the spouse's ownership);

(c) The vendor spouse must substantially reduce his/her shareholding, which means that the shareholders' interest in the company must go down by at least 25%;

(d) The vendor must cease to be connected with the company. In essence, the vendor must now own more than 30% of the issued shares or voting power

(e) The purchase by the company must benefit its trade. Note the test is for the benefit of the trade, not the benefit of the company (see HMRC SP 2/82.) The 'trade benefit test' will require the tax adviser and you to consider why the party needs the funds (e.g. are the funds needed to fund the divorce settlement or is the husband and wife's dissention damaging the business?) The company's sole or main purpose in making the payment must be to benefit a trade carried on by it or by its 75% subsidiary. The condition is not satisfied where, for example, the transaction is designed to serve the personal or wider commercial interests of the vending shareholder (although usually he will benefit from it) or where the intended benefit for the company is to some non-trading activity which it also carries on. If there is a disagreement between the shareholders over the management of the company and that disagreement is having or is expected to have an adverse effect on the company's trade, then the purchase will be regarded as satisfying the trade benefit test provided the effect of the transaction is to remove the dissenting shareholder entirely. Similarly, if the purpose is to ensure that an unwilling shareholder who wishes to end his association with the company does not sell his shares to someone who might not be acceptable to the other shareholders, the purchase will normally be regarded as benefiting the company's trade. An advance clearance mechanism is available.

In some cases, there may be a transfer of shares in the trading company between the spouses. The CGT rules discussed above will then be in point. It may also be possible, where there is no consideration, to make a gift relief claim under section 165 TCGA 1992. HMRC accept relief may be claimed where the transfer is pursuant to a court order. Hold over relief avoids any CGT on the transfer but the donee inherits the original base cost so the CGT event is normally only deferred. See HMRC help sheet 281. If the transfer is made by agreement between the parties with no court involvement, hold-over relief cannot be claimed.

In the contest of share transfers, there are a number of factors which can have a noticeable impact on the CGT rate and so you need to ask the tax adviser about tax rates. First, ask if the shareholder qualifies for Entrepreneurs relief (ER). ER is limited to a lifetime threshold of £10m per taxpayer and qualifying gains are charged to CGT at a rate of 10%. The relief is available in respect of a number of assets, including shares in an unquoted trading company, but there are a number of qualifying conditions. Two of the most important conditions have been the subject of recent change:-

(a) First, there has been a tightening (to prevent avoidance) of the rule which requires the shareholder claiming the relief to hold at least 5% of the ordinary share capital;

(b) Second, an increase in the qualifying shareholding period from twelve months to twenty -four months. The change in the qualifying period was effective for disposals on or after 6th April 2019 and, as discussed below, may make things more difficult in a divorce context.

A third condition is that the shareholder must be an employee or officer of the company for the requisite period. The employment need not be paid and need not be full time. This condition may require careful planning in the divorce process (see below).

Second, the receipt of 'carried interest' (i.e. performance-based rewards for investment fund managers) is subject to CGT at 18% or 28% and does not qualify for the 10% or 20% rates.

The tax adviser's input can also be important where one of the parties holds share options. Here it is important to be aware when the most tax efficient exercise of the option needs to take place.

The client may seek to extract funds by the liquidation of his company in order to benefit from CGT rates (but see the trap discussed under question six below). In more complex cases where a business is to be unwound on divorce, you may need to discuss demergers or share variations with the tax adviser.

Question Four. Are there any tax planning tips?

This is the question you have to ask for the simple reason that, despite the present fiscal climate (under which tax avoidance is arguably no more), many clients will still ask it of you. Your tax adviser will hopefully say that there are planning opportunities and the key is to structure things tax efficiently, an approach which HMRC endorse. Examples include:-

(a) If one party may go back to an overseas home after the divorce (so as to become non-resident) consider transferring assets standing at a gain to that spouse during the year of separation;

(b) Similarly, consider if there are any capital losses which can be used;

(c) Consider the opportunity to fund trusts for children. Normally there is a 20% inheritance tax charge where value in excess of the available nil rate band (£ 325,000 for 2019/20) is placed in a trust, but there is no 'entry charge' where assets which qualify for BPR (see above) are settled or advantage is taken of the reliefs in sections 10 (disposals not intended to confer gratuitous benefit) and 21 (normal expenditure out of income) IHTA 1984 ;

(d) Where a client has received cash and wishes to invest it consider the use of a 'family investment company'. This is normally an UK resident company which the client funds by a cash loan. The company then invests the assets but the investment returns are taxed at the (generally) more favourable corporation tax rates as opposed to the income tax or CGT rates. The client, when funds are required, can withdraw these free of tax from the company to the extent of the original loan;

(e) Remember the impact of overseas tax. Remember also the potential impact of currency movements;

(f) Planning may also be important around the time that share options are exercised. Timing may be critical too for a transfer of shares which potentially qualify for ER (see above);

(g) If the parties to the divorce are 'of a certain age' IHT may be more of a consideration, especially with the loss of the spouse exemption. In such event, it may be better not to extract funds from the company (if they are not needed for expenditure) but to keep them in the company where they may qualify for BPR. The definition of a trading company for BPR purposes is one which (because of the ''wholly or mainly'' requirement) can also encompass an investment business enveloped within a trading company;

(h) Careful planning is required if the parties' wish to preserve the full benefit of ER. There are many potential traps. For example, one party may resign as a director and employee because working with the other spouse is just too difficult. The ER on that spouse's shares will be lost. The spouse who wished to resign should be persuaded to stay in some capacity; the case of Susan Corbett v R&C Comrs (2014) provides some authority that an employee need not be paid to continue to qualify for ER, but the prudent course would be to pay a salary. Share sales. One possibility may be to transfer shares between the spouses (while they still qualify for the section 58 TCGA 1992 treatment (see above)) so that the spouse who does not (or who ceases to) qualify for ER transfers shares to the spouse who does. It is not necessary for the recipient spouse (provided (s)he has otherwise held a 5% interest) to have held the additional shares acquired throughout the qualifying period.

Question Five. What is your 'after care' service like?

It is important to stay in touch with the tax adviser after the decree absolute or other conclusion of your work, for the tax tail can sting if overlooked. A number of elections or returns may need to be filed with HMRC. If these are missed, the anticipated tax treatment may not materialise. It is also critical to agree ''who is doing what'', as otherwise you and the tax adviser may leave it to each other with the consequence 'it' never gets done. Examples of what may be comprised in the 'after care' service include:-

(a) Elections. For example, ER must be claimed by an election. There is a precedent for the claim in HMRC help sheet HS275 and the claim must be made by the first anniversary of 31st January following the tax year in which the gain arose. Gift relief under section 165 TCGA 1992 also requires an election and this may require the signature of more than one party and so this should have been agreed as part of the divorce process.

(b) Tax returns. These are a critical part of the process and you should consider if you want to review the material return before it is filed. A poorly thought through or inaccurate return may prompt an unnecessary HMRC enquiry, which is one of the quickest and most painful ways to incur costs. Disclosure is another critical issue. An inadequate disclosure in a tax return enables HMRC to raise a discovery assessment no later than four years after the end of the tax tear to which it relates (section 34 TMA 1970) (extended to six years and twenty years for careless or deliberate behaviour). You should be challenging the tax adviser to have such matters in mind during the divorce process but may need to agree the actual return wording later.

Question Six. What should I have asked?

It is increasingly important that the divorce lawyer and the tax adviser communicate. If in doubt, provide the tax adviser with information as it may be material in a way not immediately apparent. Casual chat can save tax bills and it is imperative that the tax adviser has an understanding of the family history and, just as critically, the after- divorce intentions.

As part of this process, ask the tax adviser some open questions – “what question should I have asked you which I haven’t?’’ and “what else do you need to know?’’

‘’Phoenixism’ (where a new company arises from the ashes of the old) is one example of how the tax analysis may vary depending on whether the facts before the tax adviser are full or of the ‘’need to know’’ variety. The client may have decided to liquidate his trading company to generate funds to pay his former spouse, having done his maths on the basis that after the CGT treatment and ER relief he will have a manageable tax bill. If the client is elderly the tax adviser may have assumed that the client will then retire. Perhaps knowing the client better, you know he will die in the saddle and that as soon as his spouse is out of the picture (s)he will form a new company to trade. The targeted anti avoidance provision in sections 396B and 404A ITTOIA 2005 are then in point and can cause the receipt to be taxed as income rather than as falling within the CGT regime.

Conclusion

The tax landscape has changed dramatically in the last five to ten years. The law has become much more complex and the anti -avoidance case law much deeper. One of the consequences of these changes is that the divorce lawyer and the tax adviser must work much more closely together. You may not want to marry them, but you should certainly select a tax adviser with whom you are happy to spend a lot of time!

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