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Shaping New Law into Solution Focused Advice for Your Clients

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The question to be answered:

“How do you soften the position for clients facing an expensive tax bill on divorce, eg shared business interests, second homes and multiple properties?”

“Soften the Position” or at least “Soften the Blow”

1. Minimising or avoiding tax payable – always good!
2. Ensuring clients know about a tax liability that is coming if it cannot be reduced/avoided – almost as good.

Four Topics for Consideration

1. Capital gains tax (CGT).
2. Land and buildings transaction tax (LBTT) – additional dwelling supplement (ADS).
3. Income tax.
4. Structural considerations when looking at the division of matrimonial property.

Capital Gains Tax

Basic Principle:

Mr X acquires an asset. After the acquisition it increases in value. It is then disposed of by Mr X to a third party. Tax is due on the increase in value.

That is of course subject to various qualifications – reliefs and exemptions apply.

Awareness of the issue is key.

Basic Awareness

- The key “trigger” for awareness should be when our clients are making a disposal of an asset which they own – CGT could arise.
- The “effective date” of disposal is the date a contract is entered into providing for the disposal, or the date it happens if no contract.

“Exemptions”

1. Married (non separated) couples – transfers between spouses on no gain/no loss basis – no tax payable.
2. Separated couples – “same tax year” rule.
3. Principal private residence (PPR) relief – no CGT payable on disposal of “your house”.
4. Pension transfers – no CGT payable.

1. Transfers between Spouses

This is mentioned in passing for completeness's sake. Transfers between (non separated) married couples are on a no gain/no loss basis.

1. “Same Tax Year” Rule

If assets are transferred between husband and wife (after separation) in the same tax year as a separation occurs – no CGT is payable upon any such transfer.

Importantly – the transferee acquires at original acquisition cost therefore there is a “latent” gain on which tax will be paid, effectively being deferred until disposal by the transferee.

A solution?!

Allow no clients with significant wealth to consult you from around the end of February of each year until the 6th of April!

Example 1

H and W own 50% of the shares of a limited company which operates a valuable hotel business. H effectively runs the business. It is a matter of agreement that H will have W's shares transferred to him as part of the overall division of matrimonial property. The capital uplift is unknown but is clearly very significant. H consults his solicitor on the 15th of March!

If a Separation Agreement is signed providing for the transfer after the 5th of April that would trigger a huge tax bill. If before 6th of April it would generate no tax bill.

There was an obvious reluctance on behalf of W to transfer her shares to H in isolation of an overall deal. There was an obvious reluctance on the part of H to pay money for the shares in isolation to an overall deal.

Solution = very long hours for lawyers!

Example 2

Shares in a limited company were owned 50% by H and 50% by W. There were significant other assets some of which were complicated to value. Again the date of consultation was around 15th March.

A solution proposed was that W transfer her shares to H as a standalone exercise in advance of the new tax year.

Advantage – save considerable tax.

“Disadvantage” – W no longer owns a valuable asset and gets nothing in return.

Realistically no overall deal was going to be achievable within a two week period – the result was that tax was on the face of it going to be payable and that required to be factored into consideration.

Illustrates:

1. Tax can be saved.
2. The importance of making clients aware of potential tax liabilities.

PPR Relief

If an individual owns a house that is their PPR then upon transfer/disposal to a third party there is no CGT payable.

Applicable on sale, or transfer to an estranged spouse.

Normally – no CGT payable on disposal of the house.

“18 Month Rule” (Previously “3 Year Rule”, soon to be “9 Month Rule”?)

After a property has ceased to be an individual’s PPR, it is deemed to be the individual’s PPR for a further 18 month period.

After a house ceases to be a PPR as a matter of fact, and after the 18 month period (soon to be 9 months) then CGT is payable on disposal, but only on the proportion of the gain for such period as it is not actually or deemed to be the PPR.

Example 3

H and W live together for many years and then separate. W moves into an investment property owned by her. Resolution of the division of assets is protracted and takes a few years. At resolution stage it is agreed that the title to the former matrimonial home will be transferred to the husband.

For the period when W lived at the FMH it was her PPR. For a further 18 month period it is deemed to be her PPR. Thereafter, her PPR has changed to the investment property and consequently upon transfer of the FMH to H there would potentially be a CGT liability.

It is possible to elect a property as one's PPR. To avoid CGT being payable upon the transfer of the FMH to H W could elect that the FMH is treated to be her PPR. If she does so there will be no CGT payable upon the transfer. However, she loses PPR relief in connection with the investment property, for the same period and CGT will be payable upon disposal of that property in the future.

Example 4

H and W buy a house together in 2000 for £100,000. They separate in 2010. W moves to a flat that she owns. She lives there for two years. A deal is then reached and the house is transferred from W to H. At that point it is worth £500,000.

Ignoring reliefs and exemptions:

W owns half of the house so she acquired it for £50,000 and disposed of it for £250,000. The gain is therefore £200,000.

PPR applies from 2000 to 2010 plus a further 18 month period - 11½ years.

There is no PPR available for a further 6 month period.

$0.5 \text{ year} \div 11.5 \text{ years} \times £200,000 = £8695$ chargeable gain (within annual exemption anyway)

Sometimes possible to elect which property is PPH but must be done within 2 year period.

Pension Transfers

No CGT payable irrespective of when effected.

Structural Considerations

- Transfer of house (or sale and split) normally incurs no CGT.
- Pension transfers – will incur no CGT.
- Transfer of other assets – if not in same tax year – potentially incur CGT.

LBTT - ADS

The basics are basic – if an individual buys a second dwelling for more than £40,000 (whether a second home/holiday home/investment property) then an additional 3% of consideration is due on top of “normal” LBTT.

Miscellaneous Noteworthy Points (albeit not directly relevant to divorce)

1. Properties outwith Scotland “count” (if worth more than £40,000) – so if one owns a home abroad and purchases a property in Scotland, the 3% ADS will apply.
2. Married (non separated) couples and dependent children of those couples are looked as “one economic unit”.

Example 5

H and W are married for a long time but separate. W leaves the former matrimonial home and has available cash to purchase another property. She does so. Either (a) H owns the FMH; (b) W owns the FMH; (c) H and W own the FMH jointly.

ADS would apply in (a) and (c). ADS would not apply in the case of (b).

“Replacing a Main Residence”

If doing so – ADS is avoided or subsequently repaid.

2(2) of Schedule 2A of the LBTT (Amendment) (Scotland) Act 2016:

“A buyer is replacing the buyer’s only or main residence if -

- a) During the period of 18 months ending with the effective date of the transaction, the buyer has disposed of the ownership of a dwelling,
- b) That dwelling was the buyer’s only or main residence at any time during the period of 18 months, and
- c) On the effective date of the transaction, the buyer intends to occupy the dwelling that is or forms part of the subject-matter of the transaction as the buyer’s only or main residence.

Effectively if “swapping one home for another” as long as the original one is disposed of within 18 months of the acquisition of the other any ADS paid will be returned.

Example 5 (continued)

After W purchases her property it takes some time to resolve financial issues. Upon resolution, an Agreement is entered into whereby the FMH is to be sold with the proceeds being divided. The FMH goes on the market but is slow to “shift”. If sold within 18 months of H acquiring his second property the ADS would be repaid. If it does not sell within the 18 month period the ADS is not repaid.

On a £750,000 house ADS at 3% = £22,500 - not to be sniffed at!

Investment Properties/Holiday Homes Plus New Purchase

Example 6

H and W live in a house together owned by H. W has a holiday home in her sole name. H and W separate. As part of the resolution H retains the FMH and W retains the holiday home. W then wishes to buy a house to live in. She is not replacing a dwelling house. She is acquiring a second property – 3% ADS applies.

If the FMH had been in joint names and she disposed of her half to H as part of the overall resolution (after acquiring her new property) – she is disposing of her half of her dwelling house and replacing it with another. If the disposal of the share of the FMH occurs within 18 months of acquiring the new property no ADS would be payable/any ADS would be repaid.

Summary

- Be aware of ADS.
- Be aware of the 18 month rule.
- Think about ADS when structuring settlement.

Husband and Wife in Partnership

H and W are in partnership and split profits 50/50. They obtain the benefit of 2 nil rate bands and 2 basic rate bands for income tax.

If upon separation one partners' interest is transferred to the other, the tax bill on income will go up.

It seems obvious...but...

Example – a partnership owning rental properties run by W. W had “control” over all profits but they were “notionally” split 50/50. She was retaining the partnership as part of the overall resolution. She assumed she would receive the same income. She would not!

Interest on Capital Sum Instalments

H owns 100% of the shares of a limited company. Post separation he is going to continue to operate that business. It has a significant value. There are minimal other assets. He requires to pay to W (net of other assets) one half of the value of the business. He does not have the cash available now to do so. Instalments are agreed.

The capital sum is agreed at £1.5m. Interest is agreed at 4% on all outstanding sums until payment. Instalments were agreed in the sum of £250,000 per annum until the full amount was paid.

Interest on outstanding sums is taxable as income.

Solution – Softening the Blow:

Instead of providing for interest on the capital sum, the capital sum can be expressed as inclusive of interest but discount built in for early payment. The daily rate of “discount” can be worked out.

Shortly put one gets to the same answer/result except no income tax is payable.

Structural Considerations

When dividing matrimonial property it is suggested that the tax payable further down the line should be taken into consideration when structuring a deal.

Pension v Cash

Numerous cases arise where a significant issue is the split of cash and pension transfer.

Cash of course is cash on which no tax is paid.

Pension interests – 25% tax free lump sum can be withdrawn, but thereafter income tax is payable when the benefits are received.

Shortly put £1 of pension does not really equate to £1 of cash

Section 10 of the Family Law (Scotland) Act 1985 – Matrimonial Property to be divided fairly

It seems to me that in addition to a fair division of value the structure needs to be fair also.

Example 7

Basic example – H and W separate. £500,000 in bank account. H has pension of £500,000. If W keeps cash and H keeps pension W pays no tax. H will pay tax when in receipt of the pension benefits and in net terms is worse off.

If the pension is split and the cash is split that seems fairer!

Cases Involving Private Limited Companies – A Possible Solution

H and W own shares in a private limited company. It is agreed the shares will be transferred to H. H requires to pay W a significant sum as a consequence. He will need to do so by generating money from the business in the future.

Normally H would require to pay out of taxed income. So money is paid to H from the business, he pays income tax, and from the net amount he pays W what she is due.

But in certain circumstances tax can be avoided:

If the company has sufficient distributable reserves – effectively “excess cash sitting there” the company can buy back the shares from W.

W gets her cash. The money is paid from the company, but no tax is paid on the tax exiting the company. (Clearly there are corporate matters to be attended to formally and an Agreement will require to be entered into between W and the company, but it is “do-able”. Significant savings can result.

HMRC approval required.

Conclusion

Hopefully, not too taxing! (apologies!)

Hopefully you have a better idea of the issues to look out for and some solutions that will help soften the tax blow for our clients.

Please no involved tax related Qs!!



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