

# Personal Tax: The Key Drivers

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### 1. Introduction

These notes have been prepared to accompany the talk under the above title at the Matrimonial Finance Valuation and Tax Conference on 8 November 2017.

### 2. The Tax Environment

In a rapidly changing tax environment, the “rules” on matrimonial taxation have remained surprisingly stable. Nevertheless, a matrimonial lawyer must stay close to the changes in the tax environment as they can have a significant impact –

- a. Tax planning, or at least tax avoidance, is arguably a creature of the past so there is an increased emphasis on the use of reliefs and exemptions and a key value to a client is using them effectively;
- b. History is key – has one party to the marriage a history of undertaking what HMRC may regard as “abusive” tax planning with a consequential exposure to APNs etc.?
- c. Beware too of the new duty to correct – if structures/tax profiles are not robust there can be expected to be an increased risk of HMRC investigation with consequential impact on wealth.

### 3. Timing

- ▶ Timing is critical – tax advice should be sought as soon as possible in any matrimonial process.
- ▶ It is also important to have in mind the timing rules for the main taxes:

#### Income Tax

When a marriage ends, the parties revert to single status (although of course they are separate taxpayers in most practical ways during their marriage).

For income tax purposes, the marriage ends when the parties separate “in such circumstances that the separation is likely to be permanent”.

#### CGT

- ▶ Disposals between spouses during marriage are not subject to CGT. This rule applies to transfers even in the tax year of separation.
- ▶ They are made on a no gain/no loss basis (section 58 TCGA 1992).
- ▶ Section 58 ceases to operate on separation as the section only operates where the disposal is between spouses who “in the year of assessment” were living together. Spouses are treated as “not living together” where they are separated in such circumstances that the separation is likely to be permanent.
- ▶ However, it is even worse, in that the parties to the marriage remain connected persons so any disposal between them is deemed to be at market value (section 18 TCGA 1992).

CGT depends on the concept of “disposal” and so it is critical, in the matrimonial context, to determine the point at which a “disposal” occurs (for a variety of reasons including tax rates and the question if the parties are living together at that time).

If the asset is not transferred under a Court Order the date of disposal will normally be the date of an unconditional contract or the date of an informal transfer.

In addition note:-

Action	CGT disposal date
Asset transferred under a Court Order before decree absolute	Disposal under a contract. The parties make the contract at the date of the Court Order
Asset transferred after decree absolute pursuant to Court Order made before decree absolute	The date of disposal is the date of decree absolute
Asset transferred pursuant to a Court Order made after the date of decree absolute	The disposal is the date of the order

Where an asset is transferred in pursuance of a Court Order after the decree absolute the disposal proceeds are still deemed to be equal to the market value of the asset by virtue of section 17 TCGA 1992.

#### IHT

- ▶ There is a different time line for IHT purposes. Here the inter spouse exemption continues until decree absolute. Be careful if spouses have a different domicile.

While all these taxes must be considered, this talk focuses primarily on CGT as exemptions from IHT and SDLT are normally available.

#### 4. Key Reliefs

Given the above timing rules, it is imperative to be aware of any tax reliefs which may help mitigate the potential tax charges. Key reliefs include the following (but please note that this list does not purport to be exhaustive):

##### CGT

*Section 165 TCGA 1992 (“gift relief”)* – allows gain to be held over for certain business assets.

HMRC now normally accept that there is no consideration and relief available where disposal is pursuant to a court order.

*Section 260 TCGA 1992*

Similar provision where a transfer falls within the IHT regime (even if no IHT due) – e.g. on a transfer into a trust.

## IHT

### *Section 11 IHTA 1984*

In many cases, the absence of a gratuitous intent can preclude an IHT exposure.

## 5. The Matrimonial Home

- ▶ The availability of principal private residence (PPR) relief will often be critical especially if the parties have separated.
- ▶ The matrimonial practitioner will need to be aware of recent changes in PPR law, as this area is constantly changing.
- ▶ To recap (in a broad summary) the general PPR rules:
  - a. The CGT exemption applies to any gain arising on the disposal of the taxpayer's only or main residence (sections 222-226 TCGA 1992);
  - b. Remember – the house must have been a residence. Beware temporary accommodation;
  - c. Spouses/civil partners can have only one main residence whilst living together;
  - d. Remember the importance of elections in the cases of second homes.
  - e. Last 18 months qualify in any event. This can be particularly relevant on matrimonial breakdown.

### **Common factual situations include –**

- ▶ H owns the matrimonial home but has left it and W resides there with the children. H is to pass the home (which he owns) to W in a tax year when they are separated (so section 58 TCGA 1992 (see above) does not apply). The position will be as follows –
  - a. If the disposal is within 18 months of separation no CGT due to provision referred to in 5e above. Note the meaning of “disposal” and when is the “date” of separation.
  - b. Potential relief in section 225B TCGA 1992 which deems the home to be a residence of H until the date of transfer as part of a financial settlement provided it continues to be W's only or main residence. H must not have elected for another PPR. Section 225B does not help if the home is sold in the market.

Order	Tax Analysis
H order to transfer house to W	<ul style="list-style-type: none"> <li>▶ 18 month relief?</li> <li>▶ Section 225B relief?</li> <li>▶ Otherwise market value disposal and proportionate gain</li> </ul>
H and W joint owners and no immediate sale (Mesher order). Sale when child 18 or ceases full-time education	<ul style="list-style-type: none"> <li>▶ At time of transfer – as above</li> <li>▶ On eventual sale – CGT on proportionate gain unless HMRC accept there is a settlement and section 225 TCGA 1992 applies</li> </ul>
House placed in trust for occupation and then sale	Similar to “informal” trust above but note also IHT relevant property regime charges
Outright transfer with charge in favour of person making the transfer	<p>CGT position more complex and requires advance thought –</p> <ul style="list-style-type: none"> <li>▶ Is the transferee’s right a “charge” for a specific sum and hence no tax on repayment – section 251 TCGA 1992</li> </ul> <p>or</p> <ul style="list-style-type: none"> <li>▶ A right to a proportionate share of sale proceeds in which case he will pay CGT on the share of proceeds (being the disposal of a chose in action).</li> </ul>
Declaration of existing interest	No tax event

It is also necessary to consider the IHT and stamp duty consequences of any transfer.

## 6. The International Dimension

- ▶ Knowing the residence/domicile status of the parties can be critical and in the latter case the 2017 changes are important.
- ▶ Residence is now easier to determine due to the Statutory Residence Test (SRT).
- ▶ The definition of common law domicile has not changed, and remains important, but be aware of increased HMRC challenge. In some cases, the divorce itself can be relevant to the acquisition of a domicile of choice.
- ▶ Some key issues flowing from domicile –

### a. *Rebasing*

- ▶ If a taxpayer is deemed domiciled on 6 April 2017 (broadly resident for 15 out of 20 last tax years) then CGT uplift available on transfer of assets (e.g. overseas home).

b. *Cleansing*

- ▶ May assist with remittances to fund cash transfers (but see (c) below);

c. *Definition of remittance*

If one spouse (say H) is non-domiciled, he may have monies outside the UK which are taxable on the remittance basis. Can he pay these monies to W outside the UK as part of a matrimonial settlement without thereby triggering a tax charge on himself? With care, this should be possible.

If the transfer occurs after decree absolute, W will no longer be a “relevant person” to H (as that term is defined in section 809M ITA 2007) and so there can be no taxable remittance.

Even if this timing is not possible, the better view is that this is not a remittance as the monies held by W are not derived property as required by section 809L ITA 2007.

Another key development is the non-resident capital gains tax charge on property. Non-residents now pay CGT on the disposal of UK residential property. The base cost is effectively 6 April 2015. The PPR exemption may apply but note if a party is not resident in the UK, he must satisfy the day count test for the house to qualify for the PPR relief. Very broadly, the individual must have been present in the house for at least 90 midnights in a year. The difficulty in many cases will be to satisfy this test while not then falling into a tax resident position.

## 7. Offshore Trusts

- ▶ The taxation of offshore trusts is changing rapidly and any discussion is beyond the scope of this talk.
- ▶ However two key issues to be aware of in the present context where the settlor is non-domiciled:-
  - a. The trust can be a very effective tax deferral vehicle so long as it is not tainted by the addition of further property;
  - b. Beware the new onward gift rules and remittances.

## 8. Conclusion

The key to a successful tax strategy on divorce is -

- a. Early planning;
- b. Understanding the reliefs and CGT principles;
- c. Taking particular care with offshore aspects.

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