TAX CONSIDERATIONS IN MATRIMONIAL FINANCE CASES

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The tax issues capable of arising in matrimonial finance cases are myriad. This article endeavors, with no claim whatsoever to exhaustivity, to address several of the most salient. The tax consequences of dividing the parties' assets should be at the forefront of advisers' thinking from a very early stage. Such an awareness not only undergirds a sound negotiating strategy, but is vital for the proper implementation of any financial settlement. For example, if particular assets are likely to be transferred between the parties or sold, it important to identify whether any tax will be payable. Additionally, if there will be tax to pay, it is necessary to consider not only the amount of tax in question, but which party will be liable to account for it, and whether any part of that liability should be redistributed as between the parties. The tax position of the parties apart from the matrimonial proceedings may also need to be taken into account. There may be potential liabilities that are capable of dramatically altering the apparent resources of the parties. Involvement in tax avoidance schemes, in particular, can generate liabilities far in excess of the intended savings many years after the fact.

Capital Gains Tax

This is arguably the type of tax liability most likely to arise in matrimonial proceedings. In order to work out if a potential financial settlement gives rise to a CGT charge, there are three primary questions to consider:

1. Will the potential settlement involve a disposal of assets?

2. If it does involve a disposal, will a chargeable gain accrue?
3. If a chargeable gain accrues, is there tax to be charged in accordance with TCGA 1992, in light of various exemptions and reliefs?

Is there a disposal of assets?

In addressing this first question, it is worth bearing in mind the breadth of the definition of "asset" in s.21 TCGA 1992 – it encompasses all property, whether situated in the UK or abroad, with the exception of cash in sterling (although some assets, e.g. certain wasting assets, are exempt). Debts, foreign currency, and intangible property (including choses in action) are all assets. There is a disposal of assets by their owner whenever a capital sum is derived from them (s.22(1) TCGA 1992). In considering whether a potential settlement would involve a disposal of assets, it is important to ascertain who owns the assets to begin with. For example, where a beneficiary is absolutely entitled as against a trustee, it is the beneficiary who is regarded as the owner of the assets for CGT purposes (see s.60 TCGA 1992). This means that if a property is legally held in joint names, but beneficially owned by one of the parties, only the beneficial owner will face the CGT consequences of any disposal (transfer of the legal interest alone being a non-event for CGT purposes). Alternatively, a property may be legally held by one party to matrimonial proceedings, but be beneficially owned by the other party or both together. Again, it is the beneficial owner(s) who will face the CGT consequences of a disposal.

Will a chargeable gain accrue?

Although, of course, the general rule is that a chargeable again accrues where the consideration received on disposal of an asset exceeds the acquisition cost and other allowable deductions (e.g. sale costs and the costs of certain improvements to the asset), we have to bear in mind that, where the disposal is otherwise than by way of a bargain at arm's length or for consideration that cannot be valued, s.17 TCGA 1992 deems the consideration given and received to be equal to the market value of the asset. Unless another exemption applies, s.17 will apply to a transfer made pursuant to a court order, since a court order (even a consent order) does not constitute a bargain. Additionally, spouses and civil partners are regarded as connected persons (see s.286(2) TCGA 1992), and where the person disposing of an asset and the person acquiring it are connected, they are treated as parties to a transaction otherwise than by way of a bargain at arm's length (see s.18(2) TCGA 1992). Accordingly, unless the parties are living together (such that s.58 applies – see below), any disposal between spouses or civil partners is treated as made for market value consideration. Former spouses or civil partners cease to be connected persons upon decree absolute or final dissolution.

There are special rules for disposals of assets between spouses or civil partners who are living together. Subject to certain limited exceptions, if an individual is living together with his or her spouse or civil partner in any year of assessment and one of them disposes of an asset to the other, both are treated as if the asset were transferred for such consideration as would secure neither a gain nor a loss for the one making the disposal (see s.58 TCGA 1992). For these purposes, spouses or civil partners are treated as "living together" unless they are (i) separated under a court order; (ii) separated by a deed of separation; or (iii) in fact separated in circumstances where the separation is likely to be permanent (see s.288(3) TCGA 1992 and s.1011 ITA 2007). The key question is whether the marriage or civil partnership has broken down. HMRC note that spouses may continue to live at the same address but not be "living together", provided that the marriage has broken down. Alternatively, if the marriage has not broken down, the parties are still treated as "living together", even if they do not reside at the same address (see CG22070). There is no requirement that the parties continue living together throughout the year of assessment for s.58 to apply. Provided they have lived together at some time during a tax year, any transfers they make between themselves for the rest of the tax year will continue to be treated as made on a no gain/no loss basis, even if they permanently separate. It is worth considering the future tax implications of this for the recipient spouse who will be treated, on any subsequent disposal, as having acquired the asset for its original acquisition cost.

Section 58 applies even where the recipient spouse/partner is non-UK resident, and therefore potentially outside the scope of UK CGT, allowing the possibility that UK CGT might be avoided entirely. However, a charge can still arise on a subsequent disposal by the non-resident spouse in certain circumstances (see s.1A(3) TCGA 1992):

(i) where the asset consists of a non-excluded interest in UK land[1];
(ii) broadly, where the asset consists of right or interest in a UK-property-rich company and at any time in the 2 years prior to disposal, the non-resident has held a 25% investment in the company[2]; or
(iii) at the time of the disposal, the non-resident carries on a trade, profession or vocation in the United Kingdom through a branch or agency and the asset is situated in the UK and was acquired, used, or held for the purposes of that branch or agency.[3]

Is there tax to be charged under TCGA 1992?

The preceding rules assist in determining whether a chargeable gain accrues in response to a disposal. Where a chargeable gain does accrue, the next step is to determine whether any tax is chargeable, in light of various exemptions and reliefs. There are many such, but those considered below are perhaps most likely to be relevant in matrimonial finance cases:

Main Residence Relief

There is extensive relief available for an individual on the disposal of (or the disposal of an interest in) a dwelling house, in so far as, for any period of his ownership, it has been his only or main residence. For these purposes, however, spouses or civil partners living together can only have one main residence between them (see s.222(6) TCGA 1992). This relief always applies for the final 18 months of ownership, even if the house is no longer the individual's only or main residence (see s.223 TCGA 1992).[4] Thus, if the house has been a person's only/main residence throughout their period of ownership, but not for the final 18 months, any capital gain is exempt in full. Otherwise, a fraction of the gain is exempt, corresponding to the fraction of the ownership period for which the house was his only/main residence (always including the final 18 months). This means that, although the family home immediately ceases to be the main residence of the spouse or civil partner who leaves it following separation, that person can dispose of their interest in the house to the other spouse/partner (or indeed anyone else) within 18 months of moving out and still benefit from the relief.

There are additional rules governing main residence relief for UK residents disposing of overseas residences and for non-UK residents disposing of UK residences (see ss.222A-222C TCGA 1992). It is also worth noting that large properties encompassing land and/or additional buildings may not benefit completely from the relief (see s.222(1)-(4) TCGA 1992). There is also a special provision for the disposal of residences in connection with divorce, etc., which can apply more than 18 months after the departing spouse or partner moves out. In particular, the spouse or partner who leaves can claim main residence relief on transferring the former family home to the remaining spouse or partner, provided that three conditions are met (see s.225B TCGA 1992):

(i) the transfer takes place pursuant to an agreement between the individual and his/her spouse/civil partner made "in contemplation of or otherwise in connection with" the dissolution or annulment of the marriage/civil partnership or their permanent separation, or pursuant to an appropriate court order;
(ii) in the period between the departing spouse/partner leaving and the disposal, the house has continued to be the only or main residence of the remaining spouse/partner; and
(iii) the departing spouse/partner has not given notice that another house is to be treated as his/her main residence for any part of that period.

It should be noted that no relief is available under s.225B in circumstances where the house is sold and the proceeds split between the couple.

Gift Hold-Over Relief

Where business assets (or certain shares) are transferred pursuant to a court order in matrimonial proceedings, gift hold-over relief may be available (see s.165 TCGA 1992). In such a case, the chargeable gain is not taxed when it arises (i.e. on immediate disposal of the asset), but instead is held over until disposal of the asset by the new owner. (The previously accrued gain is effectively frozen until a subsequent disposal.) However, if there is any actual consideration given (as opposed to deemed consideration under the market-value rule), the actually realized gain is taxable when it arises, and only the unrealized part of the gain is held over (see s.165(7) TCGA 1992). The deferral of tax is achieved by the transferee being deemed to acquire the asset at market value less the held-over gain.

Usually, when business assets are transferred by agreement in matrimonial cases, the transfer is completed in exchange for a surrender by the transferee of his or her rights to obtain alternative financial provision. HMRC take the view that the value of the surrendered rights represents actual consideration of such an amount as would reduce the gain eligible for hold-over relief to nil (see CG67192). Exceptionally, the parties may be able to demonstrate that the value transferred substantially exceeded what the transferee could reasonably have expected to receive as the result of a contested court hearing. In such a case, hold-over relief might still be available in respect of a transfer by agreement. However, where the transfer occurs pursuant to a court order in matrimonial proceedings (even a consent order), HMRC accept that the transferee does *not* give actual consideration for the transfer in the form of surrendered rights. This is because a court order reflects the court's exercise of its independent statutory jurisdiction and is not the consequence of any party to the proceedings agreeing to surrender his or her rights in return for assets (see CG67192). Coleridge J stated in *G v G* [2002] EWHC 1339 at [43]:

> "*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.*"

<u>Entrepreneurs' Relief / Investors' Relief</u>

Entrepreneurs' relief or investors' relief may serve to reduce capital gains tax where a contemplated disposal is not covered by s.58. Entrepreneurs' relief, in particular, may also combine with other reliefs (e.g. to reduce the tax payable on the subsequent disposal of an asset that initially benefited from gift hold-over relief). Entrepreneurs' relief provides for a 10% rate of CGT on gains from qualifying business disposals, up to a lifetime limit of £10 million (see Chapter 3 of Part 5 TCGA 1992). Broadly, qualifying business disposals include:

(i) the disposal of all or part of a business which has been owned by the individual making the disposal throughout the two years prior to the disposal;
(ii) certain disposals of business assets following cessation of a business that was owned by the individual making the disposal throughout the two years prior to the date of cessation;
(iii) disposals of shares if, throughout the two years prior to the disposal, the company has been a trading company or the holding company of a trading group, the individual disposing of the shares has been an officer or employee of the company (or a company in the same group), and that individual has held at least 5% of the ordinary share capital of the company and been entitled to exercise, by virtue of that holding, at least 5% of the voting rights in the company and either or both of the following conditions have been met: (i) by virtue of that holding, the individual has been entitled to at least 5% of distributable profits and 5% of the company assets available to equity holders on a winding up; or (ii) the individual has been beneficially entitled to at least 5% of the proceeds on a disposal of the whole of the company's ordinary share capital.[5]

Investors' relief extends the 10% CGT rate to certain other types of shareholders, allowing them to benefit from the reduced rate on their first £10 million of gains from qualifying shares (this is also a lifetime limit, but distinct from that for entrepreneurs' relief) (see Chapter 5 of Part 5 TCGA 1992). Broadly, and in so far as relevant for present purposes, this relief is available where:

(i) The shares are fully paid ordinary shares issued to an individual ("the investor") for cash on or after 17 March 2016;

(ii) At the time the shares were issued, none of the shares in the company were listed on a recognized stock exchange;

(iii) At all times from when the shares were issued until the disposal, the company was a trading company or the holding company of a trading group;

(iv) The investor has held the shares continuously from the date of issue and for at least three years from 6 April 2016;

(v) The investor subscribed for the shares for commercial reasons by way of a bargain at arm's length and not as part of a scheme or arrangement the main purpose, or one of the main purposes, of which was the avoidance of tax;

(vi) Neither the investor, nor any person connected with the investor, has at any time since the shares were issued, been a "relevant employee" of the company (broadly, most officers or employees of the company).

Unlike entrepreneurs' relief, there is no minimum shareholding requirement for investors' relief. Moreover, like gift-holdover relief, both entrepreneurs' relief and investors' relief must be claimed by the individual making the disposal.

The Family Home

In many matrimonial cases, the family home comprises the couple's most significant asset. Very often, particularly in cases where a "clean break" is sought, the house is sold and the proceeds split between the couple, or one spouse transfers his interest in the house to the other. Provided such a disposal takes place within 18 months of the transferor(s) moving out, main residence relief should be available. (Section 225B TCGA 1992 can extend this period in the case of a transfer to the other spouse.) However, there may be situations, particularly in cases involving children, where it is desirable for one spouse or civil partner to remain in the family home, and that person lacks the resources to buy the other out. In such cases, the court might take one of the following approaches:

Deferred Charge

The court might transfer the house to the remaining spouse, but give the departing spouse a deferred charge against it. The charge might be for a fixed sum or for a specified proportion of the net sale proceeds. In either case, the interest of the departing spouse is transferred to the remaining spouse, triggering a CGT disposal for which main residence relief might be available (under the 18-month rule or s.225B). The departing spouse acquires a new asset in the form of the deferred charge. Since there is a disposal of an asset whenever a capital sum is derived from it, there will be a disposal of that new asset when the house is eventually sold. Where the charge is for a fixed sum, this constitutes a debt and there will be no CGT to pay, since no chargeable gain accrues to the original creditor on repayment of a debt (see s.251 TCGA 1992). (However, if the loan carries interest or is index-linked, that will give rise to an income tax liability.) On the other hand, where the charge is for a specified proportion of the net sale proceeds, the departing spouse has a contingent right to obtain an unascertainable sum of money in the future. This is not a debt, but rather a chose in action, so the exemption in s.251 TCGA 1992 cannot apply (see *Marren v Ingles* [1980] 1 W.L.R. 983 (HL)). Accordingly, when the house is sold, the departing spouse will face a CGT charge, subject to the availability of any other relief.

Mesher Order

Another possibility is that the former family home is ordered to be held on trust by the parties, with one of them entitled to live in it rent-free and responsible for all outgoings. When the order terminates (e.g. when the youngest child of the marriage turns 18 or leaves full-time education), the house is sold and the proceeds divided between the parties according to the terms of the order. Such an order creates a lifetime settlement for CGT purposes. There is a deemed disposal (at market value) by the parties to themselves as trustees. Provided this disposal takes place within 18 months of the departing spouse having moved out, main residence relief should be available to both parties. When the order terminates, the trust comes to an end, and the parties are deemed to dispose of the property at market value to themselves as beneficiaries in the shares specified by the order (see s.71 TCGA 1992). The trustees are entitled to main residence relief on the entire gain provided that, throughout the trustees' period of ownership, the house has been the only or main residence of the occupying spouse (see s.225 TCGA 1992). If the property is later sold, only the occupying spouse can benefit from main residence relief, but if this occurs soon after the termination of the settlement, significant additional gain is unlikely to have accrued.

Inheritance Tax

Most transfers between spouses or civil partners in the context of divorce/dissolution proceedings are not chargeable to inheritance tax – either because they are not transfers of value in the first place, or else because they are exempt. Because inheritance tax is charged on the value transferred by a chargeable transfer (defined as a transfer of value made by an individual which is not an exempt transfer – see s.2 IHTA 1984), an IHT charge can only arise where there is a transfer of value. "Transfer of value" is defined in s.3 IHTA 1984 to mean "a disposition made by a person (the transferor) as a result of which the value of his estate immediately after the disposition is less than it would be but for the disposition". Some dispositions are excluded from being transfers of value under s.10 IHTA 1984. Section 10 provides that a disposition is not a transfer of value if it is not intended to confer any gratuitous benefit and was made in a transaction at arm's length between unconnected persons (or if the transfer is between connected persons, it is such as might be expected to be made in a transaction at arm's length between unconnected persons). Broadly, this means that IHT does not apply to dispositions made for consideration or pursuant to an obligation. HMRC take the view that dispositions made on divorce for the benefit of the other spouse "normally" fall within s.10 and so are not transfers of value (see IHTM04165).

Additionally, some dispositions are excluded from being transfers of value under s.11 IHTA 1986. Section 11 provides that a disposition is not a transfer of value if it is made by one party to a marriage or civil partnership in favour of the other party or a child of either party for the maintenance of the other party or the maintenance/training/education of the child until he attains the age of 18 or (if later) ceases to undergo full-time education or training. Section 11(6) extends this rule to dispositions made on the occasion of the dissolution of a marriage or civil partnership, or to the subsequent variation of such a disposition. This provision can be particularly useful where the parties wish to vary a maintenance arrangement after their divorce/dissolution, in circumstances where the disposition would otherwise be a potentially exempt transfer and therefore subject to charge if the transferor dies within 7 years (e.g. if ongoing maintenance payments are to be capitalized into a lump sum). It should be noted, however, that the disposition must be "for the maintenance" of the other party or the child. Transfers that significantly exceed reasonable maintenance may not benefit from full relief.

Transfers made pursuant to a court order in matrimonial proceedings (including a consent order), are not transfers of value in the first place because they do not involve any loss to the transferor's estate. There is accordingly no need to rely on either s.10 or s.11 to prevent a transfer of value arising. Leading practitioners' texts justify this on the basis that transfers pursuant to a court order are not dispositions – the liability is imposed by the court exercising its independent statutory jurisdiction.[6] This echoes the reasoning of Coleridge J in *G v G* (see above). HMRC reach the same conclusion relying on *Haines v Hill* [2007] EWCA Civ 1284, where the Court of Appeal affirmed at [35] that an applicant spouse's right to apply for a property adjustment order constitutes consideration equal in value to the money or property that is the subject of the order (see IHTM11032). Either way, it is accepted that a transfer pursuant to a court order in matrimonial proceedings does not bring about any diminution of the transferor's estate, because the value of that estate already reflects the transferor's obligation to the other party (see s.5 IHTA 1984).

The value of not having to rely on s.10 to exclude from the IHT net a transfer made pursuant to a court order becomes apparent in the context of interests in possession, such as are not uncommonly ordered in matrimonial proceedings. A probably unintended consequence of the changes introduced by FA 2010 is that, were s.10 to be relied upon in creating an interest in possession in matrimonial proceedings, the trust property would both form part of the beneficiary's estate and also fall within the relevant property regime. This would mean an IHT charge of 20% if the interest in possession terminated during the beneficiary's lifetime (or 40% on the beneficiary's death), together with 10-year charges and exit charges on the trust. In short, ensuring that an interest in possession created for the benefit of either party as part of a matrimonial settlement is created pursuant to a court order is the safest way of ensuring that s.10 will not be in point.

Where a disposition constitutes a transfer of value, it may be capable of benefitting from various exemptions, the most relevant of which, for present purposes, is the spousal exemption. Section 18 IHTA 1984 provides that transfers between UK-domiciled spouses are exempt from IHT, and transfers from a UK-domiciled spouse to a non-UK-domiciled spouse are exempt up to the level of the nil-rate band (currently £325,000). A non-domiciled transferee spouse may be able to make a domicile election for IHT purposes in order to benefit from the full spousal exemption (see ss.267ZA-267ZB IHTA 1984), but this has the effect of bringing the transferee's entire estate into the IHT net (at least temporarily), so care is needed. The spousal exemption (unlike the CGT provision for transfers between spouses in s.58 TCGA 1992) applies as long as the parties are still married or in a civil partnership, regardless of whether or not they are living together. This offers significant scope for dividing assets free from IHT before decree absolute or final dissolution. (A transfer of value after that date may qualify as a potentially exempt transfer and so escape charge, but only if the transferor survives the gift by seven years.)

A transfer into trust for the benefit of a spouse in matrimonial proceedings (e.g. a trust created pursuant to a *Mesher* order) should be protected from the entry charge by not being a transfer of value – either by virtue of s.10 IHTA 1984 or because it is made pursuant to a court order and therefore involves no loss to the transferor's estate). The trust will, however, be subject to 10-year and exit charges. (Transfers into relevant property trusts are not capable of benefiting from the spousal exemption, since the estate of the beneficiary is not thereby enriched). Further, subject to limited exceptions, there should be no IHT to pay on the death of a spouse who benefits from an interest in possession, since the trust property does not form part of his or her estate (see s.49(1A) IHTA 1984).

Income Tax

There are relatively few income tax issues likely to arise in divorce/dissolution cases, since spouses or civil partners are taxed separately in any event. However, it is worth noting that maintenance payments to or for the benefit of a former spouse or children are income tax free (see ss.727 and 730 ITTOIA 2005). The payer does receive any tax relief (save for limited maintenance payments relief, which is restricted to legally enforceable payments where either the payer or the recipient was born before 6 April 1935 – see ss.453-454 ITA 2007). Additionally, income arising from jointly-held property of spouses or civil partners who are living together is treated as beneficially arising to both parties in equal shares, unless an exception applies (see s.836 ITA 2007). This provision, known as “the 50/50 rule”, applies only for income tax purposes. HMRC have clarified that where property is jointly held before the marriage or formation of the civil partnership, the 50/50 rule only applies from the date of marriage (see TSEM9832). Moreover, the rule ceases to apply immediately when the couple separate permanently (see TSEM9836). The 50/50 rule can be displaced if the parties complete a joint declaration (via Form 17) that they are beneficially entitled to the income in unequal shares (see s.837 ITA 2007). Failure to complete Form 17 can create unexpected income tax liabilities for a spouse who might not might not realize that he is considered still to possess a beneficial entitlement to the income (e.g. a husband who transferred his entire beneficial interest in a jointly-held investment property to his wife many years before their separation). These unexpected liabilities may come to light in the course of subsequent matrimonial proceedings.

Stamp Duty Land Tax

Paragraph 3 of Schedule 3 to FA 2003 exempts from SDLT land transactions made between one party to a marriage or civil partnership and the other, where the transaction is made in connection with the parties’ divorce, dissolution or judicial separation. This exemption applies whether the transfer is by agreement or pursuant to a court order in matrimonial proceedings, but does not extend to transfers to third parties.

Conclusion

The tax implications of potential financial settlements should be considered from an early stage and throughout the proceedings in order to mitigate the parties' tax exposure during what is often already a stressful and difficult time.

Endnotes

1. See also s.1C TCGA 1992 (with effect from 6 April 2019).
2. See also s.1D and Schedule 1A TCGA 1992 (with effect from 6 April 2019).
3. See also s.1B TCGA 1992.
4. It was announced in the Budget 2018 that with effect from April 2020, the final period exemption would reduce from 18 months to 9 months.
5. The qualifying period for all of these qualifying business disposals increased from one year to two years with effect from 6 April 2019. However, for disposals of business assets following cessation, the increased qualifying period only applies for businesses that ceased to operate on or after 29 October 2018. (See paragraph 4 of Schedule 16 to FA 2019.) The new requirement that the individual be entitled to at least 5% of distributable profits and 5% of assets on a winding up and/or be beneficially entitled to at least 5% of the proceeds of a disposal of the whole of the company's ordinary share capital applies to disposals on or after 29 October 2018. (See paragraph 4(4) of Schedule 16 to FA 2019 and s.169S(3) TCGA 1992 as amended.)
6. See, for example, *McCutcheon on Inheritance Tax*, 7th edition at 2-43.