From bedpost to impost

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Tax and family law are a match made in heaven.

Not.

Like an uninvited party guest, the taxman lurks in the shadows of the room waiting to make an unwelcome intrusion to the family gathering. Such tax trespasses frequently occur on a divorce or separation, when a couple divide up the assets of their union. It can catch them unawares. For a client who is already worn down by the emotional and financial strain of a break-up, a surprise tax bill can cause them to lose their rag. Unfortunately, the family lawyer will be in the firing line.

For this reason, every family practitioner should have in their toolkit, a basic awareness of the tax traps that are hidden in the undergrowth of separation or divorce proceedings.

In what follows, we chart the four seminal steps that a typical couple take towards their 'ever closer union' and how later, upon the occurrence of their personal Brexit, tax can become an issue. We review what can be done to minimise tax liabilities. We also touch briefly on the international dimension, as the status of non-domiciled individuals can offer opportunities for mitigating tax.

Finally, we note the liability and reputational risk to a family lawyer who has not taken due care and attention when advising in this area and suggest what they can do to protect themselves.

Moving in together

Following a respectable period of dating, a typical couple will take their first major stride towards union and move in together. In many cases this involves jointly acquiring a property. It will become their most valuable asset and large amounts of tax are potentially at stake following a break-up.

On separation, one option is for the home to be sold with the proceeds being divided between the parties. Principal Primary Residence ('PPR') relief is the key to securing a tax-free sale. To obtain the maximum capital gains tax relief, the property must be sold or transferred within 18 months of the property ceasing to be the main residence of the sellers. This period will be halved to 9 months from April 2020 so advise any client who has already moved out to get the house on the market sharpish.

Alternatively, one party may choose to buy the other out. For married couples/civil partners, the transferring party can retain full entitlement to PPR provided three conditions are met:

(i) the transfer must be made in connection with the separation or divorce or under a court order;

(ii) the party remaining in the property must continue to use it as their main residence; and

(iii) the transferor must not elect for another property to be their main residence.[1]

The third condition will impact on the transferor's ability to claim PPR relief on a property which they may have moved into at the time of the break-up. An evaluation should be made as to which PPR claim is likely to be the more valuable. Note that this extension of PPR is not available where the marital property is sold to a third party.

Stamp Duty Land Tax is potentially due on any property transfer. Happily, the exclusion from SDLT for transfers between separating couples who are married or civil partners is

1 TCGA 1992 section 225B

widely worded and will apply to any transfer in pursuance of a court order made on divorce or separation and also at any time in contemplation or otherwise in connection with the dissolution of the marriage or civil partnership or their judicial separation.[2]

Living the dream

Ensconced in their marital home, the couple set about establishing their dream lifestyle. With their joint, and perhaps also inherited, wealth they might fund a vintage Rolex for one, contemporary artworks for the other, ski holidays at their own chalet.

When the separation comes, maintenance or lump sum awards are the means to preserving this lifestyle. Whilst the recipient of such payments will not suffer tax, there is equally no tax relief for the payer.

Where the payer is not domiciled in the UK and claims the remittance basis, a tax planning opportunity may arise. Following a decree absolute, where a lump sum is ordered by a court and paid abroad, into the sole account of the other party, a remittance to the UK may be avoided. This means that the payer can pay using their foreign income or capital gains, without incurring tax. It will be crucial that the payee does not give the benefit of that money to any person who is a 'relevant person'[3] in relation to the payer. For example, the money must not be used in the UK to benefit minor children or grandchildren of the payer or settled into a trust for their benefit.[4]

It may also be possible for a non-doms to make a payment in advance of proceedings on similar terms to the above. The monies must be retained abroad and must not be used to benefit a 'relevant person', until after decree absolute. At a later point in time, the money could however be used to purchase a UK property for the payee, in which the minor children could live.

What about the valuable possessions? On separation, these assets may be allocated between the couple. Ideally, transfers should take place within the tax year in which their separation occurs (which runs 6 April to 5 April) in which case they will be free from capital gains tax.[5] March is not a good month to split up! Where this is not possible, the tax charge will normally be calculated by reference to the market value of the asset at time of disposal.[6] Keep in mind that transfers of holiday homes abroad can give rise to foreign taxes and local advice must be sought.

It may be necessary to transfer shares in a family company or other business assets. Where such a transfer takes place as part of a court order, provided the requisite conditions are met, hold over relief may apply to defer the tax charge until a subsequent disposal.[7]

Assets can be transferred between spouses or civil partners of the same domicile without triggering an inheritance tax charge provided the transfer takes place before a decree absolute.[8] If the transfer is to a foreign domiciled spouse the exemption is restricted but an election can be made to cover the potential inheritance tax risk[9] and the assets would, in any event, fall out of charge after 7 years.

For transfers taking place after a decree absolute, other inheritance tax provisions may assist. Transfers which have been negotiated at arm's length or ordered by a court (ie where there is no gift element) are

2 FA 2003, schedule 3 paragraph 3
3 ITA 2007 section 809M
4 ITA 2007 section 809N
5 TCGA 1992 section 58
6 TCGA 1992 section 17(1)
7 TCGA 1992 section 165
8 IHTA 1984 section 18
9 IHTA 1984 section 267ZA

not subject to inheritance tax, nor are certain maintenance awards.[10]

For very wealthy clients, it may be desirable that some assets are retained in trust rather than given to the other party outright. All inter vivos gifts into trusts are chargeable transfers which trigger an inheritance tax 'entry' charge (unless the spouse/civil partner is disabled). An alternative may be for the transferor to give a property or a cash sum outright but impose conditions, for example, that the transferee agrees to leave the property to the children on death. There is a fine line between imposing conditions and creating a trust so care must be taken.

The advent of offspring

At some point comes the patter of tiny feet and the couple find themselves in the realm of nappies, nannies and not-insignificant school fees.

On separation, parents seeking to provide continuity for young children will often agree that one parent should remain living in the family home with them. There are two main routes to achieving this with differing tax outcomes.

The first is to create a so-called Mesher Trust over the family home with the parents acting as trustees. One parent is permitted to stay in the house rent-free retaining responsibility for all the outgoings. When the youngest child reaches a specified age or stage (eg 18 years or the completion of their full-time education) the trust ends and the house is sold with the proceeds being divided between the parents in specified proportions.

For tax purposes:

- Each parent is treated as making a disposal at market value when the house becomes the property of the trust. Provided no more than 18 months has passed since the departing parent left the house (or 9 months from April 2020 onwards) then PPR relief should negate any tax charge.
- When the termination date is reached there is either a deemed disposal and reacquisition of the property by the trustees[11] or, if the property is sold to a third party, an actual disposal. Here, the trustees can claim PPR relief because the inhabitant is a beneficiary of the trust and has occupied the house as their main home. The trust deed must allow the occupation for PPR relief to be claimed.
- Unfortunately, under this arrangement an inheritance tax charge is applicable of up to 6% of the net value of the property on the 10-year anniversaries of the creation of the trust.

The alternative route is for the parent who leaves the home to be granted a security charge over the property by order of the court. In return for transferring their share of the property, the charge entitles them to a capital sum once the youngest child reaches the agreed milestone birthday. It can be structured as a fixed sum which may be interest bearing.

For tax purposes:

- The transfer by the departing parent should be eligible for full PPR relief provided it takes place within the 18 month (soon to be 9 month) timeframe.
- On the eventual sale of the property, the residing parent will also be entitled to claim PPR relief.
- When the debt is repaid to the departing parent, they suffer no capital gains tax although they would be liable to income tax on any interest due while the charge was outstanding.
- Some couples choose to structure the deferred charge as being for a percentage of the eventual sale proceeds. This would prevent the transferor from claiming full PPR relief, so they would be liable to capital gains tax if the debt

10 IHTA 1984 sections 10 and 11
11 TCGA 1992 section 71

increases in value, but this may be commercially preferable nonetheless.

- There are no inheritance tax consequences for the deferred charge route during lifetime, although the debt would be included as a UK asset in the transferor's estate.

Facing mortality

The ultimate cementing of a couple's relationship is when they visit their solicitor to write corresponding wills. Separation will usually require these documents to be discarded and re-written. In the case of a divorce, the wills will automatically be revoked.

Existing lifetime trusts may also require variation and this could have inheritance tax consequences, although for non-domiciled individuals, varying a trust that holds no UK sited assets can usually be done without this consequence.

Reputation is everything

At the end of the case, when the dust has settled, can you be sure that some pesky tax point has not been overlooked, with the potential to ruin your relationship with the client and, heaven forbid, invite a negligence claim?

Here are a few risk management suggestions:

1. Make sure your client engagement letter acknowledges that bespoke tax advice may be required.
2. Be aware that some family accountants are not tax specialists, particularly when it comes to inheritance tax and stamp duty.
3. Where relevant; seek good quality foreign tax advice, UK tax professionals can only advise on UK taxes.
4. If your client is not UK domiciled or is internationally mobile, consider requesting that they confirm their tax status to you and inform you of any changes to it.

'Death, taxes and childbirth! There's never any convenient time for any of them,' wrote Margaret Mitchell in *Gone with the Wind*. Convenient or not, the family lawyer must be attuned to the impact of tax on their cases or risk finding themselves in that firing line.