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Taxation and Divorce



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In the midst of the upheaval of divorce, tax is probably the last thing on the minds of the individuals involved. However, the impact of taxation on any eventual settlement should not be underestimated. It is vital to seek advice on the UK tax implications of separation, divorce and any proposed settlement at the earliest opportunity. By planning a divorce settlement carefully, it should be possible to minimise the tax cost of transfers under the settlement leaving as much as possible available across the family as a whole for distribution between the divorcing spouses.

Income Tax and Inheritance Tax (IHT) both need to be considered in formulating a divorce settlement, and in establishing the tax position for both parties going forward once the settlement has been made. The key details for each of these taxes in the context of divorce are summarised in brief at the end of this note. However, the most important point is that there is no immediate tax charge on the transfer of assets under a divorce settlement for either IHT or Income Tax purposes.

There are, however, immediate Capital Gains Tax (CGT) considerations for any transfers between spouses following permanent separation. These are discussed in detail below.

CGT - General Principles

Spouses are taxed as separate individuals and are each potentially subject to CGT on any chargeable gains arising on disposals of assets they make in a tax year. The definition of a disposal includes not only the sale of an asset but also a disposal by way of gift or a transfer under a divorce settlement. Each individual has an annual exemption (£10,600 for 2011/12) and any chargeable gains below the annual exempt amount are not subject to CGT.

Any chargeable gains in excess of the annual exemption are subject to CGT. Basic rate taxpayers pay CGT at 18%, and higher rate taxpayers pay CGT at 28%. Entrepreneurs' Relief can apply to chargeable disposals of certain assets, for example shares in a family company or an interest in a business, so that CGT is charged at 10%. However, specific conditions must be met in order for the relief to apply.

Losses arising to individuals are available for offset against their chargeable gains. Losses are offset firstly against gains arising in the same tax year. If the losses exceed the gains arising in the same year, the losses are carried forward to be offset against future chargeable gains.

Gains arising on the disposals of certain assets such as cars (including vintage cars), chattels with a value of less than £6,000 and cash held in Sterling are exempt from CGT. Non-Sterling cash is currently treated as a chargeable asset, and gains or losses on the disposal of a foreign currency are calculated by reference to the Sterling value of the currency when it is acquired and when it is subsequently disposed of (for example

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through conversion to another currency). It is proposed that, from 6 April 2012, non-Sterling cash will also be exempt from CGT. In view of this, where a family holds significant cash balances in currencies other than Sterling, it would be worthwhile waiting until after that date before making any transfers of non-Sterling cash to minimise exposure to CGT.

CGT following the tax year of permanent separation

Transfers prior to Decree Absolute

Spouses or civil partners are treated as 'connected persons' and this remains the case throughout a period of separation and divorce proceedings until Decree Absolute is pronounced. Usually, transfers between connected parties are treated as made at market value.

In years up to and including the year of permanent separation, the nil gain/nil loss rules automatically apply to any transfers between spouses, although they are connected, and cannot be disapplied.

However for tax years following the year of separation, up to the point at which Decree Absolute is pronounced, the connected party rules apply. This means that transfers between the separated spouses are treated as having been made at the open market value of the asset in question at the date of transfer.

Gains arising on a transfer made following the tax year of separation are assessed on the transferor spouse and are based on market value of the assets transferred. However, special rules apply where assets transferred to a recipient spouse, following the year of separation but prior to Decree Absolute, are standing at a loss at the date of transfer. These losses ('clogged losses') are only relievable against chargeable gains arising from transfers to the recipient spouse whilst they remain connected to the transferor, ie before pronouncement of Decree Absolute.

Where it is not possible or desirable to complete transfers in the tax year of separation, and transfers are contemplated in tax years subsequent to separation but prior to Decree Absolute, the capital gains position for any assets which are proposed to be transferred should be reviewed. A review of this kind may enable the CGT burden across the family to be minimised by balancing the assets to be transferred at a gain with assets to be transferred at a loss, so that the transferor is able to offset any clogged losses as far as possible and avoid wasting them.

Transfers following Decree Absolute

Former spouses are no longer treated as connected post Decree Absolute. Therefore, any transfers are no longer deemed to take place at market value. Gains or losses are, instead, calculated based on actual consideration received. Losses arising from transfers may be used against any gains arising to the transferor rather than only those made on disposals to the recipient former spouse.

Transfer of the family home

The family home often forms a significant part of overall family wealth and the home itself or the proceeds on sale may form an important part of any divorce settlement.

General principles

Gains on the disposal of an individual's main home, or principal private residence, are exempt from CGT. A married couple, or civil partners, can only have one principal private residence between them. If a number of properties are owned by the couple, it is possible to elect for one of the properties to be treated as their main residence (even if it is owned in the sole name of one spouse rather than jointly). Elections may be made within 2 years of a change in a combination of residences, for example when a new residence is bought or sold. In the absence of an election, HMRC will decide which property is to be taken as the couple's main residence based on the facts of the situation. If an individual has lived in a

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property as their main home at any point, the last 36 months of ownership are treated as a period of residence regardless of whether that individual lived in the property during that time or not.

If more than one property is used as a main residence by the spouses, the capital gains position for each should be reviewed at an early stage to see whether there is scope for making an election or varying an existing election to minimise CGT across the properties overall.

Sale of property and division of proceeds

Where the family home is to be sold and the proceeds divided between the spouses under the divorce settlement, the sale will be exempt from CGT in the hands of both the spouse who remains living in the home at the date of sale and the departing spouse, as long as the sale takes place within 36 months of the departing spouse having left the family home.

If the sale takes place more than 36 months after the departing spouse left, a proportion of the overall gain attributable to the departing spouse will be subject to CGT.

If the departing spouse has elected for another property to be treated as their main residence following departure, any gain relating to the period following the election will be taxable in the hands of the departing spouse.

Transfer of property to occupying spouse

In certain cases, the departing spouse either owns the family home in their sole name or owns the home jointly with the occupying spouse, and then transfers the home to the occupying spouse under the divorce settlement. In situations like this, it is possible for the departing spouse to claim that the home should be treated as continuing to be their main residence from the date they left it until the date it is transferred to the remaining spouse. Where this claim is made successfully, there will be no charge to CGT on the transfer to the occupying spouse.

This claim cannot be made where the departing spouse has elected for another property to be treated as their principal private residence. Further, the claim can only be made in cases where the departing spouse's former interest in the family home is to be transferred to the occupying spouse rather than being sold, and where the occupying spouse continues to live in the property as their main home.

Non-UK property

If the separating spouses own foreign assets, for example a holiday home, which are to be transferred as part of the divorce settlement then the impact of foreign currency movements on the capital gains position on the disposal will need to be considered. In the same way as for any other chargeable asset, the acquisition cost and value on disposal of a property will be calculated by reference to Sterling at the relevant dates. This can give rise to seemingly paradoxical results, whereby the value of a property may have decreased in local currency terms but have increased in Sterling terms (or vice versa) as a result of movements in exchange rates.

In addition there will be local taxation issues to consider on the transfer of foreign property under a divorce settlement. Through our membership of AGN International, the worldwide association of separate and independent accounting and consulting firms, we are able to obtain advice on these issues across a large number of jurisdictions.

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Appendix

Taxation on divorce - Income Tax and Inheritance Tax

Income Tax

Spouses are taxed independently of each other on income they receive in the tax year and this continues during the period of separation and after Decree Absolute. Each spouse is usually entitled to an income tax personal allowance (£7,475 for 2011/12). The transfer of any assets under a divorce settlement is not in itself subject to income tax. However, if an individual is allocated income-generating assets like shares or interest-bearing cash bank accounts under a divorce settlement, they will be subject to tax on any income which subsequently arises on the assets they receive. Individuals are treated as no longer married for Income Tax purposes from the date of permanent separation.

Inheritance Tax

Transfers between spouses or civil partners are exempt from Inheritance Tax (IHT) and this remains the case throughout a period of separation and until Decree Absolute is pronounced. The exemption is limited to £55,000 if a transfer is being made from a UK domiciled spouse to a non-domiciled spouse. There is no limit on the exemption for transfers between non-UK domiciled spouses and UK domiciled spouses.

HMRC accept that transfers of property which take place after Decree Absolute, but are made under the terms of a court order in relation to the divorce proceedings, are exempt from IHT as long as there is no intention of conferring any gratuitous benefit on the recipient. Maintenance payments to a former spouse or civil partner are also exempt from IHT.

Any other transfers between former spouses after Decree Absolute are treated as Potentially Exempt Transfers and, under current legislation, are exempt from IHT if the donor survives for 7 years following the date of gift.

Specific advice should be obtained before taking action, or refraining from taking action, on any of the subjects covered

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