Divorce day

The dark days of early January can coincide with an increase in the number of couples seeking a divorce. Sofia Thomas considers some of the consequent tax implications.

Less than two weeks into the new year, family lawyers will already have faced a flurry of enquiries marking 'divorce day'. In most years, these peak on the first working Monday in January. Although the process from initial enquiry to final divorce can take years, the parties – whether they are married or in a civil partnership – should consider the potential tax implications from the outset. For simplicity, in this article I will refer to spouses, but this also encompasses civil partners. Unforeseen tax implications can have major impacts on clients and the most prevalent areas of contention tend to relate to:

- domestic tax issues, such as capital gains tax on the main home and the potential loss of only or main residence relief; and
- foreign aspects of divorce.

The financial landscape

The financial landscape of the assets that individuals own and how they acquired them has changed significantly. The pensions freedom legislation, including the Pension Schemes Act 2015 and the Taxation of Pensions Act 2014, has enabled some to buy second homes in the UK or overseas. And more individuals are setting up their own businesses and taking an active approach with their investments, as evidenced by the rise of cryptocurrencies.

The UK judicial system has recognised that the financial aspects of divorce are increasingly complex and require specialised knowledge to adjudicate. To this end, a network of specialist financial remedies courts has been piloted. The hope is that the specialism will allow for greater judicial focus and consistency on financial remedy cases. With such increased attention on financial matters in a divorce, this should lead to tax practitioners being instructed in cases earlier to advise about the potential tax implications of the proposed remedy.

Key points

- Divorce enquiries peak in January and these will have tax implications.
- Property adjustment orders can be made to the matrimonial home.
- Capital gains tax relief must be considered if there is a deferred trust of land on the main residence.
- Check whether the connected persons rules apply to property transfers.
- Stamp duty land tax will not apply to property transfers made under a court order.
- Property transfers before the final divorce could be classed as remittances if money or assets are brought into or enjoyed in the UK.

The matrimonial home

Generally, the matrimonial home is the most important and valuable asset held by a family. It is likely that much consideration will be given as to what will happen with this after divorce. The courts can make property adjustment orders, which enable them to change or transfer the ownership regardless of whether one spouse is the legal owner or a joint legal owner.

Four types of order may be made:

- immediate sale;
- outright transfer;
- deferred trust of land; and
- deferred charge.

With each, differing tax implications need to be considered.

Immediate sale or outright transfer

If the family home is sold or one party transfers their interest to the other, the standard capital gains tax approach will apply, but with consideration to the fact that one spouse may not have occupied the home for the entire time before the sale. It is important to consider the timing of the outright transfer or sale. Simon Denton's article 'Cutting the ties' (*Taxation*, 18 August 2016, page 15) provides detailed commentary on the tax point for capital gains tax during divorce.

Deferred trust of land

A court can order a house to be held in the parties' joint names on trust of land – often referred to as a Mesher Order or Martin Order. Under this, a property is held on trust until a triggering event, such as the youngest child reaching 18. On the triggering event the property is sold.

If such an order applies, there will almost always be a non-occupying spouse who is required to remain part legal owner of the home under the divorce order. On the future sale the non-occupying spouse could be subject to capital gains tax on the period from separation to final sale.

Only or main residence relief applies if an individual sells their main residence and is available for periods of actual and deemed occupation. If the relief is available in full, the gain is exempt from capital gains tax. The final 18 months of ownership qualify for deemed occupation as long as the property has been the individual's main home at some point. Subject to consultation, this period will be reduced to nine months from April 2020.

If the non-occupying spouse has been absent from the home for more than 18 months before the sale, only or main residence relief may not be available to fully exempt the gain in full. This is illustrated by the example of ***Tom and Jane***.

Tom and Jane

Tom and Jane married and bought a home together in 2000 for £175,000. In 2010, they separated and, ten years after the purchase, Tom moved out. Jane stayed in the home with their two minor children.

In 2015, Tom and Jane divorced. Under the terms of the divorce, Tom was required to retain his legal interest in the property until their oldest child reached 18 in 2018 when the home was sold for £500,000, having been owned for 18 years.

Tom and Jane are both higher rate taxpayers. From 2010 to 2018, Tom lived in rented accommodation and the property remained Jane's main home.

If no election was made on divorce in 2015, Tom's capital gains tax liability would be as follows.

	£	£
Proceeds		500,000
Less:		
Cost of sale	5,000	
Acquisition costs	175,000	
		180,000
Gain		320,000
Tom's half-share of gain		160,000
Less: Only or main residence relief (Note *)		102,222
Gain		57,778
Less annual exemption		11,700
Taxable gain		46,078
Capital gains tax at 28%		12,901

Notes.
* The home was occupied by Tom for ten years and there will be the final 18 months of deemed occupation – £160,000 x 138/216 months = £102,222.

Jane would have no capital gains tax to pay on her half share because the whole period of ownership would qualify for only or main residence relief.

If an individual has been absent from the home for a while due to particular circumstances, such as working abroad, it may be possible to treat that period as actual occupation if specific conditions are met. These provisions are contained in TCGA 1992, s 222(8).

Deemed occupation

In the case of divorcing couples, the deemed occupation provisions are contained at TCGA 1992, s 225B ('Disposals in connection with divorce, etc'). For these to apply, the following conditions must be met.

- Before separating, A and B lived in the property as their main home.
- Having ceased to live in the property, A retained an interest in the property due to agreement or court order.
- B continued to live in the property as the main home.
- A had elected to treat no other property as their only or main residence during the period.

If those conditions are met, an election must be made within two years of the agreement or court order for full relief to be given.

Let us revisit our divorcing couple in ***Tom and Jane 2***.

In ***Tom and Jane 2***, if Tom had bought a new home he would not be able to obtain only or main residence relief on it because only one property at a time is eligible for relief. In practice, it is rare for the non-occupying spouse to buy another home because the capital needed do so tends to be tied up in the ex-matrimonial home.

There is a helpful example of this in HMRC's *Capital Gains Manual* at CG65375.

Tom and Jane 2

The circumstances are the same as in ***Tom and Jane*** but, if Tom had made an election within two years of his final divorce, his capital gains tax computation would be as follows.

	£	£
Proceeds		500,000
Less:		
Cost of sale	5,000	
Acquisition costs	175,000	
		180,000
Gain		320,000
Tom's half-share of gain		160,000
Less: Only or main residence relief (Note *)		160,000
Taxable gain		nil

Note
* Tom lives in rented accommodation and has not elected for any other property to be treated as his main residence. An election under TCGA 1992, s 225B will allow his period of occupation from 2000 to 2010 as well as the period from 2010 to 2018 to qualify for only or main residence relief.

Deferred charge

A deferred charge is similar to a Mesher or Martin Order, but the property moves into (or remains in) the sole ownership of the occupying spouse. The non-occupying spouse's interest is represented by a charge over the property that is enforceable only upon a triggering event. The property will be sold if, at that time, the occupying spouse cannot pay the charge. The charge can be either a percentage of the sale price or a fixed sum. In practice, it is most common for a percentage to be used because the chargeholder can then benefit from any increase in the value of the property.

There are two potential tax points in the case of a deferred charge. The first is when the property is transferred to the occupying spouse. If this occurs after the end of the tax year of separation, but before the final divorce, the parties are deemed to be connected persons and, as such, any transfers are deemed to take place at market value.

If this occurs when the non-occupying spouse has been absent from the matrimonial home for more than 18 months, HMRC's helpsheet 281, at section 6 (tinyurl.com/HMRC-77583) is relevant. This tells us that only or main residence relief will be available from the date occupation ceased until the earlier of:

- the date of transfer; or
- the date on which the spouse to whom the property is transferred ceases to use it as their only or main residence.

The second tax point will be when the charge is realised. The capital gains tax implications differ depending on whether the charge is for a fixed sum or variable percentage.

If the charge is expressed as a proportion of the sale proceeds, the value of the share may have increased by the time the property is sold. In this situation, the non-occupying spouse is liable to tax on the gain using the value of the charge at tax point one as the base cost (see TCGA 1992, s 21).

If the deferred charge is for a fixed sum (rather than a proportion of the proceeds), TCGA 1992, s 251 will apply and no capital gains tax is due on the redemption of this debt. In practice, it is rare for the deferred charge to be a fixed sum.

> "A stamp duty land tax liability will arise on the transfer if more than £40,000 is paid."

Stamp duty land tax – exemptions

In most divorce cases, there will be a transfer of land. Under FA 2003, s 76 to s 77A, a stamp duty land tax (SDLT) liability will arise on the transfer if more than £40,000 is paid. If the property is transferred with a mortgage, the debt is considered a chargeable consideration so this may give rise to a tax charge. However, there is no SDLT to pay if the transfer is made under a court order. The full conditions can be found in FA 2003, Sch 3 para 3 (para 3A applies to civil partnerships).

From 1 April 2016, a 3% SDLT surcharge applies when individuals buy an additional home. As we have seen, it is common for one party to remain a legal owner of the ex-matrimonial home even if they are not living there.

Melissa and Tina

In 2014, Melissa and Tina married and bought a home together in equal shares for £350,000. In 2016, they separated and Tina moved out. In 2017, when the property was valued at £450,000, they divorced and as part of the settlement the matrimonial home was subject to a deferred charge.

Tina transferred her 50% share of the home to Melissa and in return was granted a deferred charge that would be realised in five years. If, after that period, Melissa does not have the funds to pay the charge the home will be sold and the deferred charge will be payable out of the proceeds.

Only or main residence relief would be available when Tina transferred 50% of the property to Melissa. But, because the transfer is within 18 months of Tina leaving the home, this is covered by the 18-month deemed occupation provisions. The market value of Tina's share on transfer is £225,000 – being half of £450,000.

In 2022, Tina will receive half of the market value of the home. If it is worth £500,000, Tina's chargeable gain would be £25,000, being her half share of the proceeds (£250,000) less the base cost of £225,000 at the point of deferral. However, Tina would have no capital gains tax to pay if the deferred charge stated she would receive a fixed sum of £250,000.

If Melissa continued to live in the property as her main home, she would not pay capital gains tax on the sale.

From 22 November 2017, FA 2003, Sch 4ZA Pt 3 para 9B ('Property adjustment on divorce, dissolution of civil partnership etc') introduced a provision for exactly the above scenario.

The provisions apply if:

1) person (A) has a major interest in a dwelling;
2) a property adjustment order has been made in respect of the interest for the benefit of another person (B); and
3) the dwelling is B's only or main residence, but not A's.

In those circumstances, A is treated for the purposes of Sch 4ZA as not having an interest in the dwelling.

International implications

Most tax practitioners are familiar with the concepts of residence and domicile. However, the courts in England and Wales consider another status: habitual residence. The courts have jurisdiction to hear a divorce petition if both or one party was habitually resident in the UK. Thus, it is not uncommon to have one or both parties who are non-UK domicile divorcing in England and Wales.

The initial (and very broad) basis for a divorce is that all assets should be taken into account when making decisions on the division of wealth. Consequently, situations may occur in which the non-UK assets of a non-domicile are being considered in UK proceedings. If resident non-domiciles (RNDs) are present in a divorce, the timing and nature of funds make it important to consider whether they are remittance basis users. If an RND is filing self-assessment tax returns under this basis, qualifying remittances are taxable in the UK at their top rate of tax in the year of payment. If a settlement or maintenance is payable in the UK, we must consider whether a transfer of overseas income or gains will qualify as a taxable remittance.

The rules on remittances are wide and I comment on them in the case of divorce only. In brief, under ITA 2007, s 809L, there is a remittance of foreign income or gains if they are:

- brought to, received or used in the UK for the benefit of a 'relevant person';
- used to provide a service in the UK to or for the benefit of a 'relevant person';
- used in connection with a loan or debt to provide a UK person with a UK benefit; or
- used to service a debt that relates to property or the provision of services in the UK.

Under ITA 2007, s 809M, relevant persons include:

a) the individual;
b) the individual's husband or wife;
c) the individual's civil partner;
d) a child or grandchild of a person falling within any of the paragraphs of (a) to (c) if they are younger than 18;
e) a close company; and
f) the trustees of a settlement that contains a relevant person as defined above.

During the divorce process, parties will remain relevant persons until the decree absolute. Consequently, any transfers in the period before the final divorce could be classed as remittances if such money or assets are brought into or enjoyed in the UK. Therefore, settlements paid to the ex-spouse in their non-UK bank account and which are then brought into the UK *after* the decree absolute will not be a remittance by the paying spouse because the ex-spouse has ceased to be a relevant person.

However, funds that go towards benefiting a couple's children in the UK would be classed as remittances. Even though the funds have not been paid directly to the children, condition C of s 809L applies. This states that money or assets gifted to someone who is not a relevant person will be a remittance if a relevant person still enjoys, directly or indirectly, something derived from that gift. See ***Martin and Andrea***.

The anti-avoidance provisions will not apply to the ownership of assets gifted during the marriage. The provisions state that if a person is a relevant person they cannot also be a gift recipient at the same time (see HMRC's *Residence, Domicile and Remittance Basis Manual* at RDRM33240). The question of whether they are a relevant person is considered by reference to their status when the gift was made (ITA 2007, s 809N(3)).

HMRC has a useful illustration of this at RDRM33150 (example 5).

Finally, intention is key and the parties should always be asked for their intended plans after the divorce. It is not uncommon for the care-giving parent to return to their home country where they may have family support to help with the children. Because UK tax does not operate in a vacuum, a decision here could have a ripple effect elsewhere in the world.

In the case of *Harris v Harris* [2018] EWHC 1836 (Fam) a husband and wife divorced in 2009. The parties appealed on several matters, including who should bear the burden of the tax on the spousal and child maintenance. Mrs Harris moved to Belgium after the divorce and the gross monthly payment of £1,600 awarded to her was subject to tax at 40.9% – substantially reducing her award.

> "Intention is key and the parties should always be asked for their intended plans after the divorce."

Conclusion

Weight is increasingly given to the impact of the financial aspects of divorce, and practitioners are likely to be called upon for advice. Pre-planning is key and can have a material impact on the subsequent taxes payable.

When providing tax advice for clients undergoing divorce proceedings, thought must be given to location, timings and elections to ensure that the correct amount is paid and the relevant provisions are in place.

Martin and Andrea

Martin and Andrea were married in the UK and are both RNDs living in the UK. After their divorce, Martin is ordered to pay monthly maintenance payments of £1,000 to Andrea for herself and £1,500 for their children.

Martin can pay Andrea the monthly spousal maintenance of £1,000 directly into her non-UK bank account (after the final divorce). Andrea can bring this money into the UK and it would not be taxable remittance on Martin – as long as the funds are not used to benefit his children in the UK.

Martin should pay the child maintenance to Andrea from clean capital – in other words, money earned overseas before he became UK resident. This money, as intended, can be used to benefit the children.

To complete matters, Andrea should agree not to use her spousal maintenance in a way that would benefit any individuals who are relevant persons to Martin and to indemnify him for all tax arising if she does so.

Planning point

Subject to conditions being satisfied, TCGA 1992, s 225B provides for the deemed occupation of a property to enable capital gains tax only or main residence relief to be claimed on some disposals in connection with a divorce.

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