TAX PLANNING FOR COUPLES

A technical outline of the tax planning opportunities
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INTRODUCTION

This report will consider the opportunities and traps for couples including issues on separation or divorce.

Special rules apply to married couples and civil partnerships. The parties to such relationships will be termed spouses for the purposes of this report.

Couples living together who are not married or in civil partnerships have no special rules. The parties to these relationships will be termed partners for the purposes of this report.

Generally the tax rules favour spouses over partners but there are a number of situations where it can be the other way round. Also there are some cases where partners are treated in the same way as spouses.

This is not intended to be an exhaustive treatment of the subject but to highlight a number of issues that crop up in practice with suggested solutions where appropriate.

It is assumed that the basic rules are understood by practitioners but for completeness we have included extracts from HMRC manuals and legislation which practitioners may find useful.

INCOME TAX

1. Introduction

Independent taxation introduced with effect from 6 April 1990 means that generally spouses are treated as two separate people for tax purposes.

If one spouse is paying tax at a higher marginal rate than the other spouse it is clearly advantageous in tax terms to transfer income to the spouse paying tax at a lower rate.

2. Investment income

The simplest form of planning for investment assets is for them to be held outright by the spouse paying tax at the lower rate.

Spouses may prefer to hold assets jointly. This may be attractive to allow both spouses to administer the assets. It is also helpful if one spouse dies whereupon the other spouse usually has full access to the asset without the need for probate formalities.

Under ITA 2007 s836 the income from most jointly held assets is deemed to be taxed 50:50. This applies even if the true ownership is not 50:50. However, the couple may make an election under s837 to be taxed in line with the true ownership ratio.

It should be noted that s837 does not give a couple power to have the income taxed in any ratio they fancy but only in the true ownership ratio.

Opportunity

An asset could be owned 90:10 in favour of the higher tax paying spouse. The spouse may prefer to keep the ownership ratio unchanged. By **not** making an election, the income is taxed 50:50.

Similarly the higher tax paying spouse need only give a small share in assets to the other spouse whilst still transferring half the income.

It should be noted that the rule in s836 does not apply to income from partnerships, furnished holiday letting or shares in close companies.

3. Businesses

If the higher tax paying spouse is a sole trader, transferring income is possible in one of two ways.

The first is to employ the other spouse in the business and pay a salary. The difficulty with this depends on how much work the spouse does for the business. In most small businesses, the spouse will assist to some degree but the level of involvement will vary from very little to full-time. To be deductible for income tax purposes in the sole trader's business (and if it isn't then it will cost extra tax – not save it), the level of salary must be appropriate for the duties performed by the spouse.

A way of avoiding this problem is for the spouse to become a partner in the business. Profits may then be allocated, perhaps 50:50, without regard to the respective level of duties. A drawback with this solution is the commercial risk of exposing the spouse to unlimited liability. This could be overcome by using a limited liability partnership – either the old style (under the Limited Partnerships Act 1907 – not commonly used) or the new style LLP.

With a company, the process of shifting income to a spouse is generally much easier.

Again the spouse can receive a salary. In most situations, to avoid national insurance costs, this is likely to be capped at the national insurance secondary threshold (£7,072 in 2011/12) regardless of the level of involvement of the spouse. If the spouse is appointed as an officer of the company (director and/or company secretary) justifying the level of salary is less difficult as it would be reasonable to pay a small salary to a non-executive officer even if they do very little.

If the spouse is given shares in the company, dividends can be paid even if the spouse does absolutely nothing in the business.

Trap

It is recommended that any shares given to the spouse are not restricted in any way, e.g. non-voting. The reasons for this are discussed in section 4 below.

4. Income shifting – settlements legislation

The general rule [ITTOIA 2005 s624] is that, if a person creates a settlement but retains an interest in it, the income of the settlement is treated as belonging to the settlor.

Retaining an interest is defined in s625 as including a situation where the settlor's spouse or civil partner can benefit. This alone would prevent tax saving by making gifts of income producing assets to spouses paying lower rates of tax. However, s626 qualifies the rule in s624 by stating that an outright gift between spouses is not caught provided the gift carries a right to the whole of the income and the property is not "wholly or substantially a right to income".

In the past there was concern that where, for example, a company was essentially the vehicle to provide the services of a single person, a gift of shares to the other spouse on which dividends would be paid was substantially a right to income. This fear seemed to be realised in the case of Jones v Garnett, also known as the Arctic Systems case. Arctic Systems Ltd was effectively a one man company to supply the services of Mr Jones. Mr Jones had given shares to his wife on which dividends were paid and HMRC sought to apply the settlements legislation. The case went right up to the House of Lords (Jones v Garnett [2007] STC 1536). The decision in favour of the taxpayer was that a gift of ordinary shares, not restricted in any way, even in a company such as Arctic Systems Ltd, was more than just substantially a right to income.

In 2007 the Government announced its intention to reverse this decision and introduce income shifting legislation. Thankfully this was dropped in 2008 as the proposals would have been a nightmare to implement. So this issue is on the back burner for the time being.

It is useful to consider how the settlements legislation might apply in practice.

4.1 Transfers of shares

As the Arctic Systems case demonstrates, an outright gift of ordinary shares with all the shares having the same rights is safe.

The corollary of this is that anything short of this is subject to risk. Giving shares that are restricted in any way such as being non-voting or carrying lesser rights to capital should be avoided.

Tip

The transferee spouse should receive ordinary shares of a single class.

4.2 Dividend waivers

Sometimes the higher tax paying spouse wishes to give a greater share of dividends to the other spouse by means of dividend waivers. This is highly vulnerable to challenge under the settlements legislation.

In HMRC's Trusts Settlements & Estates Manual at para TSEM4225 (http://www.hmrc.gov.uk/manuals/tsemmanual/tsem4225.htm) it states that one should look out for the following factors, which would indicate that the Settlements legislation is likely to apply:

- The level of retained profits, including the retained profits of subsidiary companies, is insufficient to allow the same rate of dividend to be paid on all issued share capital.
- Although there are sufficient retained profits to pay the same rate of dividend per share for the year in question, there has been a succession of waivers over several years where the total dividends payable in the absence of the waivers exceed accumulated realised profits.
- There is any other evidence, which suggests that the same rate would not have been paid on all the issued shares in the absence of the waiver.
- The non-waiving shareholders are persons whom the waiving shareholder can reasonably be regarded as wishing to benefit by the waiver.
- The non-waiving shareholder would pay less tax on the dividend than the waiving shareholder.

End quote

In the case Buck v Revenue & Customs Commissioners SpC 716 (November 2008), the husband held 9,999 shares and his wife 1 share. He waived his dividends to allow large dividends to be paid to his wife. It was held that this was caught by the settlements legislation.

Trap

Dividend waivers should be avoided wherever possible.

4.3 Alphabet shares

Where the spouse is only given a small number of shares, an alternative to dividend waivers is to make those shares into a different class, e.g. B shares. This allows different rates of dividend per share to be declared. These too are dangerous as was demonstrated in the recent case of Patmore [2010] TC 00619. In a case with unusual facts, the tribunal judge decided that a decision by the controlling shareholder to only issue a dividend on one class of shares rather than another (B shares in this case in preference to A shares) could be an arrangement caught by the settlements legislation.

Trap

Alphabet shares should be avoided wherever possible.

4.4 Partnerships

The same principles can be applied to partnerships.

Some examples of HMRC's views on the application of the settlements legislation to partnerships can be found in HMRC's Trusts Settlements 7 Estates Manual at para TSEM4215.
http://www.hmrc.gov.uk/manuals/tsemmanual/tsem4215.htm

The third paragraph states:

"Where the incoming partner is a spouse or civil partner and he or she acquires an unlimited share in the partnership assets and income and there are no other arrangements or conditions applied to the gift then the exemption for outright gifts will apply and a challenge under the Settlements legislation is not appropriate."

End quote

Thus, as with shares, an outright gift of a full interest in the partnership will not be caught. However, for example, an attempt to give a share in income whilst retaining all capital rights is vulnerable to challenge.

5. Settlements legislation

The comments in section 4 above dealt with the application of the settlements legislation to transfers between spouses.

It is worth commenting briefly on the settlements legislation more generally. As mentioned in the first paragraph of section 4, ITTOIA 2005 s624 taxes the income of any settlement on the settlor where the settlor retains an interest in the settlement. Retaining an interest is defined in s625 and includes the situation where the settlor's spouse may benefit from the settlement.

Thus, on creation of a settlement, it is important for the settlor not only to exclude himself as a potential beneficiary, but also any spouse, including any future spouse, whether or not marriage is contemplated at the time the settlement is established.

Tip

As stated above, it is recommended that any trust deed includes a clause specifically preventing the settlor and any spouse, present or future, of the settlor from benefitting. However, the trust can include a clause that allows a spouse to become a beneficiary following the settlor's death.

CAPITAL GAINS TAX

1. Introduction

As with income tax, spouses are treated as separate individuals for capital gains tax each with their own annual exemption (£10,600 in 2011/12).

However, spouses have one big advantage over partners. Assets can be transferred between them at no gain no loss [TCGA 1992 s58].

Planning therefore revolves around ensuring that, if possible, both annual exemptions, both 18% bands, capital losses and both £10m entrepreneur's relief bands are fully used before any 28% tax is paid.

2. Anti-avoidance

The ability to transfer assets between spouses for tax planning purposes generally works, even where the transfer takes place just prior to a sale. However, there are some situations where HMRC may challenge the position:

2.1 Circular transactions

An example of circular transactions is where one spouse transfers an interest in an asset to a spouse, it is sold and then the proceeds are given back to the transferor. This could be challenged under the case law doctrine that started with the Ramsay case many years ago whereby steps inserted for no commercial purpose can be ignored.

Tip

Where interests in assets are transferred immediately prior to sale it is sensible to ensure that the relevant share in proceeds is kept by the respective spouses or, at minimum, in a joint bank account.

2.2 Non-resident spouse

Where one spouse is UK resident and the other not (perhaps because the latter is working abroad for a period), an asset could be transferred to the non-resident spouse prior to sale. The non-resident spouse would not be liable to capital gains tax (however, beware the rule in TCGA 1992 s10A that can tax capital gains on return to the UK if there have been less than 5 years of non-residency).

Generally this is acceptable planning but in the case of Regina v H M Inspector of Taxes, Reading ex parte Fulford-Dobson 60 TC 168, the transferee spouse was only non-resident by reason of ESC D2 (split year treatment). It was held that concessionary treatment was not available because an attempt had been made to use it for tax avoidance.

Tip

If assets are transferred to a non-resident spouse in anticipation of sale, ensure the sale is delayed until after 5 April following the person's departure.

2.3 Restrictions on allowable losses

FA 2007 introduced a mini anti-avoidance rule (sometimes referred to as a Targeted Anti-Avoidance Rule or "TAAR") in relation to capital losses – see TCGA 1992 s16A. It is not wholly clear how this might apply in the context of inter-spouse transactions.

HMRC's views on the application of the TAAR in general can be found at http://www.hmrc.gov.uk/manuals/cgmanual/cg_app9.htm

It is worth mentioning some points from this in relation to inter-spouse transactions.

In the final paragraph of the "Tax advantage" section, it states

"Nor will the new legislation ordinarily prevent a genuine loss on a real disposal of an asset from being set off against a person's own gains, including the case where, before the real disposal that gives rise to the genuine loss, the person acquires the relevant asset from a spouse or civil partner at no gain/no loss under section 58."

This point is repeated in Example 5.

Examples 4 and 6 are similar but with different outcomes.

Example 4 has the husband selling shares to generate a capital loss with the wife buying the same shares a day later without each other knowing (seems farfetched in reality). This is okay. But, in example 6, the wife knowingly buys the shares and transfers them back to her husband. This is not okay. This begs the question of whether a challenge would be made if the wife knowingly bought the shares but kept them herself. Variations (i.e. between the extremes of 4 and 6) such as this are covered in Example 7 where HMRC say it is "less likely" to be challenged.

3. Principal private residence relief

With principal private residence relief partners have an advantage over spouses. Spouses can only have one principal private residence between them [TCGA 1992 s222(6)] whereas partners can have one each.

Tip

For partners with two residences then maximum relief can be obtained by each owning one property outright rather than owning the two properties jointly. However, it is advisable that each person make an election under TCGA 1992 s222(5) in favour of the property they own. This is because both properties might be considered residences for both of them, even though they each do not own one property. It might be argued that each party only has a gratuitous licence to occupy the property they don't own [see HMRC manual para

CG64470] but it is unsafe to rely on this particularly if both parties contribute to the upkeep of both properties. ESC D21 provides an extended time limit to make an election where a person is not aware of the need to make one and he only has a negligible interest in one property but, again, it is unsafe to rely on this.

For the purposes of calculating principal private residence relief, if a spouse transfers an interest in a residence to the other (including on death) at a time when the property is still the only or main residence the transferee is deemed to acquire the property at the time the transferor acquired it [TCGA 1992 s222(7)].

Trap

If a spouse owns a property that has been that spouse's residence but is no longer then care should be exercised before transferring a share to the other spouse prior to sale (perhaps to use an extra annual exemption). This is because s222(7) does not apply and so, on transfer, all principal private residence relief is lost in relation to the part transferred.

4. Entrepreneur's relief

Each spouse has a lifetime limit of £10m capital gains to which the entrepreneur's relief rate of 10% will apply. So, where gains are anticipated in excess of £10m, it is important to arrange ownership so that both spouses can benefit.

It is important to remember that being spouses confers no benefits as far as entrepreneur's relief is concerned. Each spouse has to qualify in his or her own right.

For shares, this means owning at least 5% of the ordinary share capital and being an officer or employee for at least 12 months. A transferor spouse's ownership period is not added to a transferee spouse's period.

Note that the officer or employee requirement can be satisfied by being appointed as a director or company secretary. There is neither a minimum working requirement nor even a requirement to receive a salary.

Tip

If a spouse does not work in a company, he or she can still be appointed as a director or company secretary to satisfy the requirement.

Only 5% needs to be held for at least 12 months. Once this test has been satisfied more shares can be transferred to the spouse shortly before a sale and the gain still qualify for entrepreneur's relief.

Tip

If a spouse does not have sufficient shares to qualify and a sale is likely in less than 12 months, it is worth transferring the necessary 5% in case the sale is delayed. If the sale does happen in less than 12 months the shares can be transferred back (if the original transferor is likely to have spare entrepreneur's relief).

5. Death bed planning

If a spouse is expected to die in the near future, a terminal illness for example, it may be worth the other spouse transferring any assets standing at a substantial capital gain to that spouse. By this means the base cost of assets can be increased to market value at date of death without tax cost.

Of course, it is important that such assets are transferred back to the original owner on death or at least dealt with in the will according to the original owner's wishes.

INHERITANCE TAX AND ESTATE PLANNING

1. Introduction

As with other taxes, spouses are treated as separate persons for inheritance tax purposes.

However, as with capital gains tax, spouses have a major advantage over partners in that inter-spouse transfers, even on death, are free of inheritance tax [IHTA 1984 s18].

It is important to remember that existing wills are invalidated on marriage or divorce.

2. Non-domiciled spouse

If one spouse is UK domiciled and the other is not, a transfer to the non-domiciled spouse is not exempt to the extent it exceeds £55,000 [IHTA 1984 s18(2)]. Of course this is only a problem for transfers on death or within 7 years of death otherwise the normal potentially exempt transfer rules will apply.

Simply because a foreign born spouse has come to live in the UK, whether before or after marriage, does not necessarily mean that the spouse acquires a UK domicile. However, for inheritance tax purposes only, the rule in IHTA 1984 s267 means that such a person will acquire a UK domicile if that person has been resident in the UK for at least 17 out of the last 20 years.

3. Use of nil rate band

Historically it was important to ensure that the nil rate band of the first spouse to die was utilised in full. If the entire estate was left to the surviving spouse (free of inheritance tax) then that nil rate band would be wasted.

The need for this was largely eliminated by the changes introduced by FA 2008 that introduced the ability to transfer unused nil rate band to the surviving spouse [IHTA 1984 s8A]. At its simplest, if all assets are left ot the surviving spouse, the survivor will have two nil rate bands available on death. Note that the extra nil rate band is that at the time of the second death – not the amount at first death.

Prior to that time, the common form of planning was to set up a trust on first death to take assets in value up to the nil rate band. The surviving spouse could be a beneficiary of that trust and so effectively have access to the full combined estate.

This type of planning, in absence of personal reasons to leave assets to others on first death, is now normally unnecessary.

There is no need to amend all the wills of people who adopted this idea. The position can be reviewed following first death and, if desired, assets appointed out of the trust within two years of death to the surviving spouse. This is deemed to be the same as a transfer directly from the deceased to the surviving spouse thereby allowing the nil rate band to be transferred.

4. Estate planning on first death

Paragraph 3 above considers the point that, as a general rule, all assets can be left to the surviving spouse without wasting nil rate band. Of course, the first spouse to die may have personal reasons for leaving assets to others. Leaving these aside, there are a number of specific situations where alternative planning may be useful.

4.1 Children from an earlier marriage

The deceased may have re-married following a death of or divorce from a spouse and have children from that marriage. He may be concerned that these children will lose out if he leaves his whole estate to his new spouse. However, he may be equally concerned that his current spouse has sufficient assets and income for the rest of her life.

The best solution to this is likely to be to establish a trust under which his spouse has a life interest in income with the capital to go to his children following her death. This is termed an “immediate post death interest” [IHTA 1984 s49A]. This is liable to inheritance tax as if the value was going direct to the individual with the life interest and therefore the spouse exemption applies.

If the spouse does not need the assets, the interest could be renounced. This would be treated as a potentially exempt transfer with the normal 7 year rule applying.

The trustees can also be given discretionary powers to give capital either to the surviving spouse outright, if desired, or to the children (again a potentially exempt transfer).

4.2 Business property

Subject to the needs of the surviving spouse, assets qualifying for inheritance tax relief (such as business or agricultural property) can be left to someone other than the surviving spouse (an individual or a discretionary trust perhaps). The surviving spouse could then purchase these assets (little or no capital gains tax as the base cost of the assets will equal market value at date of death) and, after two years ownership (seven years for let agricultural property so not worthwhile for such), qualify for business property relief or agricultural property relief again.

This is particularly useful where the prospect of surviving seven years after first death is doubtful.

4.3 A nil rate band discretionary trust

As discussed in paragraph 3 above, a nil rate band discretionary trust on first death is no longer the powerful tool that it was. However, it remains useful, perhaps, to hold assets where the expectation is that the value of those assets might grow faster than the nil rate band.

This is, of course, not an easy decision to make. Prior to the 2010 election, the Conservative Party spoke of increasing the nil rate band to £1m but later back-pedalled to say that this would not happen before the end of this Parliamentary session.

5. Lifetime gifts

Where assets and circumstances allow, it is attractive to make lifetime gifts of assets not qualifying for relief.

Parents may be reluctant to make substantial gifts outright to children for fear of dissipation, bankruptcy or divorce.

One solution is to put assets into a discretionary trust. As this is a chargeable transfer, inheritance tax is due at a rate of 20% (increased to 40% if death occurs within seven years) on amounts in excess of the nil rate band.

Potentially one individual can put assets of value up to the nil rate band into such a trust every seven years without inheritance tax cost.

Spouses can each do this thereby doubling the amount that can be transferred.

Tip

Note that, if assets are predominately held by one spouse, it is possible to transfer assets to the other spouse in anticipation of that spouse putting the assets into trust. Generally this is not objectionable even if the time period between the two gifts is very short.

Trap

However, nothing should be done to suggest that the first gift is conditional on the second gift being made.

6. Gift with reservation

If a donor makes a gift and either

(a) possession and enjoyment of the property is not bona fide assumed by the donee at or before the beginning of the relevant period (7 years prior to death or the date of gift, if later); or

(b) at any time in the relevant period the property is not enjoyed to the entire exclusion, or virtually to the entire exclusion, of the donor and of any benefit to him by contract or otherwise

the donor is considered to have made a gift with reservation and therefore the gift is ineffective for inheritance tax purposes (but still counts for other tax purposes) [FA 1986 s102].

As commented in paragraph 5 above in the Income Tax Section, on establishment of a trust, it is common to find a clause expressly preventing both the settlor and any spouse from benefiting from the trust. This is required to make the trust effective from an income tax viewpoint. However, a restriction

 Landmark Practice Development Specialists preventing the spouse from benefiting is not required from an inheritance tax viewpoint as this would not be deemed to be a gift with reservation.

Equally transfers between spouses are specifically exempt from this legislation [FA 1986 s102(5)(a)].

There is an exception to this rule introduced to counter the decision in the Eversden case [IR Commrs v Eversden (executors of Greenstock dec'd) CA 2003, 75 TC 340] and found in s102(5A)-(5C). Consideration of this is beyond the scope of this report.

7. Pre-owned assets

The pre-owned asset rules were introduced in FA 2004 to prevent transfers of assets in ways that sidestepped the gift with reservation rules.

A classic example, popular at the time, was the so-called “double trust scheme”. Briefly this converted the value of a house into a loan note via one trust (i.e. the house was sold to the first house in exchange for a loan note) that was gifted to a second trust. This effectively removed the value of the house from the estate whilst allowing the donor to continue to live there rent-free. A simple gift of the house would clearly be a gift with reservation.

Transfers between spouses are specifically exempted from these rules. However, it should be noted that transfers between partners could be caught.

It has been suggested that a variation of the double trust scheme could be employed to take advantage of the inter-spouse exemption. It has been named the “family debt scheme”.

Thus, for example, one spouse owns the matrimonial home. He sells the home at full market value to his spouse in return for a loan. He then transfers this loan, either outright to his children or to a trust.

To date no attempt has been made to block this idea. However, it should be noted that there is an immediate stamp duty land tax cost. Also, HMRC has argued that the original double trust scheme was flawed on the grounds that the lack of ability of the recipients of the loan to call it in means that there is a gift with reservation. This analysis, if correct, may also apply here. Finally, to be effective, the donor needs to survive seven years (the gift being a potentially exempt transfer).

Given that the introduction of the pre-owned asset rules not only discouraged schemes such as the double trust scheme taking place in the future but also struck at schemes already implemented, plus the uncertainty of success and the stamp duty land tax cost, it is questionable whether this is sensible planning.

8. The family home

Often the family home is the most valuable asset in a couple’s joint estates and has traditionally been the most difficult to deal with owing to the desire for continued occupation.

The problem has diminished with the introduction of the transferable nil rate band but it is not that unusual for the house's value to exceed two nil rate bands.

Some attempts at solutions have already been discussed such as the double trust scheme and the family debt scheme.

8.1 Full consideration

The most robust solution unlikely to be upset by changes to legislation is for the house to be transferred and the couple pay a full market value for continued occupation. It is important to ensure that the rent is at least equal to a full market rent as any shortfall, however small, may wreck the planning.

One disadvantage of this solution is that the recipient will be liable to income tax on the rental income. Over many years this cost could drastically reduce the net tax saving. A possible solution to this is to transfer the property to a trust. The trust would be liable to income tax on the rent itself but there may be scope to make distributions of income to young beneficiaries (grandchildren or great-grandchildren) who have unused personal allowances thereby allowing the income tax to be recovered.

Another disadvantage is that the recipient will be liable to capital gains tax on the growth in value between the date of transfer and date of sale – which may be many years (needs to be at least 7 to save inheritance tax!).

8.2 Co-ownership

Another relatively safe arrangement in the right circumstances is where, say, a child continues to live with the couple. In this situation a gift of a share in the property can be made without a gift with reservation provided the recipient pays no more than his fair share of the running expenses. However, if the child subsequently moves elsewhere, the planning becomes ineffective. It has been suggested that a gift of a greater proportion of the property can be made. It is understood that HMRC does not accept this but it is unclear on what basis.

SEPARATION & DIVORCE

1. Introduction

Of course a separation and particularly a divorce is rarely an easy time for any couple. However, consideration of tax planning is an important aspect and often needs to be dealt with sooner rather than later.

As it is usually how assets should be divided is the main issue, capital gains tax planning is most important. However, it should not be forgotten that inheritance tax planning will be restricted going forward and therefore may also need consideration.

2. Living together

The key is the rule that determines whether assets can be transferred tax free between spouses. TCGA 1992 s58(1) states

If, in any year of assessment,–

(a) an individual is living with his spouse or civil partner, and
(b) one of them disposes of an asset to the other,

both shall be treated as if the asset was acquired from the one making the disposal for a consideration of such amount as would secure that on the disposal neither a gain nor a loss would accrue to the one making the disposal.

The definition of living with is found in TCGA 1992 s288(3) and refers to the definition in ITA 2007 s1011 which reads

Individuals who are married to, or are civil partners of, each other are treated for the purposes of the Income Tax Acts as living together unless–

(a) they are separated under an order of a court of competent jurisdiction,
(b) they are separated by deed of separation, or
(c) they are in fact separated in circumstances in which the separation is likely to be permanent.

End

Thus if a couple choose to live apart but the marriage has not broken down then they are still considered to be living together.

But note that it is the point that a couple separate with no likely intention to get back together that is important – not the date of divorce.

The final and important point to note is that conditions (a) and (b) in s58(1) do not have to be satisfied at the same point in time – merely in the same tax year. Thus, if a couple separate permanently, they can still transfer assets between them tax-free until the following 6 April.

Tip

If a couple intends to separate, they should try to do so early in a tax year.

3. Consideration

If a couple fail to sort out a division of assets within the year of separation, any later transfer of assets may be liable to capital gains tax. In such circumstances, it is necessary to determine the consideration.

Prior to the decree absolute the couple will remain connected persons and so the market value rule applies [TCGA 1992 s18]. After that time it will be necessary to consider the terms of any settlement. For example there may be an exchange of assets where market value will apply or there may be a one way transfer of assets in consideration of settlement of all outstanding claims where market value will again apply [TCGA 1992 s17(1)(b)].

The danger here is whether any attempt to hold over gains (e.g. on business assets) will be denied on the grounds there is actual consideration. HMRC will generally take the view that the recipient spouse has given consideration in the form of giving up claims (as mentioned in the preceding paragraph) even if there is no tangible consideration. However, HMRC does accept that this is not always the case. Detailed commentary on their views can be found in CG67192 at http://www.hmrc.gov.uk/manuals/cgmanual/cg67192.htm.

4. Family home

(reproduced from the Capital Gains Tax – Principal Private Residence Relief report)

When a divorce occurs, it is normal for one party to leave the matrimonial home. Sometimes the property is sold. The departing spouse will obtain full relief for his share of any gain provided the sale occurs within 3 years of his departure. If the property is sold at a later date then the gain will not be wholly relieved.

If the departing spouse transfers his share of the property to the resident spouse, it is deemed to be a disposal at market value. The same principles will apply as in the previous paragraph. However, under TCGA 1992 s225B (formerly ESC D6), if the departing spouse does not have another PPR he can deem the original property to remain his PPR if the remaining spouse continues to so use it.

Where the departing spouse intends to acquire another property but there is no wish to transfer the original property to the remaining spouse, a tax efficient option is to obtain a Mesher order. This puts the departing spouse's share of the property into trust on terms that allow the remaining spouse to occupy it until a specified event (e.g. remarriage or the 18th birthday of the youngest child) at which point the property is sold and both parties receive their shares.

As a beneficiary of the trust (the remaining spouse) is entitled to occupy the property under the terms of the trust, relief is available for the whole gain under TCGA 1992 s225.

5. Inheritance tax

Transfers between spouses are not limited by a requirement to be living together [IHTA 1984 s18] and so inheritance tax planning can continue after the year of separation subject, of course, to any capital gains tax issues.

As mentioned in the Introduction to the Inheritance Tax section, it is also important to remember that existing wills are invalidated by divorce and so need to be rewritten.

COMPLIANCE ISSUES

1. Jointly held property

The election to tax jointly held property in line with its true ownership is made using form 17 found at http://www.hmrc.gov.uk/pdfs/form17.pdf.

APPENDIX 1 – HMRC relevant statutory references

MARKETING COPY:

Graham I will work on this.