

Forensic Accounting and Litigation Support

DIVORCE AND TAXES UPDATE

Autumn 2021



In this Forensic Accounting and Litigation Support update we look at a variety of taxes and the considerations for each when a couple separates.

When in the process of separating, taxes are rarely at the forefront of the couples' mind. Careful consideration of timings, however, can potentially make a significant difference in terms of preservation of joint wealth by minimising the tax leakage. The challenge is that for the different taxes there are different rules and different considerations. Some of the matters to be considered for the different taxes are set out below.

INCOME TAX

Married couples are taxed independently so divorce may not have any impact on their individual income tax positions. If, however, they have jointly held income producing assets then careful consideration needs to be given to the income tax position once they have separated. Individuals are no longer treated as married for income tax purposes from the date of permanent separation. The transfer of assets may give rise to capital gains tax (CGT) but is not subject to income tax. Consideration needs to be given to the assets transferred as they may well generate income in the hands of the recipient spouse. Sometimes this can mean that that

the individual has to complete a tax return for the first time in their lives.

The actual definition of permanent separation can sometimes cause difficulties in practice. For example, there was a case where an individual claimed that he was not permanently separated from his wife, although they had lived apart for five years!

CAPITAL GAINS TAX

For the whole of the tax year of separation (that is through to the following 5 April) a couple is treated as if the spouse exemption for capital gains tax applies, even if they have a permanent separation. This means that assets can be transferred between the spouses

with no CGT arising. The recipient spouse assumes the original cost of the asset from the transferring spouse. For example, if a wife had bought shares for £100 and they were worth £150 at the time of transfer, the husband would inherit the £100 original cost on the transfer. No capital gain would arise until he sold the shares at a later date.

Once the tax year of separation has passed the couple are treated as 'connected persons'. Under tax law this means that any transfer of assets between them are at deemed market value, regardless of any consideration that is or is not paid. This can be problematical since a 'dry tax charge' can arise. For example, if a property were transferred from husband to wife with no payment being made for that property, the deemed market value of the property would be the amount that the husband was taxed on, even though he received no cash in return for the property. There can also be problems if capital losses arise on transfers at this time. Such losses can only be relieved against gains arising to the same connected person.

Once their decree absolute has been granted, couples are treated as if they were third parties for

CGT purposes. This means that the agreed price of a transfer of assets between them is likely to be the value for the purposes of any tax calculation. They should still, however, be aware of a tax provision which applies to any transfer of assets. If it is considered to be a 'bargain not made at arm's length' then deemed market value can be applied by HMRC.

STAMP DUTY AND STAMP DUTY LAND TAX

There is no exemption for transfers between husband and wife in respect of stamp duty (SD) or stamp duty land tax (SDLT). There is, however, provision for an SDLT or SD exemption in the event that an interest in a property or shares is transferred as a result of a Court Order or separation agreement with a view to divorce. This also applies to the annulment of a marriage or a legal separation.

INHERITANCE TAX

The position for inheritance tax (IHT) differs once again. For this tax a couple are deemed to be able to be treated as still married until the date of their decree absolute.

Some couples, therefore, decide not to go ahead with the decree absolute if they wish to use

the spouse exemption for IHT planning. This enables assets to be transferred between them on death. This only usually happens if there is value in the joint estate in excess of the two nil rate bands (£650,000 as increased by the £1 million allowance for a private residence) and there is a desire to pass on wealth to family members, whilst minimising IHT.

CONCLUSION

As can be seen from the above there is a complex tax web to be considered when a couple separates. It is only by reviewing each asset and income stream and considering all the relevant taxes for each, that the tax payable can be minimised for the divorcing couple.



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