MARRIAGE IS ABOUT LOVE; DIVORCE IS ABOUT MONEY

TAX AND ESTATE PLANNING ON DIVORCE

It is perhaps unsurprising that studies have shown that divorce is one of the most stressful life events that an individual can experience. And quite apart from the emotional turmoil, as Richard Wagner famously stated, *"Divorce is one of the most financially traumatic things you can go through"*. Being aware of the nuances in tax legislation can be crucial to ensuring that, when all is said and done and a financial settlement is agreed, there is not a further sting in the tail.

There are three main taxes in the UK that require consideration when undertaking financial planning on a divorce: capital gains tax (**CGT**), income tax, and inheritance tax (**IHT**).

CGT

CGT is a tax on the increase in value of an asset when there is a disposal of such asset, whether by sale or gift.

Following significant changes to the regime applicable on divorce from 6 April 2023, where assets are transferred between separating spouses or civil partners before decree absolute, CGT will not be payable and transfers will be on a 'no gain no loss' basis, provided they are effected within three tax years of the year of separation. The no gain no loss basis will apply for an unlimited time when any transfer is made subject to a formal court order or other formal agreement on divorce or the legal end of a civil partnership; otherwise any transfer between ex-spouses or partners after decree absolute (or a final order in relation to a civil

partnership) will be subject to CGT in the usual way.

Special provisions apply in relation to any property that has been used by the couple as the matrimonial home so that a party who retains an interest in the former matrimonial home may still claim Principal Residence Relief when the property is sold. Equally, any proceeds of sale to which an ex-spouse or partner is entitled on the sale of a home following a transfer of their interests in that home to their spouse or partner as part of the financial settlement will be treated in the same way as the original transfer of their interest and will not be subject to further CGT where this was not paid on the initial transfer.

Income tax

Income tax is paid in relation to income received by individuals at rates between 20% and 45% depending on the level of an individual's income. Where maintenance payments are received, these are not subject to income tax.

Income tax may be relevant if it is necessary to extract significant cash funds in order to meet the terms of a financial settlement, e.g., from a family business or other investments, or from a trust,. The income tax due and payable on receipt of any such income distribution or trust distribution should be considered when negotiating amounts available for division between the parties.

IHT

The UK imposes IHT on certain lifetime gifts made by individuals (such as gifts to companies and trusts), and the estate of a deceased individual, which is deemed to include the value of gifts made within seven years of death. A lifetime gift between individuals will, subject the application of any exemptions, be a Potentially Exempt Transfer (a **PET**) for IHT purposes. A PET has no immediate IHT consequences, it is "potentially" exempt from IHT. Whether IHT is charged on a PET depends on the length of time the donor survives from the date on which the gift is made. If the donor survives for at least seven years, the gift becomes completely exempt. Otherwise, the value of the gift is included within the donor's estate and may result in an IHT liability (although taper relief offers a gradual reduction in the amount of IHT due on any failed PET).

A 'spouse exemption' applies to IHT so that there is no IHT due where transfers are made between spouses or civil partners before any final order (provided both spouses are either UK domiciled or non-UK domiciled; the position is complicated where there is a domicile 'mismatch' between spouses so that the exemption is limited in value). Additionally, legislation provides that any transfers made between spouses where there is not an intention to confer benefit gratuitously or the transfer is made by one party to the marriage or civil partnership to another for the maintenance of the other or for the maintenance education or training if a minor child (or child in full time education) which will apply to ensure IHT will not usually be due where transfers are made after a final order. However, in these circumstances, if there is some element of gratuitous

transfer in any payment this will be a PET and so may be subject to IHT in the event of the death of the transferor within seven years. This may particularly be relevant where lump sums or substantial property transfers are paid or made to children.

Where property is settled on trust in accordance with the terms of a financial settlement, there may be an immediate exposure to IHT, and so specialist tax advice should be taken before any such arrangement is entered into.

SDLT

Stamp duty land tax is in point should a property transfer form part of the agreement/order. However, the transfer of property pursuant to a final order will also not be taxable. In addition, permanent separation can have an impact on a couple's SDLT position, which should therefore be re-considered in relation to any real estate investments.

Foreign considerations

The tax considerations may be further complicated in the case where spouses have different domiciles for tax purposes, are tax resident outside the UK or where there are foreign taxes that would also need to be considered. Where tax is payable in another jurisdiction on the same event, the same reliefs as are available in the UK may not apply.

Although the UK Spring 2024 Budget statement has signaled an end to the remittance basis as we know it from 6 April 2025, this has previously caused some tax complexity for divorcing couples where one or more parties are remittance basis users. This will continue to be the case for income and gains generated before the rules change and will therefore continue to be relevant for those who have historically

used the remittance basis.

When payments are made by a remittance basis user in relation to a financial settlement on divorce there are a number of key issues to consider. In principle, an ex-spouse or partner can bring funds comprising a remittance basis user's foreign income into the UK after the decree absolute has been issued without this being treated as a remittance by the taxpayer. Therefore there is scope for a settlement payment to be made from foreign income to a non-UK account of an ex-spouse or partner, provided that funds are not transferred to or otherwise enjoyed in the UK until after the decree absolute or final order has been granted. Use of foreign income in the UK does however require careful management to ensure that tax is not visited on a remittance basis user as a result of foreign income and gains being applied for the benefit of the remittance basis user's minor children or grandchildren (although there are some exemptions where the children's benefit/ enjoyment is de minimis or incidental).

There has also been some academic discussion about the possibility that settlement of a divorce order would in itself be a remittance on the basis that a divorcing spouse who is a remittance basis user would be settling a 'relevant debt' in the UK. We do not consider this to be correct and in historic correspondence, HMRC confirmed that they do not take this view. However, HMRC recently told one of the professional bodies that further discussion on this is required – presumably this is now not a priority for HMRC given the proposed change to the regime.

Where the remittance basis is in point, it is advisable to include in any settlement agreement both an undertaking from the recipient spouse that funds derived from the remittance basis user's foreign income will not be used in the UK in a way that would trigger a remittance for the remittance basis user, and an indemnity in relation to any breach of this undertaking.

Estate planning

Aside from tax considerations, a further point that should not be overlooked is that separating and divorcing parties should consider updating their Wills. Under English law, a Will is not automatically revoked on divorce. After decree absolute, an existing Will will be interpreted as though the ex-spouse had predeceased the testator. However, this is not the case during any period of separation before decree absolute, where the provisions of any Will and references to any spouse will have effect as drafted.

As can be seen from the above, careful planning and specialist advice is required to ensure that an individual going through divorce does not find themselves with an unexpected tax bill or other disruption to their estate planning.

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