INSTITUTE OF FISCAL STUDIES CONFERENCE
APRIL 2005

The interaction of tax and family law in England and Wales
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INTRODUCTION

This is a family lawyer's view of how tax and family law and families relate to each other. Is there a consistent view of what a family is and the tax treatment of the various kinds of family? Undoubtedly tax wise, some family members are better off or worse off at different times in their relationship. Have policymakers openly decided that marriage should not be fiscally encouraged even though marriage may be more likely to provide a stable base for bringing up happy children? Is all this fair and is it as a result of intentional policy or is it just the result of the haphazard accumulation of legislation over the last 40 years and more?

Here are some statistics to help set the scene of changes which have occurred since 1971, not long after CGT began :

- 480,000 marriages in 1971 and 100,000 divorces
- 306,000 marriages in 2004 and 167,000 divorces
- Average age at first marriage was 25 for men and 23 for women. Now it is 31 for men and 29 for women
- 24% of children live in one parent families, compared with 8% in 1971
- The fastest growing group of new householders is single women in their thirties. The fastest growing age group is the 100 club
- The suicide rate for men between 25-44 has risen from 12 per 100,000 to 23 per 100,000
- Some things stay the same: Spain was the top holiday choice in 1971 attracting 34% of all holidaymakers. Today its still top at 30%.

1. WHAT IS A FAMILY AND WHO BELONGS TO IT?

Here are some examples of families who are all treated in different ways for tax purposes:

(1) A heterosexual married couple
(2) A heterosexual married but separated couple
(3) A heterosexual divorcing couple
(4) A heterosexual cohabiting couple
(5) A heterosexual former cohabiting couple
(6) A same sex registered partnership couple
(7) A same sex registered but separated partnership couple
(8) A same sex registered but then dissolving couple
(9) A same sex unregistered but cohabiting couple
(10) A widow
(11) The survivor of a same sex registered couple
(12) A single parent
(13) A child
(14) An over age 65 couple

2. HOW ARE FAMILIES DEFINED IN OUR LEGISLATION?

- Definitions under s.137 of the Social Security Contributions and Benefits Act (SSCBA) 1992 :

  "*family*" means—

  (a) a married or unmarried couple;

  (b) a married or unmarried couple and a member of the same household for whom one of them is or both are responsible and who is a child or a person of a prescribed description;

  (c) except in prescribed circumstances, a person who is not a member of a married or unmarried couple and a member of the same household for whom that person is responsible and who is a child or a person of a prescribed description;

"*married couple*" means a man and woman who are married to each other and are members of the same household;

"*unmarried couple*" means a man and woman who are not married to each other but are *living together as husband and wife* otherwise than in prescribed circumstances.

- Definitions under s.3 of the Tax Credits Acts (TCA) 2002 :

  (3) A claim for a tax credit may be made-

  (a) jointly by the members of a married couple or unmarried couple both of whom are aged at least sixteen and are in the United Kingdom,

  (5) In this Part "*married couple*" means a man and woman who are married to each other and are neither-

  (a) separated under a court order, nor

  (b) separated in circumstances in which the separation is likely to be permanent.

  (6) In this Part "*unmarried couple*" means a man and a woman who are not a married couple but are living together as husband and wife.

There are no other relevant definitions and in family law there is no definition of a family as such. There is a definition of children of the family. For the purpose of the domestic violence legislation in Part IV of the Family Law Act 1996 there are various types of people who are protected by that legislation by reference to their status and relationship and state of cohabitation whether past or present but this is definitely not a definition of family. Significantly the Daily Mail persuaded the government of the day to amend the bill to grant inferior rights to those whose claim was merely via cohabitation.

3. HOW ARE LIVING TOGETHER OR SEPARATION DEFINED

These are concepts which have considerable importance in tax and social security law. In family law, separation is one of the methods by which married couples and same sex couples who are registered under the provisions of the Civil Partnership Act 2004 (after it comes into force on 5th December 2005) may dissolve their unions.

The concept of "living together as husband and wife" has developed through social security case law and practice and is set out in the Department for Work and Pensions' very detailed "Guide for decision makers". Its opening statement is that a couple who are living together as husband and wife should be treated in the same way as a married couple. The principle behind this is that an unmarried couple should not be treated more or less favourably than a married couple. The tax position does not follow this. For tax purposes, married couples and registered same sex couples are treated differently from unmarried couples and unregistered same sex couples. They are to be treated as living together unless they are separated under an Order of the Court or by a Deed of Separation or they are in fact separated in such circumstances that the separation is likely to be permanent. There is guidance in the relevant Inland Revenue manual for "relief instructions" as follows :

"Where there is no Court Order, deed of separation or agreement to separate you will have to decide

> **whether the couple are separated, and*
>
> **whether the separation is likely to be permanent.*

The use of the word "likely" indicates that there are no hard and fast rules. Each case is decided on its own facts. Where there is a difference of opinion you may need to interview them to get all the relevant facts. Before accepting that a couple are separated "in such circumstances that the separation is likely to be permanent" you must be satisfied that

> **the husband and wife are living apart, and*
>
> **there was at the time an intention to break the matrimonial ties by divorce or by remaining apart permanently.*

It is sufficient for just one of the couple to have the intention to make the separation permanent. The one with that intention does not have to have told their husband or wife of it.

You can accept what the couple tell you about their intention to make the separation permanent unless there is strong evidence to contradict it.

Often there is no intention to separate permanently and the couple are soon reconciled. If they are reconciled after a short separation, treat them as living

together as husband and wife throughout. But see RE1062 if they press their claim to be treated as separated.

If you are unable to check the facts with the other person and the separation has continued for at least a year you may accept that the couple are separated for Income Tax purposes. The date of separation will be the date on which one of them left the other".

This definition causes problems as I will set out later in this paper.

It also differs from the family law definition of separation which is relevant because two of the sections of the Matrimonial Causes Act 1973 which provide proof of irretrievable breakdown are that the parties to the marriage have lived apart for a continuous period of 2 years and by consent or 5 years and no consent, both periods immediately preceding the presentation of the Divorce Petition. Short periods of reconciliation not in total amounting to more than six months are not treated as breaching the continuous period but instead extend the time limit. However, if the total periods exceed six months, the clock is re-set to the start of the later separation. It is possible for a couple to continue to live under the same roof while "living apart" provided that the Court is satisfied that the couple were living as two households. The same provisions will apply to registered same sex partners.

There are also occasions on which in Family Law, cohabitation (as opposed to adultery) is relevant for the assessment of what is proper financial provision. There is no statutory definition of cohabitation in family law which is therefore based on an assessment of the facts. It is quite often difficult to assess whether parties are cohabiting or indeed whether they were cohabiting as if they were husband and wife. The toothbrush Test.

It is significant that for the purposes of Child Tax Credit and Working Tax Credit claims can be made if a couple are a man and woman living together as if they were married and tax credits are therefore available irrespective of marital status. Same sex couples who have registered will have the benefit of these provisions. Interestingly even before the Civil Partnership Act 2004, in the case of *Ghaidan v Mendoza (2004 House of Lords)* which was a case about the transfer of a statutory tenancy by succession under the Rent Act 1977 their Lordships read the wording that one party "was living with the other as his or her wife or husband" as including same sex couples. This was by use of the European Convention on Human Rights and under the Human Rights Act 1998. Same sex partners

therefore whether registered under the new Act or not are able to claim tax credits. The Finance Act 2005 confirms the right to claim will apply to all couples of whatever sex living together as husband and wife. A treatment quite different to the treatment of all other tax issues.

4. PARTICULAR PROBLEMS

a) Capital Gains Tax:-

(i) Transfers between married couples and registered same sex partners produce neither a gain nor a loss for CGT purposes. The Transferee takes over the transferor's base value, built-in taxation allowance and taper relief. The incidence of CGT is postponed. Actual consideration for the transfer is ignored.

The position of transfers between married couples and registered same sex partners continues during the tax year (not the year of divorce or dissolution) in which they become separated in circumstances likely to be permanent (or are separated by a Court Order or a Deed of Separation). Therefore, for Capital Gains Tax purposes, unlike any other tax or Inheritance Tax purposes, the material point is the date of separation not the date of the Divorce.

In years following separation but before a final Decree of Divorce or Dissolution, husband and wife and registered same sex couples remain "connected persons" for CGT purposes and are taxed as though full market value would be given and received, even though no consideration passes.

This situation can give rise to considerable difficulties in practice because parties are unaware of these rules and the events which lead to their separation are governed by emotion or other facts unrelated to tax. Parties do not always seek advice when they separate, and will not realise that, for example, to separate on the 4th April and to see your solicitor on 6th April, may result in the making of a substantial payment of tax at a time when they can least afford it.

However, following a decision of Coleridge J. in G v G (2002 2 FLR) the Inland Revenue have changed its policy for the transfer of business

assets, and hold over relief is available from 31/7/02. The CGT liability is deferred and passed to the recipient to pay on a future disposal.

This only applies to business assets. The new policy does not, therefore, relate to any other assets such as residential property or works of art. A business asset is defined as an asset used for the purposes of a trade, profession or vocation carried on by an individual or in partnership or by a company in which an individual holds at least 5% of the voting rights. Hold-over relief is also available on shares in a listed company where the individual owns more than 5% of the voting rights or agricultural property for the purposes of inheritance tax.

There must be a court order (which includes a consent order) formally ratifying an agreement reached by the parties. The new policy will not apply to the transfer of business assets between spouses without recourse to the courts, unless the parties are able to demonstrate that there was a substantial gratuitous element in the transfer so that no consideration passed in the form of surrendered rights.

(ii) Secured periodical payments

The Court has power to order these where it has been convinced that a Maintenance Order will not or is likely not to be paid, and there needs to be some security to back it. These orders are rare but pose significant Capital Gains Tax problems. The transfer of assets to trustees to secure the Maintenance Order constitutes the creation of a settlement. The transferor and the trustees are connected persons and therefore deemed to be parties to a bargain otherwise then at arms length. The assets are therefore deemed to be disposed of at their market value at the date of their transfer to the trustees. When the obligation to pay maintenance ends, the transferor is entitled to a return of the assets from the trustees so that he has at all times in effect retained an interest in the settlement. In consequence any gain realised by the trustees on the disposal of trust assets while the trust continues will be chargeable gains of the transferor, and he will be entitled to recover this tax from the trustees. When the assets revert to the transferor on the termination of the maintenance obligation, a charge to CGT will arise unless the reason for the reversion is the death of the maintenance recipient. This may well have the effect not

only of advancing the date on which the transferor must pay CGT but (due to the interaction with taper relief) may actually increase the overall amount of CGT payable on the assets transferred. This is an esoteric point but, none the less, another example of the complications in the CGT legislation which do not arise in other tax legislation.

(iii) The date of disposal

The Inland Revenue's view on this issue of date of disposal is summarised in their CGT Manual, volume II, para 22426:

Disposal by	**Date of disposal**
Court order following decree absolute (whether or not by consent)	Date of court order
Consent order before decree absolute	Accept parties' agreement or obtain documentation
Other court orders before decree absolute	Date of court order
Contract	Date of contract

This must be viewed against the background that Court Orders for transfer of property are only effective on Decree Absolute.

Under TCGA 1992, s 28, where assets are transferred under a contract, the date of disposal is the date of the contract and not the date of transfer. However, TCGA 1992, s 28 does not apply to transfer under a consent order, because it is settled law that the effect of provision in a consent order derives from order itself and not from the anterior agreement.

If a disposal before decree absolute is to be effective, it should be completed. In the case of a consent order made before decree absolute, the Inland Revenue will be flexible to a point: if the tax at stake is small, they may accept the parties' agreed date of disposal; if the tax at stake is substantial, the Inspector may wish to review the consent order and all relevant documents before reaching a view on the date of disposal.

(iv) The Matrimonial Home

There are special concessions in relation to the matrimonial home. If one party leaves the matrimonial home and transfers their beneficial interest within 36 months of leaving, the whole of any gain remains exempt providing the home was previously the main residence of the transferor. Under Extra Statutory Concession D6 the same concession applies where the period of absence exceeds 36 months and the property is eventually transferred to the occupying spouse who has remained in it as part of the financial settlement on divorce and an election for a new principal private residence has not been made by the non-occupying spouse. However, if more than 3 years has elapsed and the non-occupying spouse has acquired another property, the concession no longer applies save for the purpose of apportioning the period during which the non-occupying spouse's interest is capital gains taxable in relation to the whole period. The same will apply to registered same sex partners.

There are occasions on dissolution of marriage (and, in the future, registered same sex partnerships) where it has been appropriate to leave part of the interest in the matrimonial home belonging to the departing spouse available for the other spouse and invariably for the children to use. For example, the home will be left as to 60% for the occupying spouse absolutely, and the remaining 40% upon trust to allow her (usually her) to occupy it until she shall remarry or the youngest of the children ceases full time education. These are known as *Mesher* orders. There are similar orders where there is a deferred charge equal to a specified sum of money or share repayable on a particular event as above. However, the treatment of *Mesher* orders and charges is different for CGT purposes. The position is as follows:

Where a property was in the departing spouse's sole name and is then transferred into the joint names of both spouses under the terms of a *Mesher* order, the disposal of the departing spouse's interest should not give rise to any charge to CGT because he or she should be able to avail himself or herself of the PPR exemption (provided he or she lived at the property as his or her main residence throughout the period of ownership, ignoring the three years before the order). Alternatively,

where the transfer takes place after three years have elapsed, ESC D6 may well apply.

When one of the operative events under the *Mesher* order occurs, there is no charge to CGT at that point because the Inland Revenue regards a *Mesher* order as creating a settlement (CGT Manual paras. 65365-76). TCGA 1992, s 225 applies permitting the PPR exemption to be claimed on the basis that one of the beneficiaries of the settlement has been in occupation of the property for the whole of the period since the order was made. However, where the operative event is the occupying party's death, TCGA 1992, s 225 has no effect and the non-occupying party is treated as acquiring the property for its historic base cost (TCGA 1992, s 73). Thus, the gain will be taxable in full on a sale by that party, unless he or she moves into the property as his or her main residence prior to sale. Apparently, the Revenue do not take this point in practice, so that the whole of gain, therefore, for both occupying and non-occupying spouses is exempt from CGT. However, the state of the law is unsatisfactory - should divorcing couples be dependent solely on an Inland Revenue concession?.

If the property is not sold immediately on the occurrence of one of the operative events, the occupying spouse will still be able to claim the PPR exemption, whilst the non-occupying spouse will find himself or herself with a charge to CGT based on the increase in the value of the property between the date of the operative event and the date of the eventual sale based on the market value of the property.

Whilst the practical result of a deferred charge is the same as for a *Mesher* order, the CGT consequences are quite different and can be more favourable for the non-occupying spouse. For CGT purposes, the non-occupying spouse disposes of the whole of his or her interest to the occupying spouse. There is usually no charge to CGT at this point as the non-occupying spouse is covered either by the PPR exemption and/or ESC D6. On the realisation of the non-occupying spouse's charge, any gain has been made on the debt (eg as a result of the amount repayable being indexed to the value of the property) will be exempt from CGT (TCGA 1992, s 251(1)).

(v) Exchange of interests in land following separation

There is a further complication relating to interests in land following separation where a form of roll over relief is available under Extra Statutory Concession D26. This applies where the land is held jointly and, as a result of an exchange of land, each joint owner becomes the sole owner of the land formerly held jointly (or a number of separate holdings of land held jointly and due to the exchange each joint owner becomes the sole owner of one or more buildings or land). However, where the value of the interest acquired is less than the value of the interest disposed of, an immediate charge to capital gains tax may arise.

(b) Life assurance policies

Hitherto the transfer of an interest in life assurance policies from one spouse to another pursuant to a Court Order has given rise to a chargeable gain for Capital Gains Tax. Following the decision of Coleridge J. in G v G (2002 2 FLR) the Inland Revenue have now issued a Bulletin note indicating that they have changed their position and, for transfers which are under a court order or in a court order formally confirming an agreement, then the transferee of the life policy does not give consideration in money or monies worth for the transfer and no chargeable gain arises.

(c) Inheritance Tax

Unlike Capital Gains Tax, on the dissolution of a marriage or registered same sex partnership, the transfers which are made between the parties are treated as exempt prior to decree absolute, and therefore have no IHT consequences, and the same applies to for all transfers in connection with divorce. Furthermore, on death any transfer to a widow or survivor of a same sex registered couple either absolutely or by way of life interest attracts no IHT charge.

Because of the new regime now in place relating to pre-owned assets, there may be problems in transferring certain assets on divorce. They may be pregnant with a continuing tax liability or may leave the liability with the

Transferor (for example when one occupying spouse remains in occupation or where an owner marries and then divorces).

There is also the broader issue that some countries (in particular on the Continent) treat transfers of assets and inheritance of assets on death more favourable for IHT purposes if they are made to family members than to others. This goes along with the continental systems of providing for fixed inheritance shares for members of the family which cannot be varied by Will. In this country, we allow claims under the Inheritance (Provision for Family and Dependants) Act 1973 by dependants, former wives, cohabitants, etc., where reasonable provision has not been made. As a matter of policy, and unlike some other countries, children of the family have no favourable treatment here for IHT purposes.

(d) Beneficial Interest in Joint Assets

The Revenue treats unearned income arising from jointly held property of a married couple as a beneficial entitlement to the income in equal shares. When the couple are separate or perhaps still living together but not cohabiting, the equal shares rule applies for tax purposes even though in the absence of a declaration, the true beneficial ownership may be quite different and a presumption of equal sharing unjust to one party. The same rules will apply to same sex registered civil partnerships. The presumption therefore does not always work well.

(e) Spousal Remuneration from Family Companies

Following the Inland Revenue's success in the case of *Jones v Garnett* applying the income tax legislation on Capital Settlements to family companies and partnerships, married couples (and presumably same sex registered partners) are charged to tax in circumstances where cohabiting couples and unregistered same sex couples are not.

(f) International Cases

Different countries treat their citizens differently in relation to their tax regimes. In particular this can cause problems on divorce. Examples are that US citizens wherever they may be are subject to Capital Gains Tax on the sale of their matrimonial homes. In countries such as France or Belgium, English citizens acquiring a property in those countries are invariably advised to put

them in a company in order to avoid fixed inheritance rights and still having the ability to leave the property as they wish in their Wills. However, there are severe tax consequences because, even when these properties are matrimonial homes and would therefore be exempt on Divorce provided they were dealt with promptly, there is no such concession available in Belgium or France. There are also problems with the treatment of Maintenance Orders between husband and wife (and in respect of children where one party is a US tax payer). Unlike this country, those payments will be taxable in the payee's hands and, conversely, allowable against the payer's taxable income. It would be futile of course to suggest that each country should seek to harmonise their position or otherwise deal with these anomalies in double taxation treaties. However, there is a need for educational material to be made available so that the parties and their advisers are better informed.

(g) Cohabiting couples both heterosexual and same sex (but not registered) partners

Other than in the case of tax credits as set out above, these couples have no concession of any kind whether they have children or the care of children or not. There are no family law obligations of maintenance or property transfer despite continuing pressure from family law groups on behalf of heterosexual cohabiting couples. It is said that such couples have the option of marrying or if same sex, of registering. There are serious financial disadvantages suffered if they do not marry or register. As a matter of policy and despite the number of these undoubted families there seems to be no prospect of help in family law or tax law other than tax credits.

5. PROPOSALS FOR REFORM

(1) An overall review

An overall review of policy towards the family and an assessment as to what is required to fit tax law to that policy

(2) Definitions

There should be clear statutory definitions of a "family", "living together" "separation" and "living apart". Likewise the use of the words "spouse" and "couple" require rationalisation in particularly with the arrival of same sex registered partners. These definitions should be universal.

(3) Capital Gains Tax

As to Capital Gains Tax for divorcing couples and those terminating their civil partnership, the no gain no loss rule should apply to all assets and should be extended to the later of:-

1 The end of the fiscal year of separation or

2 Six months after the date of the final Ancillary Relief Order or Decree Absolute or Decree of Dissolution (whichever is the earlier) and

3 The "disposal" date should be clarified

(4) *Life Policies*

The Treatment of life policies following *G v G* and the subsequent Inland Revenue policy statement should be made clear by legislation.

(5) Extra Statutory Concessions

D6 and D26 should be in legislation rather than concession.

In relation to deferred charges and *Mesher* orders the concession which may be applied on the occupying parties death whereby the non-occupying spouse is exempt from CGT on their share should be in the legislation.

(6) Beneficial Interest in Joint Assets or Assets Owned by One Party Against which the Other Claims

There should be clear and fair treatment for both family members in relation to beneficial interests in joint assets or assets owned by one party against which the other claims.

(7) *Inheritance Tax*

Preferential Inheritance Tax rates for children of the family (as well as widows and surviving register parties) who inherit should be considered as an encouragement for The family as a whole. Likewise the pre-owned asset regime and the treatment of income from family companies/ partnerships should be reviewed and made more family friendly.