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TAXATION OF THE FAMILY

Tracey Bowler

Tax Law Review Committee

THE INSTITUTE FOR FISCAL STUDIES
TLRC Discussion Paper No. 6



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CHAPTER 1

Introduction and Background

Introduction

1.1 This is a discussion paper written for the Tax Law Review Committee of the Institute for Fiscal Studies looking at the current taxation of the family. The views expressed do not necessarily represent the views of the Committee. It has been written as a review of the current tax treatment of the family in the UK. The paper considers the income tax, capital gains tax, inheritance tax and stamp duty implications of different types of family unit. It seeks to show where inconsistencies, confusion and discrepancies lie and considers whether marriage or the entering into a civil partnership offers tax advantages or disadvantages to the persons involved. It considers the implications of European anti-discrimination laws and looks at the stated policies of the Government, the Conservative Party and the Liberal Democrats.

1.2 The paper considers the following scenarios:

- (i) Family A – a stable family of a couple married or registered as a civil partnership and two children under 16 years of age;
- (ii) Family B – a stable family of a couple not married or registered as a civil partnership and two children under 16 years of age;
- (iii) Family C – a family where the adult partners have recently formed a relationship and where the children come from various different parental relationships. The couple have not previously maintained a long-term relationship although are hopeful that this will be a permanent relationship.

1.3 The paper addresses the tax treatment of the couple. It does not generally address the tax treatment of transactions between one or more of the couple and their children. Most of the tax issues considered are not relevant to lone parents. As a consequence, they have also been omitted.

1.4 The paper also does not address the issues, particularly found in the area of the tax credit rules, of differential treatment of couples depending upon whether they live together or apart.¹ It is a paper that focuses on the differential treatment of couples as a result of their being married/civil partners, in a long-term relationship or a short-term one.

1.5 First, the paper considers the tax implications for the families of their different structures while the relationship is ongoing (Chapter 3). Second, it looks at the position after break-up of the family (Chapter 4). Third, the paper looks at the position on the death of one of the adults (Chapter 5). In each case, income tax, capital gains tax, inheritance tax and stamp duty are considered. The income tax analysis does not

¹ See chapter 12 of R. Chote, C. Emmerson, A. Leicester and D. Miles (eds), *The IFS Green Budget: January 2007*, IFS Commentary 102, 2007 (http://www.ifs.org.uk/publications.php?publication_id=3841) and M. Brewer and J. Shaw, *How Many Lone Parents Are Receiving Tax Credits?*, IFS Briefing Note 70, 2006 (<http://www.ifs.org.uk/bns/bn70.pdf>).

include a detailed analysis of the tax credit system. The tax credit system has been designed to be neutral between married and unmarried couples. Although the tax credit system throws up issues as to whether a couple live together or apart, it does not affect the question of whether Families A, B and C are treated differently as a result of the form of their relationship. However, the tax credit system has been a significant departure from the principles of independent taxation and the paper looks at the reasons stated by the Government as to why it has moved away from those principles in this area. The paper concludes by considering what the implications of current Government, Conservative Party and Liberal Democrat policy are in this area (Chapter 7).

Background

1.6 To set the paper in context, here are a few statistics:²

- In Spring 2006, nearly 1 in 4 dependent children in Britain lived in a lone-parent family.
- By 2005, 43% of births were outside marriage (compared with 12% in 1980). Most of these births were registered by both parents and 3 in 4 of jointly registered births were to parents living at the same address, indicating an increase in cohabiting parents.
- The proportion of single-person households has increased from 18% in 1971 to 28% in 2006.
- Despite the decrease in the overall numbers of people marrying, married couples are still the main type of partnership for men and women. In 2006, there were 17.1 million families in the UK and around 7 in 10 were headed by a married couple.
- In recent years, there has been a slight increase in the number of marriages, although it is too early to tell whether this is a trend. However, even after these increases, marriages totalled 311,000 in 2004, before dipping to 283,700 (provisional) in 2005, compared with 480,300 in 1972.
- The proportion of non-married cohabiting people has increased greatly since the 1980s. This may in part be due to people marrying later. The percentage of people under the age of 60 cohabiting rose from 11% to 24% for men and from 13% to 24% for women between 1986 and 2005.
- There were 15,700 civil partnerships formed in the UK between December 2005 and September 2006.
- Cohabiting couple families are much younger than married couple families. In 2001, 50% of cohabiting couple families in the UK were headed by a person aged under 35 compared with only 12% of married couple families.
- In 2004–05, 10% of all families with dependent children were stepfamilies.

² *Social Trends Survey*, 36 and 37, February 2006 and April 2007.

Unmarried couples are a considerable and increasing³ proportion of the family population, but marriage is not irrelevant.

1.7 Recent governments have claimed to promote marriage, considering it to provide the best foundation for the upbringing of children,⁴ and Parliament has expressly required the courts to support marriage as an institution.⁵ However, it is undoubtedly the case that marriage is less popular than it was and there are a significant number of couples choosing to cohabit and not marry.

1.8 The Law Commission has recognised that the sociological evidence is to the effect that more people are choosing to cohabit outside marriage, that cohabitation is lasting longer and that cohabitation is becoming more common amongst older people.⁶ At the same time, it recognises that unmarried cohabitation is not as stable as married cohabitation, in that, even taking account of the frequency of cohabitants 'ceasing to cohabit' by getting married, relationships are more likely to break down. The myth that 'common-law marriage' gives rise to legal consequences remains prevalent⁷ and is arguably reinforced by the equal treatment of married and unmarried couples in the context of tax credits.

1.9 The Law Society of England and Wales has made detailed proposals for the conferment of rights and obligations on certain cohabitants where they have been living together as a couple for three years or have had a child by birth or have adopted.⁸ In particular, it has recommended that there should be a right for cohabitants to apply to the court for capital provision and, in restricted circumstances, for maintenance within three years of separation.

1.10 In July 2002, the Law Commission identified a wide need for the law to recognise and to respond to the diversity in family structure and expressed the view that further consideration should be given to the adoption of new legal approaches to personal relationships outside marriage.⁹ An important development in the legislative regulation of personal relationships has taken place with the introduction of the Civil Partnership Bill and consequent amendments to the tax legislation to place registered same-sex couples on a par with married couples. This offers to same-sex couples the opportunity of registering their relationship and thereby obtaining rights and obligations broadly equivalent to those of married couples.

1.11 However, where persons live together, but do not either marry or register their partnership, there remains a serious risk of financial hardship being incurred on the

³ National Statistics, *Population Trends Autumn 2005 No. 121*, estimates that the number of cohabiting couples in England and Wales will almost double between 2003 and 2031, rising to almost 3.8 million couples.

⁴ Home Office, *Supporting Families: A Consultation Document*, Cm. 3968, 1998.

⁵ Section 1 Family Law Act 1996.

⁶ J. Haskey, 'Cohabitation in Great Britain: past, present and future trends – and attitudes', *Population Trends 103*, pages 4–25, ONS, 2001.

⁷ A. Barlow, S. Duncan, G. James and A. Park, 'Just a piece of paper? Marriage and cohabitation', in A. Park, J. Curtice, K. Thomson, L. Jarvis and C. Bromley (eds), *British Social Attitudes – The 18th Report, 2001 – 59% of cohabitants thought they had the same rights as married people* (page 57).

⁸ Law Society's Family Law Committee, *Cohabitation: Proposals for Reform*, August 2002.

⁹ *Sharing Homes: A Discussion Paper*, LC278.

cessation of the parties' relationship, whether by separation or by death. Parliamentary debate on the Civil Partnership Bill highlighted the case for fundamental legislative reform for cohabitants. In the words of the Department for Constitutional Affairs, 'a project on cohabitation would be of wide social significance'.

1.12 The Law Commission is currently working on the 'cohabitation' project looking at the financial hardship suffered on separation or death of cohabitees; its preliminary proposals were published on 31 May 2006¹⁰ and recommendations are due out in August 2007. It has proposed that a cohabiting couple sharing a household may be entitled to certain protection on separation if the couple either have one or more children or have lived together for a specified minimum duration; and the economic effects of each of the couple's contributions to the relationship, including sacrifices, have not been fairly distributed between them on separation. These principles are similar to those adopted by the Scottish Parliament in its new scheme for financial relief between cohabitants on separation in the Family Law (Scotland) Act 2006, albeit that the Scottish system applies regardless of how long the couple have been together or whether they have children. However, the Law Commission has been specifically instructed not to address the tax issues arising in such circumstances.

¹⁰ Paper 179: *Cohabitation: The Financial Consequences of Relationship Breakdown*.

CHAPTER 2

Summary

2.1 Since the introduction of independent taxation, much of the tax system looks to the taxation of people individually and regardless of their family structure. However, significant exceptions remain. Traditionally, those exceptions have distinguished married couples (as now amended to extend to civil partnerships). Prime examples are the income election rules for jointly held property; the settlements rules; the capital gains tax exemption for transfers between spouses/civil partners; and the inheritance tax exemption for pre- and post-death transfers between spouses/civil partners.

2.2 In addition, married couples/civil partners are treated differently from unmarried/unregistered couples in the area of anti-avoidance. The paper considers several situations where this is the case, particularly in the context of income tax. It will be seen that the most prominent of these concern the operation of family companies, the limitation of the use of the jointly held property income election and the taxation of employment income.

2.3 There are numerous piecemeal anti-avoidance provisions aimed at married couples/civil partners but there are also two strands that will be seen to run through many of them:

- (i) to prevent members of the couple passing income without its derivation (whether that be an asset or employment) from one to the other to maximise benefits from differing marginal tax rates;
- (ii) to treat married/civil partners as ‘connected’ persons who are acting together to bring about the particular benefit that the anti-avoidance provision is aimed at.

In relation to (i), provisions are not required to deal with unmarried couples/unregistered partners transferring assets without the underlying income as the transfers themselves are tax points.

2.4 In relation to (ii), recent legislation dealing with the payment of employment income via intermediaries envisages that both married and unmarried/unregistered couples may need to be included within the scope of anti-avoidance provisions and a factual ‘living together’ test is applied.

2.5 The introduction of the tax credit system is the most recent cause of exceptions to the independent taxation model. The definitional issues arising from the tax credit system will be increasingly important if the tax system moves away from only recognising couples who are married/civil partners. The treatment of Family C particularly highlights one of the key practical issues in today’s society with the tax credit approach to taxation of the family unit: namely, that when relationships are frequently changing, it is difficult both for HMRC and for the taxpayers to ensure correct treatment. This was highlighted in May 2006 by HM Treasury’s announcement of £1.8 billion of overpayments.

2.6 Overall, the tax system still favours the married couple/civil partners mainly because of the very significant capital gains tax and inheritance tax benefits that status

brings, despite the greater limitations imposed by anti-avoidance rules on tax planning. Although separation is more complex for the married couple/civil partners, there are still tax benefits to their status and much of the tax complexity on separation could be dealt with by specific targeted reforms to the capital gains tax treatment of separation. However, the increasing tendency of HMRC to seek to counter what it considers unacceptable family tax planning by married couples is causing the tax advantages of marriage to be eroded, at least for those owning their own companies.

2.7 There is no significant tax incentive for unmarried/unregistered couples to stay together. In most respects, Families B and C are taxed in the same way. Social statistics indicate a very substantial proportion of couples choose to be not married/civil partners and their position, particularly on separation during their lifetime or on death, is the subject of considerable debate and has led to various non-tax proposals for reform.¹¹ Although Families B and C face potential tax charges on transferring assets from one to the other after separation, in practice it appears that cohabitants rarely transfer property between them on separation. Ownership appears to follow legal title prior to separation and financial and non-financial contributions are not recognised if they are inconsistent with legal title.¹² This situation would change for some couples if the Law Commission's proposals were implemented and then the theoretical tax charges would have more practical effect.

2.8 Most of the current Government policy concentrates on the question of support for the family and does not address whether there should be differing treatment for married couples/civil partners and unmarried/unregistered couples. The tax reform proposals prepared for the Conservative Party do not specifically address the distinctions between married and unmarried couples but a by-product of these proposals in the capital tax area could be a reduction or removal of the most significant tax advantages for married couples/civil partners. However, the extent to which marriage should receive fiscal support is increasingly being debated, both between and within the major political parties.

¹¹ See, for example, Law Society and Law Commission proposals referred to in paragraphs 1.9 and 1.12.

¹² R. Tennant, J. Taylor and J. Lewis, *Separating from Cohabitation: Making Arrangements for Finances and Parenting*, DCA Research Series 7/06, Department for Constitutional Affairs, October 2006.

CHAPTER 3

The Tax Position of Ongoing Relationships

3.1 Let us assume that in each case the adults are working. First the income tax treatment of the families will be considered, then the capital gains tax treatment and last the stamp duty treatment. In each case, the advantages of the family structure are looked at and then the disadvantages. A summary of the differing income tax and capital gains tax treatments of each family unit is included in table form after the analysis of each of those taxes.

Income tax

Family A

3.2 Since the introduction of independent taxation and abolition of the married couple's allowance (save for those couples where one of them was born before 6 April 1935), the basic assumption of most would be that the couple would be taxed separately for income tax purposes, but this general assumption is subject to numerous exceptions. It will be seen that in the context of income tax, Family A is at a disadvantage as a result of being married/civil partners in so far as its tax planning opportunities are more limited. This particularly affects married couples/civil partners owning one or more family businesses. For families where tax planning is not relevant, the income tax treatment is broadly neutral as between married couples/civil partners and those not married/civil partners.

Advantages

3.3 The income tax advantages for Family A being married/civil partners are limited. They arise from:

- (i) the jointly held assets rules;
- (ii) certain benefits arising from being connected persons for the capital allowances rules;
- (iii) a specific deduction for a loss arising on unquoted shares in a trading company subscribed for by a spouse or civil partner;
- (iv) the aggregation of holdings in family companies for the purposes of preserving losses and capital allowances on the transfer of a trade from one company to another;
- (v) specific Enterprise Investment Scheme (EIS) and Venture Capital Trust (VCT) share transfer rules;
- (vi) certain exemptions under the pre-owned assets regime.

3.3.1 Jointly held assets

3.3.1.1 A married couple or registered civil partnership who are ‘living together’¹³ are treated as being entitled to income arising from property jointly held, as income to which they are beneficially entitled in equal shares, unless they jointly make a declaration stating that their beneficial interests in the property and the income arising thereto are not equal.¹⁴ (The split of beneficial entitlement to the property and the income arising must be the same to make the declaration.)

3.3.1.2 This means that if the couple in Family A jointly hold assets in unequal proportions, they can rely on the provisions of Section 282A Taxes Act 1988 to ignore their actual holdings and attribute 50% of the income to each partner. So if adult X of the couple only held 5% of the asset and paid income tax at a lower rate than adult Y, the attribution of 50% of the income to adult X works in their favour.

3.3.1.3 However, there is a specific exclusion of this rule when the property is shares in a close company¹⁵ (see further below under ‘family-owned companies’ – paragraph 3.4.3) or for earned income (e.g. from holiday lets).¹⁶

3.3.1.4 The provisions of Section 282A Taxes Act 1988 provide the married couple/civil partners with a flexibility in their tax planning which is not available to the unmarried/unregistered couples.

3.3.2 Capital allowances

There are 59 references to ‘connected persons’ in the capital allowances legislation. The definition used is the relatively wide Section 839 Taxes Act 1988 one which applies to the couple in Family A. On certain occasions, the connected persons rules are helpful to Family A; for example, connected persons can elect to override the normal rules for asset transfers to prevent any tax charges or allowances arising on the transfer of an asset between them and transfer the asset with its tax written-down value. This is consistent with other rules permitting tax-free transfers of assets between spouses.¹⁷ At other times, the connected persons rules mean that Family A is at a disadvantage under the capital allowances code – see paragraph 3.4.6 below.

3.3.3 Unquoted shares in a trading company subscribed for by a spouse or civil partner

An individual may be treated as having subscribed for shares if his or her spouse or civil partner did so and subsequently transferred them to him or her by way of a lifetime gift if an allowable loss for capital gains tax purposes has arisen. Subject to various requirements being met, the allowable loss may then be treated as a deduction for income tax purposes under Section 574 Taxes Act 1988.

¹³ Section 282A(6) Taxes Act 1988.

¹⁴ Section 282A Taxes Act 1988. There are exclusions for close company shares, earned income and certain types of partnership income.

¹⁵ Section 282A(4A) Taxes Act 1988.

¹⁶ Section 282A(4) Taxes Act 1988.

¹⁷ See the capital gains tax analysis below.

3.3.4 Continuation of trading losses after transfer of a trade

Section 343 Taxes Act 1988 permits the continuation of trading losses and capital allowances on the transfer of a trade from one company to another in at least 75% common ownership. The ownership test treats differing ownerships of ‘relatives’ as one ownership. Relatives are defined to include husbands and wives or civil partners.¹⁸ So transfers of businesses between companies owned by the couple in Family A are facilitated. However, see paragraph 3.4 below for the disadvantages of the aggregation of company holdings.

3.3.5 Enterprise Investment Scheme and Venture Capital Trust schemes

One of the Family A couple can transfer eligible VCT shares or EIS shares to the other before the end of the relevant period. Following such a transfer, the shares are treated for all VCT/EIS purposes as if they had always been owned by the transferee.¹⁹ If relief subsequently falls to be withdrawn, the assessment withdrawing relief is made on the transferee but the tax to be recovered is equal to the amount of the reduction in tax that flowed from giving the relief throughout their ownership by either transferor or transferee.²⁰

3.3.6 The pre-owned assets regime

The anti-avoidance income tax charge introduced last year to tax people ‘on the benefit people enjoy when they have arranged free continuing use of major capital assets that they once owned’ does not apply to:²¹

- (i) transfers to a spouse/civil partner (or, where ordered by the court, an ex-spouse/civil partner); or
- (ii) gifts to a settlement where the spouse/civil partner (or ex-spouse/civil partner if transferred by order of the court) is beneficially entitled to an interest in possession; or
- (iii) dispositions within Section 11 Inheritance Tax Act 1984. These are lifetime dispositions made for the maintenance of children and other specified relatives (see further paragraph 4.14.2).

This exemption ties in with the exemption from inheritance tax for transfers from spouse to spouse or civil partner to civil partner.

Disadvantages

3.4 The income tax disadvantages for the couple of Family A being married/civil partners arise from:

- (i) anti-avoidance rules regarding taxation of employment income;

¹⁸ Section 344(4) Taxes Act 1988: ‘for this purpose “relative” means husband, wife, [civil partner,]1 ancestor, lineal descendant, brother or sister’.

¹⁹ Section 304(1) Taxes Act 1988.

²⁰ Section 304(3) Taxes Act 1988.

²¹ Para 10 Sch 15 Finance Act 1994.

- (ii) the income tax settlements rules;
- (iii) limitations on tax planning involving family companies;
- (iv) the aggregation of shares held by them to determine the tax treatment of share repurchases;
- (v) the employee share scheme rules;
- (vi) certain anti-avoidance measures contained in the capital allowances rules;
- (vii) anti-avoidance rules preventing the transfer of income-producing assets outside the UK;
- (viii) anti-avoidance rules applying to gift aid.

3.4.1 Taxation of employment income

Generally speaking, the tax legislation on employee benefits and expenses²² prevents avoidance of income tax through payment of benefits to the spouse or family of an employee instead of direct to the employee. It achieves this by taxing the employee on payments and benefits made to their spouse (or other members of their family as defined, and often to any other member of their household – see further below in the context of Families B and C). The married couple/civil partners are within the full range of anti-avoidance rules in this area, whereas the couples in Families B and C may not be caught by certain of the provisions. In some cases, this depends upon whether one is a ‘dependant’ of the other (see paragraph 3.5.1 below). In other cases, the legislation is neutral in its approach to Families A and B (see paragraph 3.7 below) and it is only potentially Family C who will be outside the anti-avoidance rules.

3.4.2 The settlements rules

Family A is potentially caught by the settlements provisions of Section 625 Income Tax (Trading and Other Income) Act 2005 in relation to any property. A settlor is treated as having an interest in property if there are any circumstances in which the property or related property:

- (a) is payable to the settlor or settlor’s *spouse or civil partner*,
- (b) is applicable for the benefit of the settlor or the settlor’s *spouse or civil partner*, or
- (c) will, or may, become so payable or applicable

unless the property falls to be treated under Section 626 ITTOIA 2005 as an outright gift between spouses or civil partners.²³

²² Income Tax (Earnings and Pensions) Act 2003 Part 3 Chapters 3 to 11.

²³ Although strictly obiter dicta, statements made by the Court of Appeal in *Jones v. Garnett* [2006] STC 283, regarding the meaning of what property is, confirm that ordinary share capital can be gifted between spouses and not be caught by Sections 624 and 625.

(Notably, a spouse or civil partner carries its own definition for these purposes by way of exclusion to exclude a spouse or civil partner from whom the settlor is separated by way of Court Order or agreement or where it is likely the separation will be permanent, widows/widowers or surviving civil partners of the settlor and a person whom the settlor may marry or become a civil partner of but is not yet married to or a civil partner of.²⁴)

3.4.3 Family-owned companies

3.4.3.1 This has been a particularly contentious area recently. Various steps have been taken by HMRC to seek to counter what it considers to be unacceptable tax avoidance in relation to family companies.

3.4.3.2 From 6 April 2004, married couples, and now most recently civil partners, who receive dividends and other distributions on jointly owned close company shares can no longer automatically divide the income equally between them to save higher-rate tax.²⁵ For example, the income on close company shares to which a couple are beneficially entitled in the ratio 95:5, but held in joint names, cannot be split 50:50, as other jointly held property can be, under the provisions of Section 282A Taxes Act 1988. This was an attempt to ensure that the settlements rules are not avoided by reliance on Section 282A Taxes Act 1988.

3.4.3.3 HMRC has been attacking many arrangements involving the ownership of family companies by husband and wife by seeking to rely on the settlements provisions and, in particular, what is now Section 624 IT (Trading and Other Income) Act 2005. So, where a husband and wife jointly own a company and the wife's contribution to that company is significantly less than the husband's but the wife receives equal dividends on her shares, HMRC argued that these were 'arrangements' constituting a settlement under which the settlor retains an interest.

3.4.3.4 This was brought to a head in the case of Jones v. Garnett [2006] STC 283 ('Arctic Systems'). As a result of the Court of Appeal's decision in that case, the Revenue's lines of attack of family-owned companies have been curtailed and if that decision is upheld by the House of Lords then, so long as married couples or civil partners are careful how they set up and operate their companies, they should be able to steer clear of the settlements provisions in what is now Section 624 IT (Trading and Other Income) Act 2005. However, pending appeal to the House of Lords, families such as Family A still need to be wary of the impact of the settlements rules in the context of family companies in a way in which Families B and C do not need to be.²⁶

3.4.3.5 Interestingly in the context of this paper, two of the three judges in the Court of Appeal were expressly influenced in their decision by what they considered to be the 'anachronistic' provisions in Section 660A(2) Taxes Act 1988 (now replaced by Section 625 ITTOIA 2005), treating a settlor as retaining an interest in property where

²⁴ Section 625(4) ITTOIA 2005.

²⁵ Section 282A(4A) Taxes Act 1988.

²⁶ But see paragraph 3.5.2.2 below.

the interest is held by the settlor's spouse despite the introduction of independent taxation.²⁷

3.4.3.6 Family A must also take into account the following pitfalls in running family companies:

- (i) The close company provisions in Sections 13 and 13AA Taxes Act 1988 denying the availability of small companies' relief and the corporation tax starting rate to close investment holding companies.²⁸ The holdings of the couple are aggregated to determine whether the company is a close company for so long as they are husband and wife or civil partners. In addition, one of the exceptions to the provisions – that dealing with land investment – is prevented from applying when the land is to be let to the spouse or civil partner of a person connected with the company.
- (ii) The restrictions contained in Sections 767A to 768E inclusive on the use of losses and other deductions where there has been a change of ownership of a company and there has been a major change in the nature or conduct of the trade. The holdings are aggregated to determine whether there has been a change in ownership.²⁹ For these purposes, the connected persons test contained in Section 839 Taxes Act 1988 is used and the couple will be 'connected' so long as they are married/civil partners.

3.4.4 Share repurchases

If Family A holds shares in a company which purchases its own shares then, in order for the family shareholders to treat the repurchase as a capital gains tax transaction and not a distribution, the shareholdings of the spouses or civil partners will be aggregated both to determine whether their shareholding is reduced by at least 25% and to determine whether they are 'connected' to the company by holding more than 30% of the share capital. However, for reasons which are not clear, the definition of 'associate' that is used for these purposes is much narrower than the Section 839 Taxes Act 1988 definition of 'connected persons' or the Section 414 definition of 'associate' and in particular only applies to a husband and wife or civil partnership 'living together'.³⁰

3.4.5 Employee share scheme rules

For the purposes of the employee share scheme rules, the married couple or civil partners are 'associates' for determining whether the material interest rules bite to prevent one of them receiving shares under an approved share scheme.³¹ As regards the definition of associate used here, it refers to a 'relative', which means husband or wife, parent or remoter forebear, child or remoter issue, or brother or sister.

²⁷ See Sir Andrew Morritt C at page 303 and Lord Justice Carnwath at page 309.

²⁸ See the definition of a close company in Sections 414, 416(6), 417(3) and 417(4) Taxes Act 1988.

²⁹ Section 769(2)(c) and the definition of connected persons in Section 839 Taxes Act 1988.

³⁰ Section 227(2) Taxes Act 1988.

³¹ Paras 9 and 12 Sch 4 ITEPA 2003.

3.4.6 The capital allowances rules

Provisions are included in the legislation to ‘prevent families manipulating the rules to gain a tax advantage’³² – for example, by preventing the manufacture of extra allowances.

3.4.7 Transfer of assets abroad

Anti-avoidance provisions apply where a taxpayer or their spouse or civil partner transfers assets so that income becomes payable to persons resident or domiciled outside the UK.³³ Where specified circumstances are present and income is payable to a person not resident or domiciled in the UK in consequence of a transfer of assets, that income is treated as income of a person ordinarily resident in the UK who is able to enjoy that income or benefit from it. (HMRC does not normally seek to apply these provisions in relation to the income of a non-domiciled husband, wife or civil partner where that income arises from a transfer of assets by that spouse/civil partner and the spouse/civil partner would have been able to rely on the exemption for non-UK domiciliaries for income which is not remitted to the UK in relation to the income.³⁴)

3.4.8 Deductions – gift aid

Married couples and civil partners are aggregated when considering whether they have received benefits in excess of £250 in return for potential charitable payments, or the payment is made in relation to the acquisition of property by the charity other than by gift from either member of the couple, thereby preventing the gift aid donation rules applying.³⁵

Family B

Advantages

3.5 Broadly speaking, the advantages available to Family A by virtue of being married/civil partners are not available to Family B, but set against this, the anti-avoidance provisions that are disadvantageous to Family A generally do not apply to Family B.

3.5.1 Taxation of employment income

3.5.1.1 It is not simply the case that Family A is caught by anti-avoidance provisions and Family B is not. The provisions in this area vary so much that it is easiest to split them down into different categories. In certain parts of the legislation, the tax rules have become neutral between married couples/civil partners and unmarried/unregistered couples living together as husband and wife or civil partners (see paragraph 3.7 below).

Employee benefits provided other than to the employee

3.5.1.2 Payments made and benefits made available to one member of the couple in Family B in relation to the employment of the other member of the couple would not be

³² HMRC, *Tax Bulletin 80*.

³³ Sections 739 and 740 Taxes Act 1988 and extension to spouse or civil partner in Section 742(9)(a).

³⁴ Revenue Interpretation 201.

³⁵ Section 25(11) Finance Act 1990 and Section 839 Taxes Act 1988.

within the anti-avoidance provisions contained in the IT (Earnings and Pensions) Act 2003 unless the recipient of the payment was a ‘dependant’ of the employee. Those provisions apply to payments and benefits provided to the employee’s family³⁶ or to the employee’s family or household.³⁷ ‘Family’ is defined as a person’s spouse, children and their spouses, parents and dependants.³⁸ Household extends this group of people to the person’s domestic staff and guests.³⁹ There is no extension to unmarried couples.

3.5.1.3 It is perhaps particularly surprising that the concept of unmarried couples was not included in the definition of family in the context of these particular anti-avoidance rules as it is used in the same Act in the context of other payments (see paragraph 3.7 below).

3.5.2 Family-owned companies and the attribution of income under the settlements rules

3.5.2.1 Section 625 IT (Trading and Other Income) Act 2005 looks to the settlor’s spouse and not to unmarried/unregistered couples. So, that provision of the settlements rules does not apply to attribute income to one of the couple in the wide range of circumstances listed there and which Family A must be aware of.

3.5.2.2 However, HMRC has stated that it will apply the general provisions of the settlements legislation widely and regardless of whether the income is received by a spouse/civil partner or another person.⁴⁰ Consequently, the settlements legislation is still relevant to Family B in the context of structuring family-owned companies, albeit that HMRC cannot seek to rely on Section 625 ITTOIA 2005 deeming the settlor to have an interest in the property where the property is payable to the settlor’s spouse/civil partner.

3.5.2.3 However, the shareholdings of Family B will not be aggregated under the close company provisions or for the change in ownership rules in Sections 767A to 768E and Section 343 Taxes Act 1988.

3.5.3 Other shareholdings

The holdings of the couple in Family B will not be aggregated to deny capital gains tax treatment of a share repurchase.

3.5.4 Deductions – gift aid

Each of the couple is viewed independently in relation to the gift aid rules.

3.5.5 The capital allowances rules

The couple are not connected persons for the purposes of Section 839 Taxes Act 1988 as applied in the capital allowances legislation. In the context of anti-avoidance provisions, this can be advantageous for Family B.

³⁶ Sections 74, 83 and 91 ITEPA 2003.

³⁷ Sections 97 and 201 ITEPA 2003.

³⁸ Section 721(4) ITEPA 2003.

³⁹ Section 721(5) ITEPA 2003.

⁴⁰ RI 268 and especially example 2.

3.5.6 Transfer of assets abroad

The couple in Family B are individually still subject to the anti-avoidance provisions in Section 739 described above in paragraph 3.4.7 and the provisions of Section 740 will apply to impose a liability where one of the couple benefits from the transfer of the assets abroad even if they are not the transferor. In addition, HMRC does not offer an equivalent protection from charge as described above in paragraph 3.4.7, in respect of transfers by one of couple B who is a non-UK domiciliary⁴¹ where the other member of the couple can benefit from the transfer.

Disadvantages

3.6 The disadvantages for Family B are relatively limited but the one of most significance for the majority of couples in a Family-B-type relationship concerns the application of the jointly held assets rule.

3.6.1 Jointly held assets

Family B cannot rely on the statutory presumption contained in Section 282A Taxes Act 1988. However, joint owners of land at least can attribute differing ownership of the income and HMRC indicates that this will be accepted: 'joint owners can agree a different division of profits and losses and so occasionally your share of the profits or losses will be different from your share in the property. Your share for tax purposes must be the same as the share actually agreed.'⁴² (However, this indication by HMRC does not sit comfortably with analysis of the situation. In attributing differing ownership of the income, the person giving away a right to income and not the underlying asset makes a disposal/transfer of value for capital gains tax and inheritance tax purposes. If the income is transferred, a settlement will arise⁴³ with the result that the settlor is taxable on the income attributable to his or her share of the property, although it is not clear from the HMRC Manual that HMRC takes this point currently.)

3.6.2 Enterprise Investment Scheme and Venture Capital Trusts

One of the couple cannot transfer this type of investment to the other in a tax-neutral manner.

3.6.3 The pre-owned assets regime

Family B cannot take advantage of the spouse/civil partner exemptions from the pre-owned assets regime although they can use the exemptions contained in Section 11 Inheritance Tax Act 1984 for the maintenance, education or training of illegitimate children⁴⁴ or for the maintenance of dependent relatives. However, the definition of dependent relatives is a narrower version than that available to Family A. It only covers relatives who are incapacitated and parents of the person making the disposition and does not extend to the parents of the other member of the couple in Family B.

⁴¹ RI 201.

⁴² Property Income Manual 1030.

⁴³ Section 624 ITTOIA 2005.

⁴⁴ Section 11(4) IHTA 1984.

Neutrality between Families A and B

3.7 In a few instances, the tax legislation has been moving towards neutrality in dealing with Families A and B. This is achieved by treating couples living together as husband and wife or civil partners as being married/civil partners. Most notably this has happened in the context of tax credits but also in the context of certain employment income anti-avoidance rules.

3.7.1 Employment income

3.7.1.1 For certain aspects of the legislation on employee benefits and expenses (e.g. childcare, the taxation of various social security benefits and payments via intermediaries), an unmarried opposite-sex couple has been treated as though they were married. These sections either provide that a ‘man and a woman living together as husband and wife’ are treated as if they were married to each other⁴⁵ and ‘two people of the same sex living together as if they were civil partners of each other are treated as if they were civil partners of each other’⁴⁶ or make equal provision for ‘married couples’ and ‘unmarried couples’.⁴⁷

3.7.1.2 So the provisions now apply equally to same-sex couples living together as if they were civil partners. This introduces a new concept in tax. For this purpose, it is provided that two people of the same sex are to be regarded as living together as if they were civil partners if, but only if, they would be regarded as living together as husband and wife were they instead two people of the opposite sex.⁴⁸ (In contrast, the tax credit rules only require that the couple is ‘living together as if they were civil partners’.⁴⁹ This is also the formulation used in the managed service company rules contained in the Finance Bill 2007.⁵⁰)

3.7.1.3 HMRC guidance on the treatment of ‘undisclosed couples’ (whether opposite sex or same sex) follows Department for Work and Pensions practice and is set out in the New Tax Credits Claimant Compliance Manual (CCM15040). (This guidance has currently been withdrawn, but see Appendix 1 for extracts of the HMRC and DWP rules.)

3.7.1.4 HMRC regards ‘living together as husband and wife’ as having its normal meaning, and instructs its staff to take into account whether the individuals in question live in the same household, the stability of their relationship, arrangements for financial support, whether they share joint responsibility for dependent children, and the extent to which their relationship is publicly acknowledged.⁵¹

3.7.2 Tax credits

The tax credit rules apply both to married couples/civil partnerships and to unmarried couples/unregistered couples provided that they are ‘living together as husband and

⁴⁵ Section 61(4) ITEPA 2003.

⁴⁶ Section 61(5) ITEPA 2003.

⁴⁷ Sections 318C(8), 665, 669, 673, 674 and 675 ITEPA 2003.

⁴⁸ Section 61 ITEPA 2003.

⁴⁹ Section 3(6) Tax Credits Act 2003.

⁵⁰ Clause 61I Finance Bill 2007.

⁵¹ The playing field may not yet be level between opposite-sex and same-sex couples, because the latter may still tend to be more secretive (than the former) about their relationships.

wife' or 'living together as civil partners'.⁵² Consequently the rules are neutral as to whether the couples are married/civil partners or not, subject to the evidential issues concerning Family B in deciding whether it satisfies the 'living together' criteria (see paragraph 3.7.1 above).

Family C

3.8 Family C is in the same tax position as Family B save in relation to tax credits and employment income where it is potentially more difficult evidentially to conclude whether the couple are living together as husband and wife or civil partners (although, interestingly, the managed service company provisions contained in the Finance Bill 2007 include a very wide definition of 'associate' as including a member of an individual's 'household' without the requirement of living together as husband and wife or civil partners, thereby avoiding this evidential problem). In the context of tax credits, the 'living together as husband and wife or civil partners' test has led to practical problems in determining the entitlement of families such as Family C. The complexity of the system to deal with family changes and the impact of recovery mechanisms have led to swings in income and lack of control,⁵³ so considerable amendments have been introduced to help alleviate the problems. Most strikingly, the amount of increase in income that is disregarded is now £25,000 instead of £2,500. However, these measures are only expected to cut overpayments by one-third, so most of the overpayments result from changes in family-unit circumstances rather than from income increases.

3.9 A summary of the income tax consequences for the families

<i>Tax subject</i>	<i>Family A</i>	<i>Family B</i>	<i>Family C</i>
Jointly held property 50:50 rule	Yes	No	No
Settlements rules	Yes	Potentially	Potentially
Close company rules – aggregate?	Yes	No	No
Change of company ownership rules – aggregate holdings?	Yes	No	No
Share repurchase 'connection' test – aggregate holdings?	Yes	No	No
Employee share schemes material interest test – aggregate holdings?	Yes	No	No
Allowable loss on unquoted subscribed shares available to transferee	Yes	No	No
Capital allowances connected persons test	Yes	No	No
Transfer of assets abroad by either of couple	Yes	Yes	Yes
Employment income – inclusion of non-employee member of the couple	Yes	See analysis	See analysis
Tax credits	Yes	Yes	Yes
EIS/VCT transfer without penalty	Yes	No	No
Pre-owned assets regime exemption for spouse/partner transfer/consideration	Yes	No	No
Pension income payable to spouse/partner	Yes	If dependant	If dependant

⁵² Sections 3(3)(a) and 3(6) Tax Credits Act 2002.

⁵³ See *Journal of the Child Poverty Action Group*, Winter 2006. HM Treasury announced in May 2006 that £1.8 billion of tax credits was overpaid in the 2004–05 financial year.

Capital gains tax

3.10 The starting point is that each individual is taxed separately in respect of chargeable gains net of allowable losses, arising on the disposal of assets, at the individual's marginal rate of income tax after deducting an annual exempt amount. So in each of the families, each taxpayer has their own annual exempt amount unaffected by marital status. However, the system deviates from one of independent taxation in numerous respects, as will be discussed below. It is in the context of capital taxes that marriage or civil partnership potentially can offer the greatest tax advantages to Family A.

Family A

Advantages

3.11 One of the potentially most valuable tax advantages to Family A of being married or civil partners is that transfers of assets can take place between them without triggering a tax charge and in a tax-neutral way.

3.12 Transfers between the spouses/civil partners

3.12.1 The transfers of assets between spouses or civil partners are generally treated as taking place on a 'no gain/no loss basis'⁵⁴ so that the transferee inherits the tax basis of the transferor for so long as the 'married woman is living with her husband or the civil partners are living together'. This is a significant advantage to Family A who, subject to certain anti-avoidance rules, can transfer assets between them in order to maximise tax efficiency in relation to the income (for example, by transferring income-producing assets to the one paying a lower marginal rate of tax) as well as for non-tax reasons such as ring-fencing assets that may be at risk in relation to one of the taxpayers' currently unknown but possible future liabilities.

3.12.2 Before the introduction of independent taxation, for years up to 1989–90, Section 42(2) Income and Corporation Taxes Act 1970 and then Section 282(2) ICTA 1988 stated that a husband and wife were to be treated as separated if one of them was resident in the United Kingdom and one was non-resident or absent throughout a year of assessment. The implications of this legislation were considered in the case of Gubay v. Kington (57 TC 601). The House of Lords decided that the proviso at what was then Section 282(3) applied for capital gains tax purposes. This proviso stated that no additional tax should arise from the deemed separation provision. As a result, it was concluded that an asset could be transferred from a UK-resident spouse to a spouse who was not resident in the UK at no gain/no loss and sold by the non-resident spouse without attracting UK capital gains tax liability. Thus assets could be passed outside the UK tax net. The assumption of separation in Section 282(2) ICTA 1988 has gone and assets can still be passed outside the UK tax net.

3.12.3 Where an asset has been transferred between spouses/civil partners, the qualifying holding period for taper relief is the combined period it was held by the spouses/civil partners.⁵⁵ For an asset that is not shares or securities, whether or not it qualifies as a business asset depends upon how it was held by the spouse/civil partner

⁵⁴ Section 58 Taxation and Chargeable Gains Act 1992. Exceptions for trading stock and donation mortis causa are contained in Section 58(2).

⁵⁵ Para 15 Sch A1 TCGA 1992.

who actually owned it at the time. For shares and securities, only the position of the spouse/civil partner holding the asset at the time of disposal is taken into account.⁵⁶

3.12.4 A spouse may roll over the gain on the disposal of an old asset that he or she owned into a new asset acquired from his or her spouse.⁵⁷

Disadvantages

3.13 On the other hand, there are few capital gains tax disadvantages to Family A in being married/civil partners so long as the relationship is ongoing. They arise in relation to:

- (i) the principal private residence exemption given to the family home;
- (ii) the settlements rules.

3.13.1 The family home

3.13.1.1 When Family A comes to sell the family home, it can take advantage of the exemption from capital gains tax under the principal private residence provisions of Section 222 Taxation of Chargeable Gains Act 1992. However, in contrast to Families B and C, Family A is restricted to obtaining the benefit of this provision in relation to only one residence or main residence for so long as the couple are living together.⁵⁸ So if the couple own two houses, they must jointly elect which property is the main residence.

3.13.1.2 Under the general rule, there is a two-year period in which to serve a notice nominating a house as principal private residence where the taxpayer owns more than one property.⁵⁹ As regards elections by Family A, HMRC takes the view that a new two-year period for nominating the main residence does not begin where:

- (a) one of them owns more than one residence;
- (b) the other one does not own a residence; and
- (c) there is no change of residence on marriage/registration of civil partnership.

3.13.1.3 However, a new period does begin where the couple jointly own more than one residence at marriage/registration but neither one of them separately owns any other residence. This is because both of them must make a joint nomination for it to be valid from the date of marriage/registration, even though both of them own the same residences as before (even if they had both previously nominated the same residence).

3.13.1.4 These complexities can be a disadvantage for Family A and, some commentators suggest, can deter young couples (for whom inheritance tax planning is a far distant concept) from marrying.

⁵⁶ Para 15(4)(a) Sch A1 TCGA 1992.

⁵⁷ ICAEW Taxline 1992/50.

⁵⁸ Section 222(6) TCGA 1992.

⁵⁹ Section 222(5) TCGA 1992.

3.13.2 Settlements

3.13.2.1 The capital gains tax rules that determine whether a person has an interest in a settlement treat a settlor as having an interest if their spouse or civil partner is able to derive any benefit from the settled property in much the same way as the income tax settlements rules do.⁶⁰ (The same definition of spouse is used to exclude separated spouses, civil partners, widows/widowers/surviving civil partners and persons to whom the settlor is not yet married/a civil partner.⁶¹) So Family A must take these rules into account in the context of tax and estate planning, in contrast to Families B and C.

3.13.2.2 The spouses/civil partners of Family A also come within the wider-ranging anti-avoidance provisions attributing gains of offshore trusts where the settlor or specified relatives (including spouses or civil partners)⁶² have an interest.⁶³

Family B

Advantages

3.14 No matter how permanent a relationship Family B has, the partners in it are at a significant disadvantage in relation to transfers between them. Such advantages as they do stand to gain in relation to the principal private residence exemption and the application of the settlements rules will usually be of much less value than the inter-spouse/civil partner transfer exemption.

3.14.1 The family home

Although the couple will still need to satisfy the residence requirements of Section 222 Taxation of Chargeable Gains Act 1992, there is no automatic limitation to one property as for Family A.

3.14.2 Settlements

3.14.2.1 Family B may set up trusts with one of the couple (the settlor) settling property upon trust where the other member of the couple benefits without the settlor incurring liability under Section 77 TCGA 1992 or even the wide-ranging provisions of Section 86 TCGA 1992 (dealing with offshore trusts).

3.14.2.2 However, the provisions of Section 86 TCGA 1992 attributing gains of offshore trusts to the settlor will apply if an offshore trust is set up and the children or grandchildren of the settlor have an interest in the trust. So long as the couple does not marry/register, any children of just one of the couple will not be 'stepchildren' of the other of the couple and so not within Section 86 as regards property put into trust by that member of the couple.

Disadvantages

3.15 Family B is at a significant disadvantage compared with Family A in the context of transfers of assets between the couple.

⁶⁰ Section 77(2) TCGA 1992.

⁶¹ Section 77(3) TCGA 1992.

⁶² See Families B and C for further discussion of the breadth of these provisions.

⁶³ Section 86 TCGA 1992.

3.15.1 Transfers between the spouses/civil partners

3.15.1.1 The transfers of assets between the couple do not benefit from the tax-free protection afforded by Section 58 TCGA 1992. The couple are not treated as ‘connected persons’ for the purposes of Section 18 TCGA 1992 so a market value is not automatically required for the disposal; although the couple could be caught by Section 17 TCGA 1992 in relation to non-market values being given on the transfer under the general principles of that section applying where the disposal ‘is otherwise than by way of bargain at arm’s length’.⁶⁴ No doubt many uninformed couples are unaware that they cannot simply transfer assets between them as ‘gifts’ without possible capital gains tax consequences.

3.15.1.2 If the assets are business assets, it may be possible for Family B to ‘hold over’ any gain,⁶⁵ but of course this only postpones the charge.

3.15.1.3 As the transfers constitute disposals, there is no carryover of taper relief from the transferor to the transferee.

Family C

3.16 The capital gains tax treatment of Family C is the same as that of Family B.

3.17 **A summary of the capital gains tax consequences for the families**

<i>Tax subject</i>	<i>Family A</i>	<i>Family B</i>	<i>Family C</i>
Tax-free transfers between spouses/partners	Yes	No	No
Principal private residence exemption	Restricted to 1 while living together	No restriction while living together but must satisfy residence test	No restriction while living together but must satisfy residence test
Taper relief – combined period of holding	Yes	N/A because transfer between is a disposal	N/A because transfer between is a disposal
Settlements – attribution of spouse/partner’s interest to settlor	Yes	No	No

Stamp duty and stamp duty land tax

3.18 The structure of stamp duty and stamp duty land tax (‘SDLT’) does not generally differentiate between transfers between married couples/civil partners and unmarried/unregistered couples. Couples can transfer land between them where there is no sale of the land and only pay 50p stamp duty.

⁶⁴ Which HMRC interprets as meaning as where the parties are trying to obtain the best deal in the circumstances – Capital Gains Manual, CG 45231.

⁶⁵ Section 165 TCGA 1992.

CHAPTER 4

The Tax Position on Separation and Divorce

4.1 In this chapter, the extent to which taxation treatment differentiates between married couples/civil partners and unmarried/unregistered couples is considered. It will be seen that the balance of advantages/disadvantages shifts in favour of Families B and C.

Income tax

Family A

4.2 In the event of permanent separation of the couple, there are numerous income tax consequences for Family A which are set out in Appendix 2. In certain cases, the tax treatment depends upon whether the couple are 'living together' under Section 282 Taxes Act 1988; in other cases, the tax treatment depends upon final decree of divorce or dissolution. The fact that there are these different points of time is itself a complication that the couples in Families B and C do not generally face on separation. The position is summarised in the following table.

<i>Tax subject</i>	<i>Living together</i>	<i>Final decree</i>
Jointly held property 50:50 rule	✓	
Settlements rules		✓
Close company rules		✓
Change of company ownership rules		✓
Share repurchase 'connection' test	✓	
Employee share schemes material interest test		✓
Allowable loss on unquoted subscribed shares available to transferee		✓
Capital allowances connected persons test		✓
Transfer of assets abroad by either of couple		✓
Employment income – inclusion of non-employee member of the couple	See analysis	See analysis
Tax credits	✓	
EIS/VCT transfer without penalty		✓
Pre-owned assets regime exemption for spouse/partner transfer/consideration		✓
Pension income payable to spouse/partner		✓

Family B

4.3 There are few income tax issues for Family B on the couple's relationship ceasing.

Advantages

4.4 Family B benefits from no income tax advantage on the couple's relationship ceasing. It is in the same position as Family A in relation to tax credits, being required to inform HMRC of the change in family structure.

4.5 The cessation of the relationship is also relevant in the context of employment income. Certain of the anti-avoidance rules look to the point at which the couple cease to be living together as husband and wife or civil partners. Others continue to apply if payments are made to an ex-spouse or civil partner if the recipient is a 'dependant' of the employee. (See further Appendix 2 paragraph 23.)

Disadvantages

4.6 Family B does suffer one income tax disadvantage after the couple's relationship ceases. In order for the survivor of Family B to qualify for a Revenue-approved pension on the death of their ex-partner, they must qualify as a 'dependant'.⁶⁶ Clearly, this is a more subjective test than that of being an ex-spouse or civil partner and will apply to a narrower group of ex-partners.

Family C

4.7 Family C is in basically the same position as Family B, although as a practical matter it is likely to be more difficult to show that one has become a dependant of the other for pension purposes. The fluidity of Family C's relationships makes the operation of the tax credit system more difficult.

Capital gains tax

Family A

4.8 Although Family A can benefit from significant tax advantages while married/civil partners, its capital gains tax position on separation and divorce is more complicated than that of Families B and C and can be more costly. Generally, Family A is at a capital gains tax disadvantage on separation and divorce.

Advantages

4.9 The only capital gains tax advantages for Family A on separation and divorce concern the application of the principal private residence exemption and a land exchange exemption.

4.9.1 The family home

4.9.1.1 If one of the couple leaves the family home and transfers their beneficial interest to the other partner/spouse or to a third party within 36 months, the whole of any gain arising to the transferor remains exempt under the principal private residence exemption if the other conditions of that exemption have been met and the home was previously the main residence of the transferor.⁶⁷ This treatment also applies for Families B and C. Where Family A gains an advantage is in relation to a concession extending the application of this rule beyond the 36-month period.

⁶⁶ Section 590(2)(aa) Taxes Act 1988.

⁶⁷ Section 223(1) TCGA 1992.

4.9.1.2 Where, as a result of the breakdown of a marriage or civil partnership, one spouse/partner ceases to occupy their matrimonial home and subsequently as part of a financial settlement disposes of the home, or an interest in it, *to the other spouse/partner* (or, if the transfer is after a divorce/dissolution, ex-spouse or partner), the home may be regarded for the principal private residence exemption purposes as continuing to be a residence of the transferring spouse/partner from the date his or her occupation ceases until the date of transfer, provided that it has throughout this period been the other spouse's/partner's only or main residence.⁶⁸ This will not apply if the transferring spouse/partner has elected that some other house should be treated for capital gains tax purposes as their main residence for this period.

4.9.2 Land exchanges

4.9.2.1 There is one more relief available to separating married couples/civil partners where land is held jointly and either as a result of an exchange each joint owner becomes sole owner of part of the land or a number of separate holdings are held jointly and as a result of the exchange each joint owner becomes sole owner of one or more holding.⁶⁹ The relief given is a form of rollover relief.⁷⁰ Where the value of the interest acquired is less than the one disposed of, an immediate charge to tax may arise (subject to the availability of the principal private residence exemption).

4.9.2.2 The concessionary rollover is not available if the 'new land' is or becomes a dwelling house within the principal private residence exemption. However, joint owners of homes within the principal private residence exemption who become sole owners in consequence of an exchange may claim concessionary relief if each gain would be exempt under the principal private residence exemption on a disposal immediately after the exchange. In these circumstances, the relief is allowed on condition that each party to the exchange undertakes to accept that he or she shall be deemed to have acquired the other's interest in the dwelling house at the original base cost of, and on the date of, the joint acquisition.

Disadvantages

4.10 The main disadvantages for Family A arise from the fact that after separation and before divorce, the couple cease to be able to use the no gain/no loss transfer rule and are treated as connected persons. In addition, the mechanics of the separation can be complex. This can result in unexpected tax charges arising from the division of assets.

4.10.1 Transfers of assets

4.10.1.1 The no gain/no loss transfer rules apply for so long as the couple are 'living together'.⁷¹ There is no requirement that they should be living together throughout that year. Where a husband and wife or civil partners separate during a year of assessment,

⁶⁸ Extra Statutory Concession D6. (However, it may not be advantageous for the transferor to claim relief if they have acquired another residence before the transfer of the matrimonial home. HMRC does not allow relief on a gain arising in respect of the second property if it was given on the former matrimonial home as both properties were held during the same period.)

⁶⁹ ESC D26.

⁷⁰ Under Sections 246 and 247 TCGA 1992.

⁷¹ Section 58 TCGA 1992.

transfers at no gain/no loss can be made between them for the remainder of that tax year. After the tax year of separation but before a final divorce or dissolution, spouses and civil partners remain ‘connected persons’ for capital gains tax purposes and will be taxed on the full market value even though no consideration passes.

4.10.1.2 HMRC summarises the determination of consideration on disposal in the case of Family A as follows:⁷²

<i>Date of disposal</i>	<i>Deemed consideration</i>
While husband and wife or civil partners of each other are living together	Such amount as will give neither a gain nor a loss on disposal
In year of permanent separation	As above
In year during the whole of which husband and wife or civil partners of each other were permanently separated	Market value at the date of disposal
Following divorce or dissolution of civil partnership	Sometimes market value at the date of disposal, sometimes actual consideration

4.10.1.3 This situation gives rise to considerable practical difficulties. If the parties seek financial advice after separation on 6 April rather than 4 April, there can be significantly different tax results. The Law Society’s view is that the current rules do not reflect the reality of time taken to complete a divorce settlement. In some cases, it may even act as an incentive to split the matrimonial assets quickly after separation, making reconciliation less likely. The Law Society’s opinion is that there should be a longer period after separation during which tax-free transfers can be made. Its opinion has been reinforced by two factors. First, the popularity of buy-to-let investments has meant that there are many more instances of substantial gains being liable to tax under the current rules. Second, the House of Lords has recently made it clear that the courts are likely to order more substantial transfers of property in future so as to ensure greater financial equality between the parties.⁷³

4.10.1.4 Family Lawyers Group ‘Resolution’ is working with the Law Society to lobby HMRC. A recommendation for change was put to Ministers in 1998 but without sufficient evidence to persuade Ministers of the need for change. Consequently, the Law Society is now in the process of seeking evidence from practitioners in order to try again to get change in this area.

4.10.1.5 There is then the question of when the disposal is treated as occurring. HMRC accepts that the date of disposal should be taken as the date of transfer if there is no earlier date on which there was a binding agreement between the couple to transfer the asset. Where an asset is transferred by a Court Order made after the date of the decree absolute or after the date the dissolution order was made final, the date of disposal is the date of the Court Order. This is even the case where the Order is a Consent Order, i.e. one that is giving effect to an agreement already reached by the parties. Although a person is treated as disposing of an asset when he contracts to dispose of it,⁷⁴ case law

⁷² CGT Manual 22418.

⁷³ *White v. White* [2000] 3 WLR 1571.

⁷⁴ Section 28 TCGA 1992.

has decided that the financial arrangements flow from the Consent Order and not the preceding agreement.⁷⁵ HMRC therefore treats the disposal as being at the time of the Order.⁷⁶

4.10.1.6 Where an asset is transferred by a Court Order, which is not a Consent Order but which is made before the date of the decree absolute or before the date the dissolution order is made final, the date of disposal is the date of the Court Order.

4.10.1.7 Where an asset is transferred under a Consent Order before the decree absolute or before the date the dissolution order was made final, so that the court is acknowledging what has already happened, the date of disposal is not straightforward. The date of disposal in these cases may be important where

- the value of the asset transferred changes substantially between the date of any agreement and the date of the Consent Order, or
- the date of the agreement was in the year of permanent separation, so that a disposal at that date would be at no gain/no loss, while the date of the Consent Order was in a later year, so that a disposal at that date would be at market value.

4.10.1.8 If either of these considerations applies, but there is little or no tax at stake, HMRC will accept the date of disposal agreed by the parties. Otherwise, it is a matter to be agreed with HMRC against the background of all the documentation.

4.10.1.9 The date of disposal rules are summarised in the HMRC Manuals as follows:⁷⁷

<i>Asset transferred by ...</i>	<i>Date of disposal</i>
Court Order following decree absolute or final dissolution order	Date of Court Order
Consent Order before decree absolute or final dissolution order	Accept parties' agreement or obtain documentation and advice as necessary
Other Court Orders before the decree absolute or final dissolution order	Date of Court Order
Contract	Date of contract
No contract	Date of transfer

4.10.1.10 Following a High Court decision, HMRC has changed its policy for the transfer of business assets under a Court Order and holdover relief is available from 31 July 2002.⁷⁸ (This same analysis also applies without a Court Order where it can be shown that no consideration passed in the form of surrendered rights.) However, the circumstances of this relief are limited and holdover relief is only a deferral of the tax liability.

⁷⁵ *Lasala v. de Lasala* 1980 AC546.

⁷⁶ CGT Manual 22421.

⁷⁷ CGT Manual 22423.

⁷⁸ *G v. G* [2002] 2 FLR; confirmed in HMRC Bulletin 66.

4.10.2 Secured periodical payments

4.10.2.1 These are Court Orders where the court feels security is needed in relation to an order to make maintenance payments. It is apparently rare for one of these orders to be made, but when made they do cause capital gains tax complexities and potentially give rise to additional tax being payable.

4.10.2.2 The maintenance order is secured by the transfer of assets to trustees. This gives rise to a settlement and the following tax points:

- (i) When the assets are transferred to the trustees, there is a disposal of those assets by the transferor. As the transferor and the trustees are connected, a market value is imputed.
- (ii) When the obligation to make maintenance payments ends, the transferor is entitled to a return of the assets. As the transferor has this interest, any gain realised by the trustees on the disposal of trust assets will be chargeable gains of the transferor which he will recover from the trustees under the terms of the security.
- (iii) When the assets are transferred back to the transferor, there is further disposal by the trustees and another charge to capital gains tax arises unless the reason for the reversion is the death of the maintenance recipient.

4.10.2.3 As a result of the interaction with taper relief, the overall effect of (i) to (iii) may be to increase the tax payable as compared with an outright transfer of the assets.

Family B

Advantages

4.11 Family B is no better or worse off for capital gains tax purposes as a result of separation than before. There were and are no exemptions available to the couple in Family B and any transactions not on arm's length terms will still have a market value imputed to them.⁷⁹ The advantage for Family B is that its tax position is simpler and consistent with its position prior to separation. Much of that simplicity derives from the fact that the couple can cease their relationship without the mechanics of a divorce process.

Disadvantages

4.12 However, Family B does theoretically suffer one disadvantage in relation to the tax treatment of the family home.

4.12.1 Transfer of the family home

Family B can utilise the same exemptions and reliefs as Family A save for the specific concessionary extension of the principal private residence relief where more than 36 months have passed since one of the couple has left and their interest is transferred to the other member of the couple.⁸⁰ However, in practice, transfers of homes from one of

⁷⁹ Section 17 TCGA 1992.

⁸⁰ ESC D6.

the couple to the other rarely seem to occur.⁸¹ When they do occur, a tax charge does not appear to affect the couple in practice, whether through failure by the transferor to declare a tax charge (due to lack of understanding of the intricacies of the capital gains tax legislation) or otherwise.

Family C

4.13 Family C's tax position is the same as Family B's.

Inheritance tax

Family A

Advantages

4.14 Family A's inheritance tax position on separation and divorce is generally clear and should not give rise to unexpected inheritance tax consequences. (Complications may arise in relation to settlements but this is not as a result of the couple's married/civil partner status.) Family A also benefits from a specific inheritance tax advantage in relation to arrangements made for the maintenance of dependent relatives and children.

4.14.1 Transfers

Transfers will not usually be inheritance tax events. Either the inter-spouse exemption (see further paragraph 5.4.1 below) applies, or after divorce there is no gratuitous intent where the transfer takes place in accordance with a Court Order.

4.14.2 Maintenance dispositions

Dispositions for the maintenance of dependent relatives and children of married persons or civil partners are exempt from inheritance tax and for this purpose the definition of dependent relative includes relatives of either spouse or civil partner where incapacitated, or the mother or father of either of the couple.⁸² The couple do not need to be living together at the time of the disposition. 'Marriage' for these purposes includes a former marriage where the disposition is made on the occasion of⁸³ the dissolution or annulment of a marriage or varies such a disposition.⁸⁴

Disadvantages

4.15 There are no inheritance tax disadvantages for Family A on separation and divorce.

Family B

Advantages

4.16 There are no inheritance tax advantages for Family B on separation.

⁸¹ R. Tennant, J. Taylor and J. Lewis, *Separating from Cohabitation: Making Arrangements for Finances and Parenting*, DCA Research Series 7/06, Department for Constitutional Affairs, October 2006.

⁸² Section 11 IHTA 1984 as amended by the Tax and Civil Partnership Regulations.

⁸³ It is understood that 'on the occasion of' is not construed strictly by HMRC; *New Law Journal*, 2 December 1976, page 1183.

⁸⁴ Section 11(6) IHTA 1984.

Disadvantages

4.17.1 Family B potentially suffers significant inheritance tax disadvantages on separation. Family B cannot rely on the inter-spouse exemption and cannot rely on a Court Order removing the necessary element of gratuity. Accordingly, Family B may find that when separating, transfers made between the couple are only potentially exempt transfers unless care is taken to remove any element of gratuity. However, as noted in paragraph 4.12.1 above, transfers of assets rarely seem to occur between separating cohabitants.

4.17.2 If Family B were to agree some form of maintenance arrangements for dependent relatives or children, it could not rely on any inheritance tax exemption in relation to property dispositions.

Family C

4.18 Family C is in the same position as Family B.

Stamp duty and stamp duty land tax

Family A

Advantages

4.19 There is an exemption from stamp duty/SDLT for transfers between the couple in pursuance of Court Orders in the context of divorce or judicial separation and in pursuance of an agreement of the parties made in contemplation of or otherwise in connection with the dissolution of the marriage, their judicial separation or the making of a separation order.⁸⁵

Families B and C

Disadvantages

4.20 These families have no stamp duty/SDLT exemption to benefit from on separation. However, they can gift land or property between them and only pay the fixed 50p duty. A gift may give rise to inheritance tax issues though, as indicated in paragraph 4.17 above.

⁸⁵ Para 3 Sch 3 Finance Act 2003.

CHAPTER 5

The Tax Position on Death

5.1 On the event of the death of one of the couple, the married couple in Family A are in a significantly better position in relation to tax than the unmarried/unregistered couples.

Income tax

Family A

Advantages

5.2 Family A can benefit from one advantage on the event of the death of one of the couple.

5.2.1 Pension schemes

An HMRC-approved pension may be paid to the surviving member of a married couple or civil partnership if the scheme provider decides to include such a provision (as it would commonly do).⁸⁶

Families B and C

5.3 There are no income tax advantages for Families B and C on death.

Inheritance tax

Family A

Advantages

5.4 On death, the fact that the couple are married/civil partners carries only advantages for inheritance tax.

5.4.1 Transfers pre- and post-death

5.4.1.1 The couple in Family A can transfer assets to each other and in most cases the transfer is exempt from inheritance tax.⁸⁷ This has long been one of the most important reliefs available to married couples and is now available to civil partnerships. It applies without limit except where the transferee is not domiciled in the UK, in which case a limit of £55,000 applies.⁸⁸

5.4.1.2 The results of this exemption feed through into numerous parts of the inheritance tax legislation such as the gifts with reservation rules⁸⁹ (although as a result of the changes introduced in the Finance Bill 2006, the value of these rules for family tax planning has been significantly diminished) and valuation rules.⁹⁰ So, for example, the related property provisions, whereby property given to an exempt recipient

⁸⁶ Section 590 Taxes Act 1988.

⁸⁷ Section 18 IHTA 1984.

⁸⁸ Section 18(2) IHTA 1984.

⁸⁹ Section 54 IHTA 1984.

⁹⁰ Section 18 IHTA 1984.

continues to be taken into account in valuing the property retained by the transferor, apply to property transferred from one of the couple to the other.⁹¹

5.4.2 Gifts in consideration of marriage or civil partnership

The exemption for gifts in consideration of marriage would have applied to Family A. The exemption now applies to gifts in consideration of marriage or civil partnership and will apply to gifts made by one or both of the parents in Family A to their children in consideration of the children getting married/registered as civil partners. This exemption for gifts to their children extends to children of both of the couple and those of one of the couple and to adopted children.⁹² Gifts can be settled and the class of beneficiary can include the children in Family A.⁹³

5.4.3 Business and agricultural property reliefs

5.4.3.1 Where property is inherited on the death of a spouse or civil partner, the survivor is deemed to stand in the shoes of the deceased in determining the requisite length of ownership for the business property and agricultural property reliefs.⁹⁴ This is irrespective of the length of the marriage.⁹⁵

5.4.3.2 Also, where the property is owned for the requisite time period and is transferred in life or on death, the transferee or the transferee's spouse can in turn make a transfer of value (so long as one of the two transfers is on death) and the property can qualify for relief without meeting the time condition on the second transfer.⁹⁶

5.4.4 The home

Where a spouse inherits a dwelling house from the other spouse, he or she also inherits the other spouse's period of ownership for principal private residence relief purposes.⁹⁷

Family B

Disadvantages

5.5 Family B only suffers disadvantages on death as a result of not being married/civil partners.

5.5.1 Pension income

In order for the survivor of Family B to qualify for a pension on the death of their partner, they must qualify as a 'dependant'.⁹⁸ Clearly, this is a more subjective test than that of being spouse or civil partner and the survivor often will not be able to qualify as a 'dependant'. Even ex-spouses/civil partners can be in a better position!

⁹¹ Section 161 IHTA 1984.

⁹² Section 22 IHTA 1984.

⁹³ Section 22 IHTA 1984.

⁹⁴ Sections 108 and 120 IHTA 1984.

⁹⁵ Confirmed by IHT Manual 25321.

⁹⁶ Sections 109 and 121 IHTA 1984.

⁹⁷ Section 222(7)(a) TCGA 1992.

⁹⁸ Section 590(2)(aa) Taxes Act 1988.

5.5.2 Transfers pre- and post-death

There is no general exemption for transfers between couples regardless of how long they have been together if they are not married or civil partners. This is one of the greatest disadvantages facing unmarried/unregistered couples. Current official advice to couples seeking to try to reduce their liability to inheritance tax is to marry/register.⁹⁹

5.5.3 Gifts in consideration of marriage or civil partnership

The couple in Family B are not able to receive gifts under this exemption unless they marry or register as civil partners. They can use the exemption to make gifts to their own children in consideration of their children's marriages or civil partnerships.

5.5.4 Business and agricultural property reliefs

The couple in Family B cannot benefit from the carryover of one party's ownership of property across death. (In contrast, the woodlands relief postpones charge where woodlands are transferred other than for money or money's worth with no restriction to spouses or civil partners.¹⁰⁰)

Family C

5.6 Family C is in the same position as Family B.

5.7 **A summary of the inheritance tax consequences for the families**

<i>Tax subject</i>	<i>Family A</i>	<i>Family B</i>	<i>Family C</i>
Exempt transfers pre- and post-death	Yes	No	No
Pension paid to survivor	Yes	If dependant	If dependant
Business and agricultural property reliefs	Yes	No	No
Woodlands relief	Yes	Yes	Yes
Principal private residence ownership period inherited	Yes	No	No

⁹⁹ See, for example, [http:// www.advicenow.org.uk](http://www.advicenow.org.uk).

¹⁰⁰ Section 125 IHTA 1984.

CHAPTER 6

Conclusions from the Analysis of Families A, B and C

6.1 The tax system is not consistent as to whether a married couple/civil partners should have advantageous treatment compared with an unmarried/unregistered couple. However, Family A still benefits significantly from the capital gains tax and inheritance tax exemptions available to it for so long as the couple remain married/civil partners. Set against this, Family A is the subject of more anti-avoidance measures.

6.2 More recently, in the context of employment income, the tax rules have moved towards closer alignment of treatment of married couples/civil partners and unmarried/unregistered couples. However, this is not achieved in a consistent definitional manner, which gives rise to anomalies and inconsistencies.

6.3 The tax treatment of separation and divorce is confused and inconsistent. Certain provisions apply while a couple is living together; others look to final divorce or dissolution. The capital gains tax treatment of transfers between married/unregistered couples after separation appears to cause considerable practical difficulties.

6.4 The concept of when a couple are 'living together as husband and wife or civil partners' is imprecise and may cause particular problems for same-sex couples who wish to keep their relationship discreet. The imprecision of couple definitions has been seen as a reason to keep special treatment for married couples/civil partners.

6.5 The problems encountered by the tax credit system in seeking to react to changes in family units highlight the type of problems that can arise when the tax system tries to tax a particular type of family unit other than the easily identifiable married/civil partnership.

6.6 The tax system gives no recognition of the length of an unmarried/unregistered relationship or whether the couple have children.

6.7 The balance of the advantages and disadvantages available to the different family structures alters significantly if the couple separate and, as a result of the capital gains tax complexities, Family A can face unexpected tax charges.

CHAPTER 7

Where Next?

7.1 Some of the questions that arise from this analysis are:

- (i) Should the tax system continue to differentiate between married couples/civil partners and unmarried/unregistered couples?
- (ii) Should the anti-avoidance provisions look to how people are acting together rather than their family relationship?
- (iii) How does one define couples for tax purposes? Should the tax system continue to recognise couples to any extent or move to a completely independent system of taxation?
- (iv) If couples do receive different treatment, should they be ‘rewarded’ by the tax system for stability?

7.2 These are questions for politicians to answer. They are also possibly issues that will be addressed by the European Court.

7.3 **The European Court of Human Rights and discrimination**

7.3.1 Last year, the European Court of Human Rights made an important decision in the case of PM v. UK.¹⁰¹ The case concerned a father making maintenance payments in respect of his daughter. He claimed a tax deduction under the old rules. He was separated from the mother and had never been married to the mother. He had been denied a deduction on the ground that he had not been married to the mother. The Government argued that marriage is a special regime which confers specific rights and obligations on those who choose to join it. While the ECHR did not disagree with this statement, it seriously limited its use. The ECHR decided that the father was being discriminated against. He was acting in his role as father, not a married or unmarried person, and there was no reason to treat him differently from a previously married father.

7.3.2 How far can this line of reasoning be taken? For example, why should the pre-owned assets regime exclude transfers to spouses/civil partners or the provision of consideration by a spouse/civil partner and not an unmarried/unregistered partner? Why should the capital gains tax and inheritance tax rules favour married couples/civil partners? The case can be restricted to situations where the taxpayer is seeking equality of treatment in relation to the payments made to, or received from, a third party, as opposed to the taxpayer’s treatment of transactions with their partner, but it would be possible for the reasoning to be taken much further.

7.3.3 Most recently, two sisters (the ‘Burdens’) claimed that the current inheritance tax laws exempting inter-spouse transfers and transfers between civil partners is discriminatory and they were given leave to appeal to the European Court of Human

¹⁰¹ [2005] STC 1566.

Rights.¹⁰² Although their claim failed by a majority decision of four judges to three, this may yet be an area ripe for anti-discrimination challenges by unmarried couples who are not civil partners. To quote one of the dissenting judges: ‘once the legislature decides that a permanent union of two persons could or should enjoy tax privileges, it must be able to justify why such a possibility has been offered to some unions while continuing to be denied to others’.¹⁰³

7.4 **What is the latest Government policy in relation to taxation of the family?**

The Government states that there are policies that underpin its tax measures.¹⁰⁴ These policies include a policy of ‘protecting revenue’ and another of ‘building a fairer society’.

7.4.1 Protecting revenue

The fact that most income tax anti-avoidance measures are limited to applying only to married couples/civil partners does not fulfil this policy objective. More recent provisions such as those concerned with the payments of certain employment income (see paragraph 3.7 above) have extended to couples living together as husband and wife or civil partners and do reflect this policy.

7.4.2 Building a fairer society

This is open to various interpretations, but it could be said that providing preferential tax treatment to married couples/civil partners and not to couples such as that in Family B, living together as husband and wife or as civil partners, is not ‘fair’. Similarly, applying anti-avoidance measures to Family A but not Family B could be seen as not ‘fair’.

7.4.3 Specific family policy

7.4.3.1 The Government’s policy statements specifically relating to the taxation of the family concern the interaction between the tax and benefits system. There are no stated policies in relation to whether the tax system should favour married couples/civil partners.

7.4.3.2 In 2005, the Treasury produced a paper indicating how it saw the tax and benefits system developing.¹⁰⁵ The following points come out of that paper:

- (i) The separation between the tax and social security systems was seen to obscure the fundamental financial relationships between government and individuals or families over their life cycles and to label people as either ‘taxpayers’ or ‘claimants’. The stigma potentially attached to claiming benefits – even in-work benefits – was one of the factors thought to explain low take-up.
- (ii) Whereas tax credits can be paid to households, increasing the personal allowance can only reduce a household’s tax bill to zero.

¹⁰² *Burden and another v. UK* App No. 13378/05.

¹⁰³ Paragraph 2 of the joint dissenting opinion of Judges Bonello and Garlicki.

¹⁰⁴ Chapter A, 2006 Budget Report.

¹⁰⁵ *The Modernisation of Britain’s Tax and Benefit System*, March 2005.

- (iii) Tax credits can tailor support according to family circumstances.
- (iv) Tax credits can provide the same financial support irrespective of the household's marginal rate of tax.

7.4.3.3 Pursuing this line of reasoning and integrating tax and benefits produces a system of negative income tax. HM Treasury recognises that to do so would mean, amongst other things, abandoning independent taxation and, being such a major change to the system, could entail significant risks. So, to minimise the risks, HM Treasury is adopting a piecemeal approach. Currently, it is testing a new return-to-work tax credit of £40 per week, payable for 52 weeks. (The credit is available to people who move from incapacity benefits to work of 16 hours a week or more and is payable to anyone whose annual earnings are less than £15,000.) The HM Treasury paper indicates that housing benefit and incapacity benefit are the next targets for reform.

7.4.3.4 It is not clear whether such a piecemeal approach will provide a clear, workable system. The implication of this approach is that the structure of the family is seen as largely irrelevant for tax purposes and that the tax system is seen by the Government as being directed at the family, whatever its structure. There is no indication as to what the approach to current inconsistencies should be.

7.5 What is the policy of the Conservative Party?

7.5.1 The Conservative Party's policies are recognised as being in a state of flux currently. Recently, a set of proposals, *Tax Matters*, have been published.¹⁰⁶ These include the following statements and proposals:

- (i) The tax system should treat organisations and people in similar circumstances in a similar way.
- (ii) A transferable allowance for couples with a child aged 5 or under should be introduced.¹⁰⁷
- (iii) The current complex capital tax regime should be replaced by a simple short-term capital gains tax. No capital gains tax should be imposed on a gain arising on disposal of an asset that has been held for over 10 years. Inheritance tax should be abolished and replaced by this short-term capital gains tax payable on death.

7.5.2 The statement in (i) suggests that the inconsistencies between Families A and B should be removed. The details of proposal (iii) are not clear, but such changes could potentially enable the current capital gains tax and inheritance tax advantages for married couples to be removed as they would no longer be of such value.

7.5.3 However, set against this are statements made by David Cameron that 'a modern Conservative Party should support marriage. We should use the law, the tax and benefits system and other mechanisms to encourage families to get together and

¹⁰⁶ Report of the Tax Reform Commission, 19 October 2006.

¹⁰⁷ For further consideration of this proposal, see chapter 12 of R. Chote, C. Emmerson, A. Leicester and D. Miles (eds), *The IFS Green Budget: January 2007*, IFS Commentary 102, 2007 (http://www.ifs.org.uk/publications.php?publication_id=3841).

stay together'.¹⁰⁸ This would indicate retaining some tax advantages for Family A and perhaps increasing them by some form of tax allowance. Although it is not clear how much statements such as this will form part of actual policy, debate between Labour and the Conservatives on this issue has been increasing and the tax treatment of different family structures has become increasingly contentious.

7.6 What is the policy of the Liberal Democrat Party?

There are relatively few policy statements in this area from the Liberal Democrat Party. In August 2006, the Liberal Democrats published a set of tax proposals.¹⁰⁹ Of these, the only one of direct relevance to this paper is a proposal that inheritance tax should be charged on an 'accession' basis on each recipient, with possible personal allowances for the recipients. This is designed to encourage the spreading of wealth among more recipients on death. To the extent that there is any form of personal allowance introduced for recipients, the tax position of the survivor of unmarried couples would improve. It is not clear whether the Liberal Democrats would alter the inter-spouse exemption.

¹⁰⁸ Speech, 29 June 2005.

¹⁰⁹ *Fairer, Simpler, Greener*, Policy Paper 75.

CHAPTER 8

Conclusion

8.1 The tax treatment of couples does depend upon whether they are married/civil partners or not. In the context of income tax, the differences are relatively detailed and in some cases affect relatively few people. However, in the context of capital taxes, Family A benefits from significant tax advantages for so long as the couple remain married/civil partners. On separation of the couple, Family A can be at a significant disadvantage as a result of both the more complex mechanics of separation and the operation of the capital gains tax rules.

8.2 Current policies of the Government and Opposition generally focus on the family rather than the legal structure of the family, although there are signs that this may be changing, at least for the Conservative Party. In contrast, recent proposals for the Conservative Party may have the result of removing some of the distinctions between family structures as a result of changing the way in which capital taxes are operated, but this is not yet clear.

Appendix 1. Definitions and extracts from Manuals

Definitions from the SSCBA 1992 – S137(1)

“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;

Extract from HMRC Manuals Tax Credit Applicant Compliance Guide 9010

(note the Manual has not been updated to reflect civil partnerships)

Since the inception of the Welfare State in 1945 the question of whether a man and woman live together as husband and wife has proven to be a difficult and sensitive subject. Since 1977 the DSS have had a common approach to this situation regardless of the type of benefit being claimed. The Inland Revenue has adopted that same approach for WFTC.

The principal behind this is that an unmarried couple should not be treated any more or less favourably than a married couple.

The law says there are certain consequences for entitlement to tax credits where an applicant is part of an “unmarried couple”.

Living together as husband and wife has its normal meaning in everyday language but the courts and administrative practice have developed a number of criteria to help apply that meaning to situations that may occur. When all of these criteria have been examined, the question as a whole still needs to be answered; do this man and woman live together as husband and wife.

These criteria are:–

- Live in the same household.
- Stability of relationship
- Financial support
- Sexual relationship
- Dependent children
- Public acknowledgement.

In both post and pre-award cases no single point can decide the question of living together as husband and wife. It is essential to have as much information as possible on all of the points to consider them as a whole. Remember that in pre-award cases the onus is on the applicant to prove that the conditions of entitlement have been satisfied.

HMRC guidelines in the context of child tax credits

Living together as husband and wife is not defined in the legislation. But it is a relevant rule for various Social Security benefits. Court decisions in these cases show that no one fact necessarily decides whether a man and a woman live together as husband and wife. But the Social Security rule is used for some benefits where no children are involved. This is important because in Children's Tax Credit cases there will be children.

In cases where both of the unmarried couple are the parents of a child or children who reside with them Social Security precedents show that a couple almost certainly live together as husband and wife.

Where only one or neither of the unmarried couple are parents of the child or children who live with them you may need to consider other factors.

In cases where the unmarried couple does not accept they are living together as husband and wife you will have to consider the following factors in deciding whether or not they are living together as husband and wife:

- Membership of the same household
- Stability of relationship
- Life time bond is not essential
- Financial support
- Sexual relationship
- How other people see the relationship
- Start and end of relationship

- Membership of the same household – A couple are unlikely to live together as husband and wife unless they live in the same household. But absences caused by work, visits to relatives and the like do not mean they are not living together as husband and wife.

- Stability of relationship – A couple are not living together as husband and wife if they have a very brief or occasional relationship. When a couple first live together it may be clear at the start that they are living as husband and wife. For example, when the woman takes the man's name and bears his child. But in other cases it may take more time before such a close relationship develops.

- Life time bond is not essential – One of the main features of a marriage is that the couple bind themselves to each other for life. An unmarried couple may not make such a formal commitment, but they can still live together as husband and wife. They do not have to intend to stay together permanently. It is enough if they intend to stay together for the foreseeable future.

- Financial support – In a marriage we normally find that one partner supports the other, or there is a sharing of household expenses. Where an unmarried couple also do this they are more likely to be living together as husband and wife. But the absence of these features does not prove the couple are not living together as husband and wife. After all, even a married couple can keep their financial affairs quite separate.
- Sexual relationship – The couple’s sexual relationship is of little help in deciding whether they live together as husband and wife. There are two reasons for this. First, there may be no sexual relations in a marriage; for example, where elderly persons marry for mutual comfort and support. Second, sexual relations occur outside marriage and outside any intention to live together as husband and wife. So their presence or absence proves little.

Do not ask any questions about the sexual relationship of a couple or about the sleeping arrangements in the household. Take note of any information the taxpayer volunteers but bear in mind that it is unlikely to be conclusive for the reasons given above.

- How other people see the relationship – A couple can live together as husband and wife even if they keep their own surnames. But it is a strong pointer to a husband and wife relationship if they call themselves ‘Mr and Mrs X’.

It can be hard to decide when a couple start or stop living together as husband and wife. Normally you accept what the couple tell you. But if the couple have lived together as husband and wife in the past it is usually easier to show that the relationship continues. Woolf J said this in a 1982 decision.

‘Once one has established the relationship to exist then it is much easier to show that it continues, and it may well be that although many of the features of living together between husband and wife have ceased, perhaps because of advancing years or other reasons, the paragraph will still continue to apply. This would be the position even though a Court would have come to a different conclusion as to whether the paragraph applied, if at the outset all that existed was that state of affairs.’

(Crake v Supplementary Benefits Commission [1982] 1 All England Law Reports, page 502h)

Extracts from the Department for Work and Pensions guide

11001 “Couple” means

1. a man and a woman who are married to each other and are members of the same household
2. a man and a woman who are not married to each other but are living together as husband and wife
3. two people of the same sex who are civil partners of each other and are members of the same household **or**

4. two people of the same sex who are not civil partners of each other but are living together as civil partners.

Note: Two people of the same sex are to be regarded as living together as civil partners only where they would be regarded as living together as husband and wife if they were two people of the opposite sex.

11002 The general principle in Social Security is that couples should be treated in a similar way. For example, a couple who are living together as husband and wife, or living together as civil partners should be treated in the same way as if they were married or in a civil partnership. The principle behind this is that an unmarried couple or couple who are not in a civil partnership should not be treated more or less favourably than a married couple or a couple in a civil partnership.

Appendix 2. The tax position on separation and divorce

Family A

1. Before looking at how specific tax rules operate, the primary assumption in Section 282 Taxes Act 1988 should be noted. This states that a husband and wife or civil partners are treated as living together for the purposes of income tax unless:

- (a) they are separated by Court Order or deed of separation; or
- (b) they are separated in circumstances where the separation is likely to be permanent.

Jointly held assets

2. As soon as the couple stop 'living together', they cease being able to rely on the deemed equal rights to income of jointly owned property.¹¹⁰ HMRC states in the Manuals that if the couple separate permanently before their divorce, the 50:50 rule ceases to apply.¹¹¹ Where the couple do not separate before their divorce, the 50:50 rule ceases to apply when the divorce becomes absolute; that is, when they cease to be married.¹¹² The position is then the same as in the year of permanent separation.¹¹³ A couple may be permanently separated but living in the same house.

3. On the other hand, the declaration provisions in Section 282B Taxes Act do not cease to apply simply because a couple cease to be living together. HMRC states that the declarations cease to operate on permanent separation or divorce if not earlier divorced albeit that Section 282B looks to the time at which the beneficial interests in the income or property cease to accord with the declaration.¹¹⁴ In practice, this may amount to the same time but will not always do so.

Family-owned companies

4. The close company provisions apply to husbands and wives/civil partners until the final decree of divorce or dissolution.¹¹⁵

5. The restrictions on the use of reliefs where there has been a change in ownership of a company apply to husbands and wives/civil partners until the final decree of divorce or dissolution.¹¹⁶

6. The Section 343 Taxes Act 1988 relief on the transfer of a trade between companies in common ownership aggregates the ownership of husband and wife/civil partners until the final decree of divorce or dissolution.¹¹⁷

¹¹⁰ Section 282A(6) Taxes Act 1988.

¹¹¹ HMRC Independent Taxation Manual IN 137.

¹¹² HMRC Relief Instructions Manual RE 1090.

¹¹³ HMRC Independent Taxation Manual IN 137.

¹¹⁴ Section 282B(5) Taxes Act 1988.

¹¹⁵ Section 417(4) Taxes Act 1988.

¹¹⁶ Section 839(2) Taxes Act 1988.

¹¹⁷ Section 343(4) Taxes Act 1988.

Other shareholdings

7. The aggregation of husband and wife/civil partner shareholdings under the provisions of Section 227 Taxes Act 1988 on a share repurchase looks only to the holdings of the couple while ‘living together’.¹¹⁸ (A narrower specific definition of ‘associate’ is used rather than the broader definition of associate used in the close company rules or the broad ‘connected person’ rules in Section 839 Taxes Act 1988.)

8. In contrast, for the purposes of the approved share scheme limitations on granting options where the recipient or spouse/civil partner has a material interest in the shares, the shareholding of the spouse/civil partner is relevant until the final decree of divorce or dissolution.¹¹⁹

Capital allowances

9. The use of the Section 839 Taxes Act 1988 definition of ‘connected persons’ through the capital allowances rules means that the couple are ‘connected persons’ until the final decree of divorce or dissolution.

Transfer of assets abroad

10. The anti-avoidance provisions under Sections 739 and 740 Taxes Act 1988 apply to an individual and their spouse or civil partner until the final decree of divorce or dissolution.¹²⁰

Employment income

11. The position is far from consistent. The provisions taxing a spouse or civil partner on payments made or benefits enjoyed by them rather than the employee apply until the final decree of divorce or dissolution or later if the spouse/civil partner becomes a ‘dependant’. These provisions tax payments and benefits enjoyed by members of the employee’s ‘family’, which is defined to include spouse or civil partner or dependant.¹²¹

12. The taxation of payments made via intermediaries looks at the interests of the spouse or civil partner in the company or partnership intermediary until final divorce or dissolution.

13. The taxation of social security benefits looks at whether the couple is a ‘married couple’ or ‘unmarried couple’ as defined in the Social Security Contributions and Benefits Act 1992. This defines a couple as being married where they are married and living in the same household (see Appendix 1). Often, the couple will cease to live in the same household before they cease to be married. The Department for Work and Pensions sets out guidance as to when persons cease to be living in the same household (see Department for Work and Pensions Guide, paragraph 11071).

¹¹⁸ Section 227(2) Taxes Act 1988.

¹¹⁹ Para 12(3) Sch 4 ITEPA 2003.

¹²⁰ Section 742(9)(a) Taxes Act 1988.

¹²¹ Section 721(5) ITEPA 2003.

14. The tax treatment of certain childcare costs depends upon the childcare not being provided by the employee's 'partner', which is defined as one of a married or unmarried couple. However, in this case, the definitions contained in the social security legislation are not imported, so there is no household test. Accordingly, in the case of Family A, the rules will apply until final divorce or dissolution.

15. So for Family A, one statute contains three different definitions with three potentially different times resulting for the legislation to operate. It is understandable that the legislation imported the social security definitions in the context of the taxation of social security benefits: to do otherwise would cause greater confusion and inconsistency, but the fact of the differing rules within one area of legislation reinforces the tensions between the tax treatment of couples and the social security treatment of couples which underlie so many of the criticisms of the current system.

Unquoted shares subscribed for in a trading company

16. The family status of the couple is irrelevant at the time of the allowable loss being claimed on the shares. It is only relevant for the tax-free transfer of shares between them previously (see further above, paragraph 3.3.3).

Settlements

17. There is a specific definition of spouse or civil partner for the purpose of the application of the settlements rules attributing income to a settlor where their spouse or civil partner has one of the specified interests in the property. This definition means that the couple in Family A will be treated as spouses/civil partners until separation by way of Court Order or agreement or where it is likely that the separation will be permanent.

Deductions – gift aid

18. The limitations on gift aid deductions look at whether persons are connected as defined by Section 839 Taxes Act 1988. Accordingly, they apply until final divorce or dissolution.

Pension schemes

19. An HMRC-approved pension may be paid to a surviving ex-spouse or civil partner if the scheme provider decides to include such a provision.¹²²

Tax credits

20. Family A is required to notify this change in circumstances. The change in circumstances arises at the point the couple is separated under a Court Order or where the separation is 'likely to be permanent'.¹²³ From April 2007, the time period in which to do this is reduced from 3 months to 1 month, which most would consider too short even for Family A.

¹²² Section 590(2)(aa)(i) Taxes Act 1988.

¹²³ Section 3(5) Tax Credit Act 2002.

Enterprise Investment Scheme and Venture Capital Trust shares

21. The couple in Family A must still be married/civil partners and living together for transfers between them to take place without relief being lost. (For the rules as to what constitutes 'living together', see Appendix 1.)

Family B

Employment income

22. The provisions taxing a spouse or civil partner on payments made or benefits enjoyed by them rather than the employee do not apply to unmarried/unregistered couples at all unless the payment is made to one of them as a 'dependant' of the other. If one is a dependant of the other after separation then the provisions can apply regardless of the separation.

23. So far as the provisions taxing social security benefits and limiting the availability of untaxed childcare, and the anti-avoidance provisions applying to payments via intermediaries are concerned, the question is at what point the couple cease to be living together as husband and wife or civil partners. (See Appendix 1 for the guidelines applied to determine this question.)

Tax credits

24. Family B will be in the same position as Family A.