

Riding out the economic storm – the tax implications and practical considerations of delayed/deferred property sales

There are a variety of reasons why parties to a divorce may decide to defer the sale of a property, and, consequently, their capital entitlement in it. These might include securing accommodation for the children of the marriage during their minority and/or education, an inability to sell the property in a deflated housing market or a wish to delay a sale until the economy starts to improve and a greater financial gain can be realised. Triggers for sale, such as the elapsing of a period of time or a child finishing university, can be agreed and documented by the parties to provide certainty and the ability to plan for the future.

This article looks first at the possible scenarios that may arise, summarises the relevant basics of Capital Gains Tax (CGT), and then looks in more detail at the tax, legal and practical considerations for the family lawyer when a deferred property sale is contemplated.

Possible Scenarios

Scenario A – the former matrimonial home (FMH)

- A (i)** The FMH is retained by one party in their sole name. The other spouse has no interest in the property.
- A(ii)** As at **A(i)** save that the other spouse does retain an interest in the property with a sale deferred until a 'trigger' event. The owning party resides in the property.
- A(iii)** The FMH is retained in joint names with a deferred sale until a 'trigger' event. Only one party resides in the property.
- A(iv)** As at **A(iii)** save that both the husband and wife reside in the property.
- A(v)** The FMH is sold immediately and the proceeds are distributed between the parties.

Scenario B – investment properties and holiday homes ('second properties')

- B(i)** The property is retained by one party in their sole name. The other spouse has no interest in the property. The husband/wife moves into the property as their primary residence.
- B(ii)** As at **B(i)** save that the husband/wife does **not** move into the property as their primary residence.
- B(iii)** The property is retained by one party in their sole name. The other spouse retains an interest. There is a deferment of sale until a specific 'trigger' event. The husband/wife moves in to the property as their primary residence.
- B(iv)** As at **B(iii)** save that the husband/wife does **not** move in to the property
- B(v)** The property is retained in joint names pending a future sale. Only one party resides in the property as their primary residence.
- B(vi)** As at **B(v)** save that neither party resides in the property as their primary residence.
- B(vii)** The property is sold immediately.

A brief run through capital gains tax in this area

The basics

CGT is only payable on a disposal of property. For tax purposes, a disposal is when a party ceases to own the asset. Therefore an exchange, transfer or gift of the property as well as a sale can create a charge. CGT is payable by individuals who are UK resident, UK ordinarily resident trustees of a settlement or only temporarily non-UK resident.

During the tax year of separation, separating couples are able to enjoy the same tax advantages (the asset is treated as if there is no gain or loss in value upon transfer) as those who are married and cohabiting. They must remain married at the time of the disposal – so think of this before applying for decree absolute. It is important to note that the year of separation is fixed to the tax year - 6 April to 5 April the following year. If a couple were to separate in March, they will have until 5 April of the same year to benefit from the above tax advantages. If the couple separate in May, they will have the benefit of almost a full tax year to April 5 the following year to finalise their finances without paying CGT on transfers between them. A court order within this period is not necessary. A valid and binding contract (which will usually include a signed but unsealed consent order) will be sufficient, as will a deed of separation.

Following the Civil Partnership Act 2004 there is no difference between the tax position for married couples and those who have entered into civil partnerships.

Any gain from a disposal of buy-to-let properties, holiday homes, agricultural land, farm and business premises and properties bought for children to live in, will be liable to CGT subject to any reliefs and exemptions. Reference should also be made to the 'interaction with income tax' section below.

Reliefs and exemptions

(1) The Private Residence Relief (PRR)

When a party transfers the FMH to their spouse as part of their financial settlement outside the year of separation, it is likely that no CGT will be payable as the parties will have the benefit of PRR. To benefit from full PRR, the property would have to satisfy the following criteria:

- to have been occupied by the family for the whole period the couple owned it as their main residence;
- not being used as anything but a family home;
- not let out or have more than one lodger at any one time;
- the garden and grounds should not exceed 5,000 square metres (1.23 acres); and
- the property was not bought primarily to be improved and sold on at a profit.

If all of the above points are met then the parties will be eligible for PRR for the whole period of ownership. Should the property have been rented out for a period of time during the marriage then PRR will not be available for that period, but may be for other properties.

(2) Final period exemption (FPE)

In addition to the above, if a property was at any time the family home of the couple, the gain relating to the final thirty-six months of ownership will be free of tax when it is sold ('the Final Period Exemption').

(3) Annual exemption

If any gain remains the annual exemption can then be deducted. At the time of writing (tax year 2009/10) the annual exemption is £10,100 for individuals and £5,050 for trustees. CGT is payable at 18% and by 31 January the year after the end of each tax year.

(4) Letting Relief

Where PPR is restricted because the parties chose to let some or all of the property out, lettings relief may be available (s.222 of the Taxation of Chargeable Gains Act 1992 (TCGA 1992)). The Court of Appeal case of Owen v Elliott in April 1990 stipulated that it was not necessary for the people renting the property to make the accommodation their home and could use it as part of a trade. Since 19 March 1991 lettings relief has been the lower of £40,000 or the amount of the gain that attracts PPR. There is no commentary confirming whether letting relief can be used on a transfer (again, a disposal for tax purposes) of part of a property as a part of a financial settlement. Our view is that it can be.

(5) Other Reliefs

There are various other reliefs. Taper relief, a relief that reduces the gain based on the length of time the property has been owned, is no longer relevant for contemporaneous disposals of personal property – only those sold or disposed of prior to 6 April 2008. Business property reliefs could be available for business assets and include business asset roll-over relief, gift hold-over relief and entrepreneurs' relief. A full explanation of the CGT treatment of business or agricultural property is beyond the scope of this article.

Allowable expenditure

Following a disposal of an asset, allowable expenditure can be deducted from the gross gain. Allowable expenditure can include:

- the original asset acquisition costs (which includes the purchase price and legal fees);
- disposal costs; and
- money spent enhancing the property.

An example of the calculation

The following example will hopefully demonstrate how the above reliefs / considerations are dealt with in a CGT calculation:

A married couple purchase a house (property A) on 1 November 1999 for £51,220. The property is lived in for a few years until the couple decide to purchase another home (property B) in December 2003 and move into it. Property B becomes the family home. Property A is retained as an investment property and is rented out.

The husband and wife subsequently separate. Property B is retained by the wife. Property A is sold on 1 October 2009 and a CGT calculation is required. The property has been owned for a total of 119 months.

First, PPR should be calculated. The period of occupation (01.11.99 to 31.12.03) is 49 months. As the property was the marital home and was subsequently rented out, the final period exemption of 36 months can be applied. PPR therefore applies to 85 out of the 119 months.

Sale proceeds	£379,000
<i>Less</i>	
Acquisition cost (including conveyancing costs)	(£51,890)
Enhancement expenditure (a new kitchen)	(£2,500)
Costs of sale	(£7,500)
Subtotal (the gain)	£317,110

<i>Less</i>	
PRR relief (as calculated above - 85 months out of 119). The calculation is: $£317,110 \div \text{by } 119 \text{ (months)} \times 85 \text{ (months)} = £226,507.14$	(£226,507)
Subtotal (the gain in the letting period)	£90,602
<i>Less</i>	
Lettings relief	(£40,000)
Subtotal	£50,602
<i>Less</i>	
Annual exemption (2009/10 tax year) x 2	(£20,200)
Grand Total (gain liable to CGT)	£30,402
CGT at 18%	£5,472

Losses

Practitioners should not forget that a loss made on an asset that would normally attract CGT can be deducted from a chargeable gain on another asset. Losses can also be carried forward to other tax years to reduce capital gains to the level of the annual exemption with the remainder carried forward to future tax years. However, it should also be noted that whilst a couple are married they are regarded as connected persons. If a loss arises on a disposal between connected persons that loss can only be set against gains arising from transactions with the same connected persons.

Interaction with Income Tax

If a party to the marriage 'trades' property, i.e. buys property, makes improvements and sells at a profit, the profit will be liable to income tax rather than CGT. Given the Inland Revenue's need to raise revenue from taxes it is possible that they will be more likely to challenge taxpayers if they have reason to believe a couple have been trading.

Selling a property in one party's name on contemplation of marriage

If a couple entering into a marriage or civil partnership both have properties, no CGT will be payable on the sale of one of the properties as long as it is sold within three years of the date the marriage or the civil partnership.

Back to the main subject: deferred property sales

Similar to a meshor/martin order, a number of case-specific 'triggers' can be used to plan for the eventual/delayed sale of a property. They could include the elapsing of an agreed time period, the property increasing in value over an agreed figure, mutual consent of the parties to sell or even the death of one of the parties. Thought needs to be given to all of the potential factual scenarios that the parties would wish to trigger a sale, or not.

For example, it is unlikely that the spouse in occupation of the property will want to have to sell the property on the death of the other. This should be considered when drafting the consent order. Parties should also consider whether the death of the non-occupying spouse should revoke their right to a proportion of the property in that instance or whether the beneficiaries of the estate should retain their entitlement to be realised when a sale is triggered.

CGT – the former matrimonial home

If the FMH is transferred into either the husband/wife's name and no interest is retained by the other party (scenario **A(i)**) no CGT will be payable if PRR relates to the whole period of ownership. If it does not, then a CGT liability will arise upon the transfer (if the transfer takes place outside of the tax year of separation or after decree absolute). Practitioners must again remember that a 'disposal' for tax purposes does include a transfer or gift.

Under scenarios **A(ii) and A(iii)** the non-occupying spouse will not incur any CGT and will continue to benefit from PRR on any future gain as long as the FMH is sold within three years of him/her leaving the property (FPE). If sold after this period the non occupying spouse may have a capital gain depending on the facts.

If the parties continue to reside in the property together (scenarios **A(iv) and A(v)**) then obviously neither party will incur a CGT liability when the property is sold assuming PRR is available and not restricted.

CGT - second/investment properties

Disposals of second homes and investment properties are obviously more likely to lead to a CGT liability than a disposal of the FMH. The potential capital gains tax liability should be calculated from the outset to 'net down' the value of the property so its current value can be used in negotiations. This is important in **all scenarios**.

Upon separation, a party may choose to move into a second/investment property owned by the couple (scenarios **B(i), B(iii) and B(v)**). If they do, they will accrue some PRR to reduce any eventual chargeable gain. They will also have the benefit of FPE when they come to sell the property. If neither party moves in to the property/elects it as their primary residence (scenarios **B(ii), B(iv) and B(vi)**) then the owner will be liable to CGT for the whole period that this remains the case.

Practical considerations relating to scenarios A and B

i. Percentage or defined lump sum?

Relevant to scenarios **A(ii), A(iii), A(iv) and A(v)**
 B(iii), B(iv), B(v), B(vi) and B(vii)

Note: Even though **A(v)** and **B(vii)** make reference to an immediate sale, the parties will still need to decide how the proceeds of sale will be divided.

Deciding whether a party's share of the property should be expressed as a percentage of the sale proceeds or a defined lump sum will depend on the structure of the settlement.

If the capital entitlement is expressed as a percentage, both parties will benefit if the housing market recovers and both will lose out if the market shrinks further. If the capital entitlement is expressed as a defined sum, the receiving party has certainty as to the amount they will be receiving as long as there is always enough equity in the property to cover the outstanding mortgage (if any) and their capital entitlement.

A declaration of trust could be drafted to confirm the shares which the parties have in the property. This can be exhibited to the consent order. This will also avoid the need to recite the terms of the trust word for word in the order itself.

The property should be held as tenants in common so as to prevent any sale or remortgage without the non-occupying spouses' knowledge and agreement. This will also negate the need to register a charge on the property. Practitioners will also recognise that a matrimonial home rights (MHR) notice will not be available to protect a party's share as the parties will be divorced. In addition MHR is only available for a FMH, not an investment property.

ii. When to adjust the beneficial ownership of the property

Relevant to scenarios **A(ii), A(iii), A(iv) and A(v)**
 B(iii), B(iv), B(v), B(vi) and B(vii)

Note: Even though **A(v)** and **B(vii)** make reference to an immediate sale, practitioners should consider how long it will take for a property to sell and whether the sale will extend into the next tax year. Their client may still be able to benefit from the considerations discussed below.

If the beneficial ownership of the property needs to be altered to reflect the settlement agreed to by the parties, then it would be of benefit to the spouse retaining a minority share for the ownership to be adjusted straight away. For example, consider the couple who own a property 50:50 as joint tenants during the marriage and at the time of the divorce it is agreed that the husband will retain 70% of the property with the wife retaining 30%. The wife therefore needs to transfer 20% of her share of the property to the husband to reflect the agreed beneficial ownership. The benefit of transferring the 20% share now is that she is able to benefit from her annual exemption in the year she transfers the 20% and then have another annual exemption available to her in the year the property is finally sold and she realises her 30% capital entitlement.

In addition, it is worth crystallising as much of the capital gains as possible now when the market is deflated than when it recovers in the future.

iii. Enquiries of the mortgagee

Relevant to scenarios **A(i) and A(ii),**
 B(i), B(ii), B(iii) and B(iv),

If there is to be a transfer of equity, enquiries should be made with the mortgage company to check whether there is any restriction on a change of ownership. In any event, Form A should be served on the mortgagee at the first opportunity in accordance with rule 2.59 of the Family Proceeding Rules 1991. It would also be useful for the parties to explore whether they should be re-mortgaging at a more preferable interest rate, given the current low rate, than their current mortgage may provide for. Parties will of course have to consider what penalties, if any, they will be subjected to if they change mortgage provider as well as the fact that interest rates will of course increase in the future. Independent financial advice should be sought.

iv. Maintaining the property

Relevant to scenarios **A(ii), A(iii), A(iv) and A(v)**
 B(iii), B(iv), B(v), B(vi) and B(vii)

Note: Even though **A(v)** and **B(vii)** involve immediate sales, it will be worth considering this section as it might be some time until the property is sold. One party might be in occupation until that time.

It would be wise to consider and document the occupying spouses' duty in terms of maintaining the property to prevent disrepair reducing the final sale price. An arbitration clause may need to be inserted to allow an agreed surveyor to settle disputes relating to structural repairs or other factors affecting the building. Insuring the property should also be dealt with as well as who will have the responsibility of paying any service charge and all other expenses relating to the property.

v. Renting out the property

Relevant to scenarios **All (potentially)**

Note: Reference should be made to the 'trigger' events to see if moving out of the property would trigger a sale (and prevent the property being let).

Obviously, if the property is to be rented out the parties will be receiving an income. Consideration should be given to who should benefit from that income, and whether any excess should be used to reduce the mortgage capital.

Income tax is not chargeable on sums used to discharge interest on a mortgage. It is, however, payable on rental income used to reduce capital sums owing to the mortgagee as well as other sums in excess of allowable expenditure on the property.

If a party retains a share of the property and it is subsequently rented out, then they will continue to have an income tax liability on their share of the rental income. To use the example above the wife will have an income tax liability of 30% of the income.

Consideration needs to be given to how the deductible expenses are to be allocated; whether in the proportions of the equitable ownership, depending on who pays them, or in some other way. It may be wise to draft a clause in the consent order requiring the relevant party to provide, within a short period after the end of each tax year, say twenty-eight days, evidence of all income received and all expenses incurred.

Alternatively, it may be appropriate to prohibit the letting of the property or to regulate its occupation by particular individuals (e.g. a new partner).

vi. When the occupying spouse does not comply with the order.

Relevant to scenarios **A(ii), A(iii), A(iv) and potentially A(v)**
 B(iii), B(iv), B(v), B(vi) and potentially B(vii)

Practitioners will of course be aware that however well an order is drafted parties may not comply, for instance by failing to pay the mortgage, and consideration needs to be given to the most appropriate method of enforcing the order; whether by using the available enforcement tools, by including in the order a clause transferring ownership, requiring a sale, or altering the occupation rights in the event of a default. A 'liberty to apply' clause should be included in the consent order.

Conclusion

It has always been important for practitioners to consider not only the tax consequences of financial transactions on divorce but also to take into account the practicalities of how and when a transaction will be conducted. There is no substitute for being thorough at the outset, so that all parties can limit their exposure to tax and have as much certainty as possible in their dealings with a property at a time when solicitors are ideally no longer involved.

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November 2009