DIVORCE, TAX AND REMITTANCES[1]

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On divorce, the assets must be divided up as the couple agree or if no agreement is reached, as the Family Court ultimately determines. For the purposes of this article we shall assume that H has to pay W some cash or property in final settlement of her claims.

If the paying party (assume H) is not UK domiciled he may have large amounts of untaxed relevant foreign income or foreign chargeable gains that have been carefully kept abroad and not remitted. His matrimonial adviser tells him that these assets have to be included in the total resources available to the couple and that he may need to pay W using some of these funds. H objects that he will have to pay tax on these funds if they are brought to the UK. Is there a tax efficient solution?

1. Position for foreign domiciliaries

Domicile

The first point that H's tax adviser must do is to check that H's foreign domicile status is secure otherwise H may find that what he thought was a tax free fund is in fact a fund on which past tax is already due. HMRC are naturally coming under increasing pressure to challenge foreign domicile claims. So the tax adviser must not just assume that H is foreign domiciled simply because HMRC have never challenged the position in the past but adopt an investigative approach. On what basis has the client claimed foreign domicile? Are the reasons originally given still valid or have his intentions gradually changed? HMRC seem particularly interested in cases where the individual had a UK domicile of origin and is now

1 These issues are discussed in Trusts and Estate Planning by Chamberlain and Whitehouse 4th edition published by Sweet and Maxwell and a longer version of this article also covering tax issues for UK domiciliaries can be found online at: www.taxadvisermagazine.com/cgtondivorce

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claiming a foreign domicile of choice. Even where the individual had a foreign domicile of origin if the individual has been resident in the UK for any length of time a foreign domicile claim may be difficult to sustain if he cannot show there is any reasonable prospect that he intends to leave the UK.

Any settlement between H and W may need to provide that, in the event H's foreign domicile status is successfully challenged by HMRC for any tax year when past foreign income or gains are still potentially assessable, she will indemnify him in respect of a share of tax arising. This will be particularly important if W's settlement has been calculated on a gross basis for foreign income and gains without allowance for tax that may yet turn out to be assessable on H in respect of past tax years.

Paying W abroad voluntarily before decree absolute

In 2012 there was correspondence between the CIOT/HMRC that in general terms confirmed the following:

(a) If payment takes place <u>after decree absolute</u> pursuant to court order

(b) H pays W to her sole account abroad and

(c) W gives no benefit to H or to any relevant person in relation to H at any time using those funds,

then there is no taxable remittance by H. So put simply W must not use the funds in the UK to benefit minor children or grandchildren of H or settle such funds into a trust for the benefit of his issue in case that trust remits the funds here.

However, what is the position if H decides to give W funds **abroad** before decree absolute voluntarily in the hope that the court will then order him to pay less later? In short this is a gift to W when she is still a "relevant person" as defined in ITA 2007 s809M in relation to H.

Under ITA 2007 s 809L, remittance occurs if either Conditions A and B are met or if the specific terms of the anti-avoidance Conditions C and D are met. Conditions C and D are not relevant if the transfer is made before decree absolute as a gift made to W at a time she is still a relevant person cannot be treated as a gift to a gift recipient just because W ceases to be a relevant person after decree absolute. Conditions A and B **are** potentially relevant as W is still a relevant person in relation to H at the date she receives the monies. However, no immediate problems should arise if W does not bring the money to the UK before decree absolute. After that date she ceases to be a relevant person. The reason for this is as follows.

General remittance under Conditions A and B occurs if money or other property "is brought to, or received or used in, the UK by or for the benefit of a relevant person" (Condition A) and such funds derive from foreign chargeable gains or relevant foreign income. (Condition B). H, W (while still married to H) and any minor children or grandchildren as well as any trust that benefits them are all relevant persons. See ITA 2007 s809M. [3]Both Conditions must be satisfied if a taxable remittance is to arise on H.

Therefore if H pays W abroad voluntarily before decree absolute when she is a relevant person in relation to H it is vital that she retains the funds abroad until after decree absolute. Prima facie then Condition A is not satisfied. W will not remit until after decree absolute, at which point she will have ceased to be a relevant person. It is very important however that even after decree absolute W does not set up a trust that can benefit minor children or grandchildren of H (or H) if that trust remits the funds. This requirement is effectively unlimited in time at least while H is alive and UK resident. So W should not give minor children an allowance out of these funds. H will have to pay maintenance for the children out of clean capital.

W should therefore undertake in a separate deed not to remit the funds in such a way so as to benefit any relevant person in relation to H and W must indemnify H in respect of all tax, interest and penalties arising if she does so. Of course H may not know until much later if W has used the funds in a way that causes him a taxable remittance. The penalty therefore has to lie firmly on W in all respects. However, even with an indemnity this route is not free from practical problems as H will have to collect the money from W if she does breach the conditions and she may not tell him the right figures. In fact if she pays him back some money that he gave her abroad pursuant to the indemnity that could in itself be treated as a further taxable remittance by H as W has used the funds to benefit him and trigger grossing up!

It should be noted that the legislation does not prohibit <u>all</u> benefits to relevant persons. For example, if W is given the funds abroad and then later uses such funds to buy a house here in which the minor children live, although that technically benefits them in the UK it does not constitute a taxable remittance by a relevant person. This is because s809L(3)(b) (ii) makes it clear that in relation to derived funds (i.e. those which have been gifted) the property must at the relevant date of remittance be property of a relevant person. Although W may be <u>benefiting</u> relevant persons at the date the funds are in the UK, she is not putting the funds into the minor children's own hands.

3 The definition of relevant persons also includes a close company in which any other relevant person is a participator and further categories not discussed here.

Payment to W abroad under court order before or after decree absolute

However, it may not always be possible for H to pay W under a voluntary agreement and instead H has to be ordered to pay W pursuant to a court order or as part of heads of agreement ratified in a court order. Clearly then a debt has arisen being an obligation imposed by the Court which is satisfied by H's payment to W.

The issue therefore becomes whether H's debt to W is a relevant debt. That term is defined in s 809L(7) as a debt which relates to property brought to or received or used in the UK for the relevant person. What then does H's debt to W relate to? Normally we would assume it relates to the property that the borrowed money is used to purchase: for example, borrowing abroad to fund the purchase of UK houses or chattels brought to the UK. Here, H's debt to W was not incurred to buy any item of property. If there is a debt that relates to anything at all it must relate to W's rights under UK matrimonial law.

It seems difficult to see that such rights are "property" received or brought to or used in the UK by a relevant person. In *Haines v Hill* [2007] EWCA Civ 1284, Sir Andrew Morritt indicated at para 29, that entitlement under matrimonial law was not a proprietary right. Until the Court makes an order, W has no interest at all in H's property. Can W's rights under matrimonial law be said to be "brought to, or received or used in, the UK by or for the benefit of a relevant person". It is difficult to see how a right of action can be "used." On that basis it would make little difference whether payment is before or after decree absolute.

In the CIOT / HMRC correspondence on remittance and divorce in 2012, HMRC emphasise that their conclusion there is no taxable remittance is based on (a) the payment from husband to wife being made after decree absolute and (b) no relevant person receiving a benefit. Maybe the payment is assumed to be made after decree absolute on the basis that W is not using anything at a time when she is a relevant person and therefore no debt issue arises.

However, if W is paid after decree absolute, is there a risk that Condition C in s 809L would be engaged because W is a gift recipient? In that event any benefit to the minor children might need to be avoided. In the author's view W is not a gift recipient. Section 809N(5) states that an individual makes a gift of property if he disposes of the property either for no consideration or: *"For consideration less than the full consideration in money or money's worth that would be given if the disposal were by way of bargain at arm's length."* In *Haines v Hill* cited above the husband had been ordered in matrimonial proceedings to transfer an asset to his wife and the issue was whether this asset was available to the creditors in his bankruptcy. The Court of Appeal held not, on the grounds the wife had given full consideration. On a superficial reading this would appear to contradict *G v G* [2002] which held in the context of hold over relief that there was no consideration and therefore a transfer ordered by the court is eligible for hold over relief. However, as the judge noted at para 30 of *Haines*, the fact that a transfer ordered by the Court does not give rise to a payment of consideration between the parties so as to reduce the value of holdover relief for capital gains tax does not entail a conclusion that a property adjustment order must be regarded as being made for no consideration within the meaning of the Insolvency Act. A transaction made pursuant to court order is not a voluntary transaction at all and not made by one party to another but ordered by the court. It is a transaction at arms length.

Conclusions on remittance question

There is no clear answer as to whether H is better to pay W the sum abroad before or after decree absolute. It is not thought that either option in itself causes a tax problem. But if he can pay her as a voluntary payment to her sole account abroad, with W undertaking not to remit until after decree absolute and in any event not to let the funds be used in such a way that they are remitted by a relevant person then that is the best option. If he cannot do this, then the payment is probably best done to W's account after decree absolute. In any event W should sign a deed pursuant to which she undertakes not to use the funds in such a way that could cause H a taxable remittance and to indemnify him in respect of any tax that may arise on H (including any grossed up tax) if she does so.

2. Indemnities

Irrespective of domicile issues, either party may want an indemnity from the other in relation to points of uncertainty particularly in relation to tax e.g. if H was involved in a tax scheme and has yet to establish whether this is accepted by HMRC. Possibly H is undergoing a tax enquiry in relation to his domicile status and therefore tax may turn out to be payable on past foreign income and gains. It would be unfair if H received no discount for his risk and yet ended up paying the full amount of tax that may turn out to be due. Equally deducting the full potential amount of tax would be unfair to W if the tax never materialises.
The court may decide to deal with tax risks in one of two ways:

(a) Assess the realistic tax risk and then discount the amount that has to be paid by H to W. That is a rough and ready approach as the risk may end up materialising or disappearing and one side will invariably gain. However, it achieves a clean break.

(b) Order the transferee (W in our example) to indemnify H and pay him a reverse contingent lump sum if such risk materialises. Of course if H has paid W a sum abroad and she then later has to pay some of that sum back to him under the terms of an indemnity, this could constitute a further taxable remittance by H of foreign untaxed income leading to that sum having to be grossed up. Moreover he is clearly then receiving a benefit pursuant to s809L (contrary to what was anticipated when he paid her the settlement abroad) leading to potential double grossing up! These issues, although resolvable, will have to be considered carefully in drawing up the terms of any divorce settlement.

Time limits

The time limits that are relevant in relation to any tax indemnity are as follows:

(a) If full disclosure is made when H submits his tax return and the Inspector's attention is specifically directed to the relevance and completeness of all the information provided with the return including where relevant his domicile status and divorce remittance issues, then after 12 months from filing HMRC should not be able to raise any further challenge. TMA 1970 s9A. The 12 month enquiry window runs from the date of filing.

(b) It is very unlikely that H will be able to make a sufficient disclosure on all tax risks to preclude any possibility of a discovery assessment into his return. In these circumstances a discovery assessment can be made at any time up to 4 years after the end of the year of assessment and if H fails to take reasonable care can be extended to six years from the end of the year of assessment. A small failure by H on one point would arguably allow HMRC to extend any discovery assessment much more widely. This would enable HMRC to challenge the tax position on payments by H made in this tax year for some time to come. So W's indemnity might need to cover any tax challenge made for at least 4 tax years from the end of the year in which the relevant tax risk arises. Of course W's indemnity may have to last considerably longer than this if the tax challenge is made within these time limits but not resolved quickly.