

PPR issues on separation & divorce

(Lecture P1232 – 13.51 minutes)

Introduction

They say that absence makes the heart grow fonder. They also say that familiarity breeds contempt.

They (whoever “they” are) are certainly being proved right if the latest murmurings about marital breakdowns during lockdown are concerned, as it seems that many relationships are splintering on the rocks of COVID-19. The coronavirus outbreak is leading to big changes in the way we live our everyday lives and some relationships are struggling to survive in the wake of that.

There is a myriad of tax issues to be considered on the breakdown of a relationship with the rules differing depending on whether that relationship is a marriage/civil partnership or one which is not. These notes will look at the effect of a relationship breakdown for the purposes of principal private residence (PPR) relief and will concentrate on spouses rather than unmarried couples.

To reduce my word count, any subsequent references to “spouses” in these notes should also be taken to include civil partners. References to husband and wife should also be taken to include same-sex partners in a civil partnership.

PPR issues for spouses – General principles

A husband and wife are treated as a “single person” for PPR purposes and can accordingly only have one exempt residence between them. This will typically be the matrimonial home which will often therefore escape a CGT charge on disposal.

This state of play operates for as long as the couple are living together as husband and wife. This single “spousal unit” for PPR is therefore broken on separation at which point each party is thereafter entitled to PPR relief on their own main residences.

The date of separation is generally taken to be the date at which the relationship is irretrievably broken, and in most cases has historically been signalled by one partner leaving the matrimonial home.

But these are strange times. Working out the date of separation during the current coronavirus outbreak may not always be straight-forward.

At the moment it may be impossible for some separated couples to physically move into separate households. This is partly due to government lockdown regulations but also because – with economic pressures caused by the pandemic – couples may no longer have the financial capacity to meet the costs of running two separate households.

It is possible to formally separate in the eyes of the law whilst remaining under the same roof. I don't think we need to go into what “living together as husband and wife” means as that takes us into an altogether different genre. But a couple can be living together whilst separated. This will not be uncommon in the current climate, so conversations might need to be had with our clients to find a separation date.

Disposals after separation – property transferred between the parties

Separation (or more likely divorce) will often bring about the sale or transfer of all or part of a property which had at some point been the main residence of the divorcing parties. This will constitute a disposal by the spouse giving up his/her interest.

The first step is therefore to calculate the chargeable gain.

If the transfer takes place in the tax year of separation, the disposal takes place at no-gain-no-loss. This, it must be said, is relatively unusual as the course of the law rarely runs that quickly. However, do remember that a disposal is triggered by a contract, so if the parties are amicably committed to a transfer, there is no reason why contracts can't be put in place quickly to ensure the transfer takes place during the no-gain-no-loss window.

If this can be organised, a swift transfer brings with it the obvious advantage that the donor spouse does not then need to worry about PPR relief as there is no gain to relieve. The donee spouse will inherit his (low?) original base cost, but this is unlikely to prove to be an issue since the likelihood is that the donee spouse will have full PPR relief to shelter whatever gains arise on an eventual disposal.

But the no-gain-no-loss window shuts on 5 April in the tax year of separation. If the transfer takes place between the 6 April following separation and the date of the divorce, the consideration for the disposal is deemed to be the market value of the interest transferred at the date of transfer. This is because the parties (despite being estranged) are still "connected persons" for CGT by virtue of them still being married.

However, it should be borne in mind that the open market value of an interest in the matrimonial home is normally heavily discounted to take account of the rights of occupation of the spouse residing in the home under the Matrimonial Homes Act 1967 (so very often a substantial discount will be in order to reflect these rights). There is no fixed discount rate in these situations, but there are grounds for applying a 15% discount to the half share.

Per the VOA's internal IHT manual (which should also apply for CGT):

"Where at the valuation date any co-owner remains in occupation of the property as their main residence (other than the co-owner whose share is being valued), the normal approach is to take half the freehold vacant possession value and deduct 15%. This approach is in accordance with the Lands Tribunal decision of Wight and Moss v CIR (264/935/82)..."

If the transfer takes place on or after decree absolute, the parties are no longer connected persons. In the absence of any clear gratuitous intent by one party towards the other, HMRC normally accepts that a subsequent sale/transfer of a property by one party to the other is a "transaction at arm's length". No alternative value is imputed and the disposal consideration is simply the money (or money's worth) changing hands. This "money's worth" will normally be the values agreed between the parties as recorded in the divorce papers.

[One word of caution here is that divorced spouses could still be "connected" for CGT by virtue of being business partners, should this business relationship still continue after the marriage has been dissolved. Complex business relationships can sometimes take a little time to unwind, so this may therefore act to impute a market value where one is not expected.]

Where the transfer of the property is made in pursuance of a Court Order, HMRC practice is to deem the disposal consideration to be equal to the market value of the asset at the date of disposal. This is because an order of the Court is not a “bargain” between the parties as it is the Court which decides the terms of the agreement, not the parties themselves. As such, the transaction cannot be a “bargain at arms’ length” and S.17 TCGA therefore applies to impute market value.

The basis of the valuation should be disclosed in the tax return and might thereafter be referred to the HMRC Valuation office.

Disposals after separation – property sold to an unconnected purchaser

The other option of course is for the couple to sell the house and divide the proceeds.

In the event of a third-party disposal of a jointly held property, the capital gain on each owner’s share of the property should be computed and reported separately.

Remember that from April 2020, the disposal – assuming that it produces a CGT liability – must be reported on an online “Capital Gains Tax UK property disposals return” within 30 days of completion together with a payment on account of the estimated CGT. An online return is required for each joint seller. No online return is therefore required for gains wholly covered by PPR relief. [The position is different for non-UK residents who must report all gains and losses on property disposals.]

The sale proceeds, costs of sale, costs of acquisition (including enhancement costs) and incidental expenses of acquisition should be divided between the parties in the ratio of their respective beneficial interests. These ratios may or may not be obvious.

In many cases beneficial interests will follow the legal interests, so a husband and wife who are the joint registered owners of a property will normally each have a 50% beneficial interest. This is the default position unless it is shown otherwise.

However, do be aware that if one partner has contributed towards the costs of acquiring the property or towards the mortgage payments without being a registered owner at the Land Registry, he/she will nevertheless have acquired an equitable interest in the home proportional to those contributions and will thereby be entitled to a share of the proceeds on sale. This beneficial share will dictate the CGT treatment.

If the respective beneficial shares cannot be determined by mutual agreement, it will be determined by the Courts. Where such an agreement is reached, both parties will be considered to have held their equitable interests in the home from the outset.

PPR relief

Once the gain is established, the next step is to work out how much PPR relief is due.

PPR relief is based on ownership and occupation. Occupation means actual physical occupation of the property as one’s “home” plus deemed occupation being periods when the CGT legislation pretends a taxpayer was living in the home even though he wasn’t.

The final 9 months of ownership is treated as occupation provided the taxpayer had some actual occupation at some point. This has reduced from 18 months for disposals after 5 April 2020 thereby increasing potential CGT liabilities. Therefore, assuming that the gap between the cessation of actual occupation and the transfer of the property exceeds 9 months, a chargeable gain will arise.

One side-effect of separating couples living under the same roof is that the taxpayer making the disposal is likely to have a longer period of actual occupation than he/she would have had if they had left the matrimonial home when the marriage failed. "Occupation" in these cases extends beyond the actual date of separation. This will shorten non-qualifying periods for PPR relief and save CGT.

Illustration 1

Mark and Kelly married in June 2012. In July 2012 they bought a house, in joint names, for £200,000. They each had 50% beneficial interests. The house was occupied as their main residence.

In May 2020 Mark and Kelly decided that their marriage had broken down irretrievably and decided to separate. However, Mark was unable to leave the marital home until lockdown restrictions were lifted in July 2020 at which point he left and moved into their holiday flat on the south coast.

Kelly continued to reside in the house after the separation. The couple were divorced in March 2022 at which point the Court directed that Mark transfer his half share in the matrimonial home to Kelly.

The house was valued at £800,000 in March 2022. HMRC Valuation Office accepted that the value of Mark's 50% interest subject to Kelly's rights of occupation would be £340,000 (£400,000 x 85%).

Mark's chargeable gain in March 2022 will be as follows:

		£
Proceeds		340,000
Less: Cost	1/2 x £200,000	<u>(100,000)</u>
Gain		240,000
Less: PPR relief	£240,000 x 105/117	<u>(215,385)</u>
Chargeable gain		<u>24,615</u>

PPR relief:

	Qualifying	Non- Qualifying
July 2012 – July 2020	96	
July 2020 – July 2021		12
July 2021 – March 2022 (last 9 months)	<u>9</u>	<u>—</u>
	<u>105</u>	<u>12</u>

Note that in the above example, as the PPR "spousal unit" was broken at the date of separation, Mark's new home (being the holiday flat) will become a qualifying property from the date he occupies it as a residence. No nomination is necessary as this property is, as a question of fact, his main residence.

However, if after the date of separation, Mark has more than one property available for him to use as a residence (and he concurrently resides in both) he is entitled to make a nomination. The 2-year time limit for nominating runs from the date of separation.

S.225B TCGA 1992

The CGT charge can be mitigated in appropriate cases by a claim for relief under S.225B TCGA 1992. Note that (unlike PPR relief in general which is given automatically if the conditions apply), relief under S.225B must be claimed by the taxpayer making the disposal.

S.225B allows the former matrimonial home to be treated as the only or main residence of the transferring spouse (Mark) from the date his occupation ceased (August 2017) until the date of transfer. In this instance, the period from August 2017 to May 2020 would be a period of deemed occupation for Mark, thereby extinguishing his chargeable gain.

However, there are some stings in this particular tail:

- 1) Relief under S.225B is only available where an interest in a property is transferred to a former spouse or civil partner. Therefore, where the couple is selling to an external third-party buyer, S.225B cannot extend the occupation period (even if proceeds are subsequently transferred to the former spouse). Relief is not available for transfers between unmarried couples.
- 2) Throughout the period between the individual ceasing to reside in the property and the disposal to the spouse, the property must continue to be the only or main residence of the spouse. If the former spouse moves out before the transfer takes place, S.225B relief will be denied.
- 3) A S.225B claim can only be made if the departing spouse has not made an election for a different property to be his qualifying residence. This prevents two properties qualifying for PPR relief simultaneously.

Condition 3) is normally the most troublesome hurdle as a S.225B claim may not be beneficial if the departing spouse has acquired a new residence after the date of separation (which is common) and that property is appreciating in value.

If the departing spouse has a new residence and nevertheless wishes to make a claim for relief under S.225B in respect of the old residence, his occupation of his new residence will be treated as period of absence until the disposal of the former marital home.

Note here that it is not possible for a S.225B claim to be varied so as to only apply for part of a period of absence (for example, to leave enough gain in charge to be covered by the annual CGT exemption).

Condition 2) above is also a potential pitfall and must be carefully navigated as shown in the illustration below.

Illustration 2

James and Amy separate. James leaves the family home and moves in with his brother. James and Amy agree that Amy will buy James' share of the property for an agreed discounted value as part of their divorce settlement.

Amy decides that the house is too big for one person and puts the house on the market for sale before the divorce is finalised.

If James wishes to claim relief under S.225B and thereby avoid a CGT liability on the disposal of his share in the property, he must transfer his share to Amy before she moves out. Otherwise, a claim will fail as the property is no longer Amy's main residence.

Finally...

Given the recent reduction in the final period PPR exemption to 9 months, it is now increasingly likely that a partner who leaves the family home as a result of separation will find him/herself with a chargeable gain when and if their interest in the property is sold or transferred on divorce.

Be aware that a S.225B claim can fix this problem, but this is not always a tool which is available.

Also don't be surprised to be receiving more queries of this nature given the effect that COVID-19 seems to be having on matrimonial health.

Contributed by Steve Sanders