

## **CGT and inter-spouse transfers – FA 2023 (Lecture P1333 – 14.56 minutes)**

All references to “spouses” in these notes should also be taken to include civil partners.

All statutory references are to the Taxation of Chargeable Gains Act (TCGA) 1992 unless stated otherwise.

### *Introduction*

Legislation is being introduced to take effect from 6 April 2023 which will tweak the rules concerning the Capital Gains Tax (CGT) treatment of assets transferred between spouses.

These notes will recap the current situation then outline the proposed amendments.

The changes will only apply for CGT. There are no proposals to change the inter-spouse rules for other taxes.

### *The current regime*

Under s.58 TCGA 1992, transfers of chargeable assets between spouses take place at “no-gain, no-loss” for CGT purposes.

This is different to the disposal being ‘exempt’ from tax. A disposal has taken place. However the consideration which is treated as passing between the spouses is equal to the CGT base cost of the spouse making the transfer, thereby giving a nil result. The effect of s.58 is that the donee spouse inherits the historic CGT base cost of the donor. The treatment is automatic. There is no opt out.

Any actual consideration paid by one spouse to the other for the transfer of the asset is ignored for CGT. [Although it may trigger a liability to Stamp Duty Land Tax if consideration is given for the transfer of UK land or buildings (for example, on the reassignment of a mortgage).]

Note that the donee spouse is NOT treated as acquiring the asset on the same date that the donor acquired it. We are not stepping back in time. The donee’s date of acquisition is the date of the inter-spouse transfer.

This could be important in situations where a relief would only be available if the taxpayer held the asset at a certain date (for example, rebasing relief for non-UK residents disposing of UK land and property). Therefore if an individual (H) bought a UK residential property before 2015 and gifted it to his spouse (W) today, a disposal by W in a later non-resident period would not qualify for April 2015 rebasing as she did not own the property at 5 April 2015. Gains would therefore be calculated by reference to H’s historic base cost. Any benefits of rebasing would be lost.

There are a couple of occasions where an inter-spouse transfer is not deemed to take place at no-gain / no-loss.

These are relatively rare and include:

- Death-bed transfers between spouses (these are treated as made on death so the transferee spouse will inherit the asset at probate value instead of historic base cost);
- Where the asset transferred formed part of the trading stock of the donor and / or where the asset transferred becomes trading stock for the donee. Such transfers take place at market value.

### *The effects of separation*

S.58 contains the important proviso that the spouses must be “living together” in the tax year in which the transfer takes place. This does not have to be taken literally and s.58 can apply in situations where a married couple are physically living in separate homes.

For example, if one spouse is living abroad (perhaps on a short-term work assignment) while the other spouse remains in the UK, no-gain / no-loss treatment still applies to transfers between them.

“Living together” is instead taken to mean that the marriage has not irreversibly broken down. “Separation” will therefore be the event that starts to take couples out of S.58. The date of separation is a question of fact and is commonly pinpointed to be the date on which one of the spouses leaves the matrimonial home in the expectation that the marriage has irretrievably broken down. The date of separation could, in fact, be earlier than this in cases where the spouse continues to live under the same roof but not as a couple. Practitioners will clearly need to show sensitivity and be guided by their clients in this regard.

Once the date of separation has been established, any transfers up until the 5 April following that date will take place at no-gain / no-loss on the basis that the couple had been living together at some point in that tax year. Therefore one can normally be reasonably relaxed about determining the precise date of separation (we just realistically need to place it in the correct tax year).

The practical problem with the s.58 in its current form is that, in the inevitable disruption which accompanies the breakdown of a marital relationship, thoughts seldom turn to how the couple should best time their asset transfers to take advantage of the no-gain / no-loss rule. The “we need to talk” conversation in these instances is rarely about CGT planning.

Ideally CGT liabilities can be avoided by making transfers before the end of the tax year of separation. However, that planning window can be very short indeed and once it has closed, the market value rule takes over.

### *The market value rule*

Inter-spouse transfers after the end of the tax year of separation are deemed to take place at market value. This is by virtue of the legally married couple still being “connected persons” for CGT purposes.

This will mean that:

- If the market value of the asset exceeds the donor's historic base cost, a chargeable gain will arise. Gift relief might then be available, but only if the asset is a 'business asset' within the definitions laid down in s.165 (unlisted trading company shares and furnished holiday lets being the most common). Note that no holdover relief is available under s.260 as the gift is not immediately chargeable to Inheritance Tax. [In fact, IHT exemption for inter-spouse gifts continues until the date of divorce.]
- If the market value is less than the donor's CGT base cost, a loss will arise. However that loss is restricted by virtue of s.18(3) such that the loss can only be used against gains on disposals to the same connected person (i.e. the separated spouse) in the same or future tax years. Care must therefore be taken to time disposals such that relief for any losses is not wasted.

Inter-spouse transfers after the date of the divorce (decree absolute) are no longer transfers between connected persons as the legal ending of the marriage breaks this connection. However transfers will still be treated as taking place at market value by virtue of s.17 (which deems any transfer not made at 'arms' length – i.e. with some gratuitous intent - to be made at market value).

Shifting the statutory authority from s.18 to s.17 is usually immaterial where gains arise. However it does mean that the 'clogged losses' rules no longer apply as these sit in s.18(3). Any losses arising on inter-spouse transfers post-divorce can therefore be used against any gains without restriction.

#### *Proposed changes*

Representations have long been made to the Government that the CGT rules for separating spouses should be relaxed to keep the planning window open for longer and give couples more time to make financial decisions.

In a CGT Report in May 2021, the Office of Tax Simplification (OTS) commented that "it is unrealistic to expect separating couples to have resolved their affairs by the end of the tax year of their separation".

Finance Bill 2023 therefore proposes to make certain 'tweaks' to the inter-spouse transfer rules which will affect inter-spouse disposals made on or after 6 April 2023.

S.58 will be amended so as to allow no-gain / no loss treatment to continue until the earlier of:

- The 5 April following the third anniversary of the date on which the couple separate; and
- The date on which the couple divorce (or the date on which the marriage or civil partnership is dissolved or annulled).

This means that if a couple separate on (say) 16 August 2022, any inter-spouse transfers made between 16 August 2022 and 5 April 2026 will take place at no-gain / no-loss (assuming there is no divorce in the meantime).

If the couple were to divorce before 5 April 2026, any transfers after the date of the divorce would not be covered by this three year 'extension' and would instead take place at market value as they do currently.

These new rules will apply for disposals on or after 6 April 2023. The separation does not need to take place on or after 6 April 2023 for the new rules to apply.

The new rules will not affect couples who separate in 2022/23. No-gain / no-loss treatment will continue to be available for the whole of 2022/23 under the current s.58. The new rules will apply thereafter.

However, couples who separated before 6 April 2022 and did not transfer their assets before the end of the tax year of their separation, will now need to wait until 6 April 2023 to make any tax-free transfers (as the market value rule will apply in 2022/23). Whether it is practical or desirable for them to wait a further year or so to make any transfers depends on their personal situation. But conversations will need to be had.

According to HMRC, the proposed FA 2023 changes are intended to make the CGT rules fairer in circumstances when spouses are in the process of separating as it will give them more time to transfer assets between them without incurring CGT charges. This logic is irrefutable.

But whether this does indeed make this “fairer” depends on one’s perspective. The changes will certainly be beneficial for the donor as he/she will have more opportunity to transfer assets to their estranged spouse without a CGT charge.

However, the flip-side to this is that the recipient donee will then be picking up assets at the donor’s historic CGT base cost as opposed to obtaining a base cost uplift to market value as might have been the case before April 2023. One person’s capital gain is another’s base cost hike. Donees will therefore be taking on more of the donor’s inherent gains than they did before. These gains are not going away. They are just being transferred along with the asset. If you are representing the recipient spouse in this situation, whether or not the donor spouse has a chargeable gain may not necessarily be your concern.

Looking at the bigger picture, the proposals will, as HMRC say, “avoid further depletion of household income or existing accumulated household wealth through dry tax charges”. There are plenty of provisions which defer tax charges where no money changes hands. This just adds to the list.

#### *Other proposed changes*

##### a) Transfers on divorce:

- It is proposed that no-gain / no-loss treatment will also apply to assets that separated spouses transfer between themselves as part of a formal divorce agreement.
- Until April 2023, any such transfers outside of the tax year of separation will take place at market value. This change will remove the potential CGT liability for a donor spouse on divorce. In effect, it enables all ‘dry’ gains made as a result of transfers on divorce eligible for a form of deferral relief (as the donor’s inherent gains will be automatically passed to the donee). Previously this only applied to business assets. Again this will be automatic.

b) Private Residence Relief:

- A spouse who retains an interest in the former matrimonial home will be given an option to claim Private Residence Relief (PRR) when that property is sold.
- Currently, when one spouse leaves the matrimonial home, that property ceases to be the departing spouse's main residence for CGT purposes. This will in turn create periods of absence on an eventual sale (with PRR restricted accordingly). The final nine months of ownership will remain eligible for relief but the period between moving out and nine months before disposal will not.
- There is currently scope under s.225B for the departing spouse to continue to treat his/her absence from the property as a period of deemed occupation provided that:
- The property continues to be the only or main residence of the former spouse; and
- The departing spouse does not have another property which qualifies for PRR (which is typically the case where the departing spouse moves in with friends / family or into rented accommodation).

From 6 April 2023, the departing spouse will be able to elect for his/her retained interest in the former matrimonial home to continue to be eligible for private residence relief. This will, of course, mean that if the departing spouse has acquired another property which is simultaneously eligible for relief, that "new" property will not qualify. Practitioners with clients in this position will need to make sure that their PRR is placed where it is most effective.

This does have more than a faint whiff of PRR nominations for second homes, so it will be interesting to see if the new rules enable elections to be changed and varied as they can be now.

c) Deferred consideration on sale of former homes:

- Individuals who have transferred their interest in the former matrimonial home to their ex-spouse and are entitled to receive a percentage of the proceeds when that home is eventually sold, will be able to apply the same tax treatment to those proceeds that applied when they transferred their original interest in the home to their ex-spouse.

Let's unpick this.

Assume A and B are married and living in a matrimonial home. They separate and B moves out. Under the terms of the subsequent divorce, B transfers their interest in the former matrimonial home to A who thereafter remains in occupation with their children. It is contractually agreed that once the children cease full-time education (or if A remarries if sooner), the property will be sold and B will receive a share of the sales proceeds.

At the moment, B's transfer of their interest in the house to A will be a disposal at market value giving rise to a gain (some or all of which will be eligible for PRR). At that point, B no longer has an interest in the former home but instead has a different asset being their right to receive future proceeds of an unknown amount (*Marren v Ingles* rings bells here).

The base cost of this intangible asset is the value of this right at the date it is created. [Note: Going forward, as transfers on divorce will take place at no-gain / no-loss, the base cost of the intangible asset received on divorce will be nil.]

When A eventually sells the house and B receives a share of the sale money, this triggers a further disposal, this time of B's right to receive proceeds. If the amount received for the disposal of this right exceeds its CGT base cost, a gain will arise. This gain will not be eligible for PRR as the asset being sold is not, in itself, a qualifying residence.

Under new proposals, the gain on the disposal of the right will be eligible for the same PRR as was (or would have been) available when the interest in the property was originally transferred.

#### *Example*

Richard and Liz married in June 2016 and moved into a house they had bought jointly for £200,000.

In June 2024 the couple separated and Richard moved into a flat he had owned before the marriage and which had been let in the meantime. He did not elect for the family home to continue to be his only or main residence.

In June 2026 Richard and Liz were divorced and as part of the divorce settlement, Richard transferred his 50% interest in the family home to Liz on the condition that Richard would be entitled to 50% of the eventual proceeds of disposal. The house was worth £400,000 in June 2026 and was sold in June 2028 for £500,000.

#### *CGT implications:*

The marital house ceases to be Richard's qualifying residence in June 2024.

Richard's disposal of his 50% interest in the house in June 2026 takes place at no-gain / no-loss (being a transfer on divorce after April 2023). Liz therefore acquires her additional 50% interest at Richard's original base cost giving her a 100% interest in the house with a base cost of £200,000.

In June 2026, Richard acquires a separate asset being the right to receive future consideration. As this is acquired as part of a no-gain / no-loss transaction, the asset has a base cost of nil.

In June 2028, Richard receives future consideration of  $£500,000 \times 50\% = £250,000$  thereby making a gain of £250,000 on the disposal of the intangible right.

This gain will qualify for the same private residence relief as would have applied at the time of the disposal of the 50% interest in June 2026.

The PRR up to June 2026 is the period of Richard's actual occupation (June 2016 to June 2024 being 8 years), plus the final 9 months (giving 105 months out of a total period of ownership of 120 months).

Richard's chargeable gain in June 2028 will therefore be:

	£
Gain on sale of right	250,000
Less: PRR	$£250,000 \times 105/120$ (218,750)
Chargeable gain	31,250

Note that if Richard had elected for the marital home to continue to be his qualifying residence after the date of separation (which he can from April 2023), PRR would have continued to be available until the date of the disposal of his interest on divorce. The subsequent gain on the disposal of his right in 2028 would therefore be fully covered by PRR and would be nil. However, the flat would not then be eligible for PRR between separation and divorce.

Liz will make a gain of £50,000 (being 50% of the £500,000 sales proceeds, less her CGT base cost of £200,000). This will be fully covered by PRR.

*Contributed by Steve Sanders*