Marriage, Separation and Divorce and their Effect on Family Wealth

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This article reviews some of the issues that a couple should consider before they get married in order to protect their assets on divorce and explores the application of principal private residence relief (PPR) to properties owned by a couple during the course of their relationship.

Considerations such as taxation and succession planning may not occur to the client caught up in the excitement of an engagement or the sadness of separation and divorce. However, a change in marital status can raise a number of important issues. The scenarios below illustrate some of the matrimonial and private client considerations that individuals should be aware of at an early stage.[1]

Scenario 1—marriage

Simon and Trudy are engaged to be married. The wedding is planned for one year's time.

Both Simon and Trudy own a property in their sole name. Each bought their respective properties prior to meeting each other. They have talked about buying a home together. They plan to sell their respective properties and pool the equity in order to do so.

Simon's wealthy father has recently liquidated some of his investments and given £1million to Simon. Simon's father is in poor health and, as an only child, Simon stands to inherit substantially. Simon's father (who had been divorced acrimoniously from Simon's mother) wants Simon to take steps to ensure that the cash gifts he has made to Simon together with any future gifts or inheritance are unavailable for division upon divorce. As a consequence, Simon has asked Trudy to enter into a pre-nuptial agreement.

Issues arising: the pre-nuptial agreement

Following the recent Supreme Court decision in the case of *Radmacher v Granatino*[2] parties to a pre-nuptial agreement can expect to be held to its terms if the court considers it to be "fair". In *Radmacher*, the Supreme Court upheld a foreign pre-nuptial agreement (subject to some minor modifications) and decided that the French husband should not receive a share of his German heiress wife's wealth. The judgment makes clear that the decision was reached exclusively on English law principles. However, the foreign aspects of the case were relevant insofar as they added weight to the finding that Mr Granatino's and Ms Radmacher's intention was to be bound by the pre-nuptial agreement, given that such agreements in their respective "home" jurisdictions of France and Germany are binding. It is possible that, in a case similar

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[1] References to spouses and marriages can also be read as civil partners and civil partnership respectively.

[2] *Radmacher v Granatino* [2010] UKSC 42; [2011] 1 A.C. 534 and see C. Jenkins "Protecting inherited assets against divorce: the rewards of a virtuous life" [2011] P.C.B. 99.

to *Radmacher*, where both parties were English, and the agreement concluded in England (and where, as in *Radmacher*, the safeguards set out below had not been followed), that the Supreme Court might have attached less weight to the pre-nuptial agreement.

When determining what is fair, the court will have regard to the circumstances of the case, the welfare of any children of the family and the statutory list of factors set out in Matrimonial Causes Act 1973 s.25. The factors include (but are not limited to) the ages of the parties, the length of the marriage and the financial needs and resources of the parties and any children.

The starting point in divorce proceedings is an equal division of the assets.[3] However, the court has a wide discretion to determine whether a departure from equality is justifiable. The existence of a pre-nuptial agreement might be one factor which will allow the court to depart from equality. There are, however, potential reasons for the court to depart from an equal division of assets. These include where one of the parties to the marriage has assets that they owned prior to the marriage, particularly where they have kept these assets separate rather than intermingled them with the assets of the marriage, where one party has received gifts or inheritances (again, particularly if these are kept separate) or where one party has made a "stellar contribution". A stellar contribution is an unmatched financial contribution so great, and stemming from that party's particular endeavours resulting from a great talent for, say, business, that the court considers it fair that that party should retain more than 50 per cent of the assets. However, where the needs of a party would dictate that an equal division of assets is preserved, or indeed where the other, poorer, party requires more than 50 per cent of the assets to meet their needs, this will usually override the other reasons for a departure from equality.

To ensure that an English pre-nuptial agreement is given as much weight by the court as possible, it must be clear that the parties were aware of the implications of making the agreement when they did so, intended to create legal relations and acted of their own free will. Trudy and Simon will each need to receive independent legal advice on the agreement. They should exchange full and frank disclosure of their financial position and any information about significant assets which they are likely to acquire in the future. As Simon knows he is likely to inherit substantial sums he should disclose details available to him about this.

In the event that the couple divorce and the court finds the circumstances surrounding the making of agreement unfair,[4] the court would give the agreement little or no weight. To reduce the ability of one party later claiming that he/she was pressured into the pre-nuptial agreement, the parties should sign it well in advance (at least three weeks) of the wedding date.

Trudy and Simon should be advised that, in the event of divorce, if there are insufficient assets to meet their real needs (and the needs of any children they might have together) without dipping into funds that the pre-nuptial agreement purports to ring-fence, the court may even override all or part of the agreement.

It would be helpful if Trudy and Simon each kept the property ring-fenced by the pre-nuptial agreement separate throughout the marriage and avoid utilising it for joint expenditure to uphold its treatment as "non-marital property".

Issues arising: tax and succession planning

Much like the topic of divorce, tax and succession planning will not be high priorities in Trudy's and Simon's wedding plans.

Any significant change in circumstances provides a timely reminder to review succession plans. If either Trudy or Simon was to die before they marry without a Will, the intestacy provisions would apply to the devolution of their estates. Only assets owned jointly between them would pass to the survivor

[3] *White v White* [2000] 3 W.L.R. 1571; [2001] 1 All E.R. 1.
[4] For example, if one party was under undue pressure or there was unscrupulous conduct such as misrepresentation or fraud.

automatically.[5] However, the intestacy rules do not make provision for fiancé(e)s. Wills entered into before they marry will be revoked by their marriage unless the Wills explicitly state that they are made "in contemplation of marriage". Once married, Trudy and Simon will be able to take advantage of the spouse exemption from inheritance tax (IHT) which provides that assets passing between spouses during their lifetimes and on death are free of IHT.[6]

If they do not prepare Wills Trudy and Simon would be wrong to think that the intestacy rules will apply to ensure that the deceased's estate passes in full to the survivor. In fact, other than in relation to jointly owned assets, the surviving spouse only receives the first £450,000 plus half of the remaining assets. The other half will pass to the deceased's surviving parent(s) or to his siblings or remoter family members, depending upon the family tree. Depending on the value of the deceased's estate, this could be significant, both in terms of provision for the survivor and IHT. If Trudy and Simon had children when one of them dies, the intestacy provisions operate less favourably in favour of the survivor. The survivor would receive only £250,000 and an interest in the income of half of the balance. The children would receive the other half absolutely. If Trudy and Simon had divorced at that point, their children would inherit the deceased's estate absolutely.

Another, often overlooked, issue which Simon and Trudy need to consider is the possibility of capital gains tax (CGT) arising on the sale of their properties. It is well known that where an individual uses a property as his principal or main residence any gains realised on the sale will not be subject to CGT.[7] Accordingly, Trudy or Simon can avoid CGT if they both sell their homes before they get married. However, if they only sell one of the properties prior to the proposed purchase of the family home, they must jointly elect, within two years, for one of the properties to be treated as their main residence for tax purposes.[8] Trudy and Simon could change their main residence election while they own multiple properties. There was talk prior to the 2011 Budget that the rules on main residence "flipping" would be tightened following the bad press given to MPs in 2009. However, no changes were made to the relief.

Trudy and Simon can only make an election if the property is a "residence".[9] Therefore, if Simon and Trudy were to rent out Trudy's property the relief would not apply for the rental period. Nonetheless, provided that the property was once their only or main residence and sufficient time had been spent at the property, the relief would apply to Trudy's period of occupation prior to rental. Further, the last 36 months of the period of ownership will always be relievable.[10] Therefore, if the property was owned as Trudy's main home from 2000 to 2011 and it was rented out from 2011 until it was sold in, say, 2013, the whole period of ownership would qualify for the relief, first by virtue of Trudy's occupation until 2011; and secondly as a result of the 36-month exemption.

In addition, if the property is let out, the let property exemption[11] will apply and any gain attributable to the period of the letting will be exempt to the extent that it does not exceed the lesser of £40,000 and the gain otherwise exempt (under the main residence rules).

[5] Property owned as joint tenants passes automatically to the survivor on death, whereas property owned as tenants in common will be subject to the intestacy rules.

[6] If one spouse is not domiciled or deemed domiciled in England for IHT purposes, the spouse exemption is limited to £55,000 in the case of gifts from the domiciled spouse to the non-domiciled spouse (but not vice versa).

[7] Taxation of Chargeable Gains Act 1992 (TCGA 1992) s.222.

[8] If an election is not made under TCGA 1992 s.222(5)(a), which property is the main residence will be determined on the facts.

[9] The First-tier Tribunal has heard a number of cases in the past year on what constitutes occupation for the purposes of the relief. The cases, mainly dealing with buy-to-let property, claim by renovations that they occupied the property whilst they carried out the necessary works failed on the facts. Lack of energy consumption at the properties showed the tribunal that the "occupants" were not using the cooking facilities or hot water at the property, indeed in one case, *Malcolm Springthorpe* [2010] UKFTT 582 (TC) at 832, the property was not connected to the gas. See also *Moore v Revenue and Customs Commissioners* [2010] UKFTT 445 (TC) at 710 and *Metcalfe v Revenue and Customs Commissioners* [2010] UKFTT 495 (TC) at 753.

[10] TCGA 1992 s.223(1).

[11] TCGA 1992 s.223(4).

Scenario 2—separation

Eight months into the marriage relations between Simon and Trudy turn sour and Trudy decides she wants a divorce. Simon moves out of the matrimonial home and is renting until matters between him and Trudy are finalised.

The only jointly owned property is the matrimonial home, held as joint tenants, and a sum of cash in a joint bank account. Simon and Trudy agree that the matrimonial home should be sold and the net proceeds of sale divided equally between them: the joint bank account should be closed and the balance split equally. Each will keep all other assets that are in their sole name.

Issues arising: reasons for divorce

It is not possible to file a petition for divorce in the first year of marriage: Trudy will need to wait until 12 months have passed before she can formally start divorce proceedings. The ground for a divorce is the irretrievable breakdown of the marriage which must be supported by one of five facts (or one of four facts for the dissolution of a civil partnership).[12] It will depend upon the circumstances at the time the petition is being filed as to which fact is available and appropriate.

Trudy and Simon should be aware that the act of divorce revokes provisions in Wills for the benefit of the former spouse and the appointment of the former spouse as executor.[13] Accordingly, they may want to change their Wills now or wait until the decree absolute has been pronounced. A "holding Will" could be prepared for them both to take advantage of the spouse exemption in the event that one of them dies before the decree absolute, for example, a life interest in favour of the survivor, subject to an overriding power of appointment, could be used if appropriate.

If Trudy and Simon change their Wills to exclude each other and one of them dies before the decree absolute is issued, it would be open for the survivor to make a claim against the estate under the Inheritance (Provision for Family and Dependants) Act 1975. The length of the marriage, and the fact that the parties were not living together at the time of death, would not necessarily affect the strength of the survivor's claim as the court is keen to stress the distinction between the termination of the marriage by death and the termination by divorce. The holding Will suggested above could be one way of avoiding the expense of a court hearing in these circumstances.[14]

To ensure that each party has financial certainty going forward, it is advisable for Trudy and Simon to record and convert their financial agreement into a court order. If possible a "clean break" should be achieved, so that they know where they stand going forward.[15]

Although Trudy and Simon have separated and Simon has moved out, the marital home can continue to be Simon's main residence for tax purposes, provided he does not elect for another home to be treated as his main residence. In which case, the sale of the property would not be subject to CGT.[16]

Issues arising: capital gains on the sale of the home

As Trudy remains in occupation until the property is sold she will obtain the relief for the entire period of ownership. If Simon's position changes and he acquires a new home he might consider making an election to treat the new home as his main residence. Provided the property is sold within three years of

[12] The five facts are adultery, unreasonable behaviour, desertion, two years' separation with consent of the other party and five years' separation (without the necessity for consent). The fact of adultery is not available to support the ground of irretrievable breakdown of a civil partnership.

[13] Law Reform (Succession) Act 1995 s.3.

[14] It is also possible for a divorced spouse to bring a claim against their ex-spouse's estate, provided the former has not remarried, and subject to that claim having been dismissed in any financial order made on divorce.

[15] A "clean break" is the formal dismissal of each party's claims arising from the marriage (in life and upon death), so there is no ongoing liability.

[16] TCGA 1992 s.225B.

his departure from the family home he will escape CGT on the sale and will obtain the relief on his new property from the date of acquisition. If he did not make such an election HMRC might argue that the relief would not apply to his new home for the period during which Simon owned two properties.

Scenario 3—divorce

Simon and Trudy manage to get over their problems and reconcile. They are happily married for another seven years before relations take a turn for the worst and Simon leaves Trudy. Simon is staying with a friend whilst the divorce and financial matters are finalised.

At this stage Trudy and Simon jointly own the matrimonial home plus a holiday home in Norfolk which they bought together five years into the marriage and they used on weekends and during holidays. Trudy and Simon agree that these two properties should be sold and the net proceeds of sale split equally. They will each retain the assets which are in their own names in keeping with the terms of their pre-nuptial agreement. The Norfolk property is put on the market for sale and a buyer is found within weeks. However, a buyer of the matrimonial home is harder to come by and it takes some time to sell.

Issues arising: capital gains tax on the sale of the properties

As the Norfolk property was used as a holiday home, it will not be possible for Trudy and Simon to claim the main residence exemption upon the sale. Therefore, any gains will be taxed but the gains of each one will be reduced by his or her annual exemption.[17]

Provided Trudy continues to occupy the former matrimonial home, it will continue to be her main residence for CGT purposes and any gain arising on the disposal of her share will be relieved from tax.

Simon's position is different. If Simon moves out of the family home and elects for another property to be treated as his main residence, he will not be able to claim principal private residence relief for the whole of his period of ownership. However, if a buyer is found and Simon has been absent for less than three years, the whole of the period of his ownership will be relievable.

If a buyer can not be found for the matrimonial home, Simon might decide to sell his interest in the property to Trudy. He could obtain principal private residence relief even if he had been absent for longer than three years, provided that the sale was pursuant to the decree absolute[18] or an agreement between them in contemplation of their separation.[19]

If a buyer could not be found for the Norfolk property, Simon might decide to sell his interest in the property to Trudy to free himself of the financial ties to her. Transfers between husband and wife do not give rise to a charge to CGT (the disposal is no gain no loss), therefore it would be possible for Simon to sell his share of the property to Trudy without the disposal being subject to CGT. However, transfers between spouses are only free of CGT in the tax year of their separation and prior to their divorce. Therefore, the sale to Trudy would need to take place prior to April 6 following their separation and prior to the decree absolute. Stamp duty land tax will not be payable if the transfer to Trudy is made as part of an agreement or court order.

Conclusion

An awareness of the overlap in matrimonial and tax and succession issues can result in clients being better protected when matters of the heart take over the reasoning of the head.

[17] The annual exemption for CGT in 2011/12 is £10,600.
[18] TCGA 1992 s.225B(2)(b).
[19] TCGA 1992 s.225B(2)(a).