The Chartered Tax Adviser Examination

May 2019

Application and Professional Skills

Taxation of Individuals

Suggested solution

REPORT TO MICK GRUBER ON THE TAX IMPLICATIONS OF ASSET TRANSFERS ON DIVORCE AND COMMENCING EMPLOYMENT IN RURITANIA

INTRODUCTION

This report considers the following:

1) The tax implications of the transfer of assets to your wife Josie, in light of your separation and anticipated divorce; and

2) The effects of your new situation on your tax position going forward.

1. EXECUTIVE SUMMARY

You will remain UK tax resident in the current 2019/20 and 2020/21 tax years so your Ruritanian income will be subject to UK Income Tax.

In 2020/21 you should ensure your employment is carried out wholly in Ruritania so that your employment income can be taxed under the Remittance Basis. By paying the Remittance Basis Charge of £60,000 a net saving of at least £65,600 of Income Tax will be made.

If you remain UK resident, you will be deemed to be UK domiciled from the 2021/22 tax year and taxed on your worldwide income. To avoid this, you should ensure that you spend less than 91 days in the UK, of which there should be less than 31 working days.

There will be no tax on the transfer of Larkview to Josie, however transfers of other assets will be subject to Capital Gains Tax based on their Market Value.

You should transfer Saltpot Cottage and Pepperpot Cottage to Josie, together with your shares in Jam plc and Butter plc. This will result in Capital Gains Tax of approximately £80,000 for a transfer of value of approximately £1.3 million.

2. DOMICILE

Your domicile, or permanent home, has always been Ruritania, and the fact that you have been resident in the UK has not changed that. Being non-UK domiciled can bring considerable tax advantages. While you are not UK domiciled you have the option to claim the Remittance Basis of taxation in the UK. Where the Remittance Basis is claimed, your foreign income and gains are only taxed in the UK to the extent they are remitted here. For Inheritance Tax purposes, non-UK assets are effectively exempt while you are not UK domiciled, as they are 'excluded property'.

3. RESIDENCE

Although you have remained domiciled in Ruritania, you have been tax resident in the UK since the 2006/07 tax year. As you will be starting work in Ruritania, it is necessary to reconsider your residence position.

You will be automatically non-resident in the UK if either you spend fewer than 16 days in the UK in a tax year, or you work full-time in Ruritania and spend fewer than 91 days in the UK, of which fewer than 31 UK days are spent working. Work is classed as full-time if you work at least 35 hours a week, and a UK workday is one in which more than 3 hours is spent working in the UK.

Conversely, you will be automatically UK resident if you spend 183 days or more in the UK in a tax year; if you have a UK home for at least 91 days (part of which falls in the tax year), at which you spend at least 30 days while spending less than 30 days in an overseas home during the tax year; or if you work full-time in the UK for a continuous period of 365 days with no significant break and at least one of those working days is in the tax year.In years where the conditions to be automatically non-resident or automatically resident are not met, your

residence will be determined based on your ties to the UK combined with the number of days you spend in the UK (the sufficient ties test).

The following ties are taken into account:

1. Family tie – as you are separated from Josie, she no longer counts as a family tie for you. Alfie does count as a family tie until he reaches 18 years old, unless you spend fewer than 61 days with him in the UK in the tax year.

2. Accommodation tie – as you have a home in the UK, you will have this tie.

3. Work tie – you have a work tie if you do more than 3 hours of work in the UK on at least 40 days in the tax year. I assume you will not have this tie after you take up employment in Ruritania.

4. 90-day tie – you have a "90-day" tie for a tax year if you spent at least 90 days in the UK in either of the previous two tax years. You currently have this tie.

5. Country tie – you have a country tie if the UK is the country in which you were present at midnight for the greatest number of days in the tax year. You will not have this tie from 2020/21.

In the current tax year, you will be spending more than 183 days in the UK and will therefore remain UK resident.

In 2020/21 you will not meet the conditions to be either automatically non-resident, or automatically resident. Therefore, the sufficient ties test will apply. Given that you will be spending at least 104 nights in the UK, to lose your UK tax residence you can have no more than one UK tie. As you have UK family, UK accommodation, and were in the UK for more than 90 days in both the previous two tax years, you will remain tax resident in the UK.

The 2021/22 tax year will be your sixteenth year in the UK. From that year, if you remain UK resident you will be treated as though you are UK domiciled for Income Tax (IT), Capital Gains Tax (CGT) and Inheritance Tax (IHT). This means that you will be taxed in the UK on your worldwide income with no option to claim the Remittance Basis, and that your worldwide assets will be liable to UK IHT.

To avoid this, you should ensure you meet the conditions to be non-resident in 2021/22 and the following years. The conditions you must meet are to work full-time in Ruritania, and to spend less than 91 days in the UK in the tax year from 6 April 2021 with fewer than 31 of those UK days being work days. You will spend weekends in the UK until September 2021, so should reduce your days in the UK proportionately between September 2021 and 5 April 2022, to ensure you meet the conditions to be non-resident.

4. TAXATION OF INCOME

The salary from your new employment will be taxed in Ruritania at 25%, and credit is given in the UK for this tax. Where your employment income falls in the additional rate Income Tax band it will effectively be taxable in the UK at 20% (being UK additional rate Income Tax of 45% less tax already paid in Ruritania of 25%). In the current tax year UK tax due on Ruritanian employment income will be £58,333 (£700,000 x (45% - 25%) x 5/12).

In future years the additional UK tax payable will depend on the level of your other income, with a minimum of £125,600 (based on 2018/19 rates - £34,500 x 20%, + £115,500 x 40%, + £550,000 x 45%, less Ruritanian tax of £700,000 x 25% = £125,600) if you have no other UK income.

Until 6 April 2021, this tax can be reduced if the employment income is classed as foreign income and the Remittance Basis is claimed.

To achieve this, you should ensure you carry out the duties of your new employment wholly abroad. If more than incidental duties are carried out in the UK, the entire amount becomes taxable in the UK. Responding to telephone calls or sending emails while in the UK would be regarded as substantive.

Under the Remittance Basis your foreign income will only be taxed in the UK to the extent that it is remitted here.

A remittance is any money or property which is brought, received or used in the UK either for your benefit or for the benefit of any other relevant person. For these purposes, Josie is a relevant person until the divorce is finalised. Alfie is a relevant person until he reaches 18 years old.

If you claim the Remittance Basis, a charge of £60,000 per year is payable. In the current 2019/20 tax year it will not be worth your while to pay the Remittance Basis Charge because UK tax on your Ruritanian income of £58,333 is lower than paying the Remittance Basis Charge of £60,000.

As all your 2019/20 income will be taxed in the UK, Ruritanian income can be remitted and used to pay UK expenses.

In 2020/21 it will be beneficial for you to claim the Remittance Basis and pay the £60,000 charge, provided over £300,000 of your Ruritania income is not remitted to the UK. It is likely that you will not need to make any remittances of your 2020/21 income, as all your income from the previous year can be remitted. Claiming the Remittance Basis will save you at least £65,600 of tax. (£125,600 minus £60,000)

To avoid remittances of your Ruritanian employment income, you should set up a separate bank account in Ruritania and all Ruritanian earnings from 6 April 2020 should be paid into this account.

If the divorce has been finalised by this point, remittances can be reduced by making maintenance payments to Josie for her own benefit to a foreign bank account in her own name.

From 6 April 2021, the Remittance Basis will no longer be available to you (as you will be deemed UK domiciled based on your length of UK residence) and if you remain UK resident you will be taxed in the UK on all of your Ruritanian income. The additional UK tax payable on your £700,000 salary will be at least £125,600 each year. This can be avoided if you meet the conditions to be non-UK resident from this year, in which case you will only be taxed in the UK on your UK source income.

Conclusion on Income

Your Ruritanian earnings for 2019/20 will be fully taxable in the UK so can be remitted and used to fund maintenance payments and your UK living expenses.

From 6 April 2020 you should carry out your employment duties fully in Ruritania to ensure your earnings are classed as foreign income. This will enable you to save tax of at least £65,600 in the year by claiming the Remittance Basis.

From 6 April 2021 you should spend less than 91 days each year in the UK while you are working full-time in Ruritania. This will prevent you from becoming deemed domiciled in the UK and taxable on your worldwide income and gains, with no option to use the Remittance Basis.

5. TRANSFERS OF ASSETS

Transfers of assets between husband and wife are normally made on a no gain-no loss basis for Capital Gains Tax (CGT) purposes and are exempt transfers for Inheritance Tax (IHT) purposes.

When a husband and wife have permanently separated, no gain-no loss treatment only applies until the end of the tax year of separation. As you and Josie separated before the start of the current tax year, no gain-no loss treatment no longer applies to transfers you make to Josie.

You and Josie are classed as ‘connected’ to each other until the divorce is finalised, so transfers of assets between you are deemed to take place at market value, and CGT is charged on gains. This cannot be avoided by waiting until after the divorce to make transfers, because all transfers not at arm’s length are deemed to be at market value for CGT purposes. Thus, whether you transfer assets, or sell assets and transfer cash, CGT will arise. Assuming transfers or sales occur before 5 April 2020, CGT will be due on 31 January 2021.

Non-UK residents are generally only subject to CGT on disposals of residential property situated in the UK, therefore you could pay tax at the lower Ruritanian CGT rate by delaying disposing non-residential property until after you lose your UK tax residence in April 2021. However, given the likely need to transfer assets to Josie this year, this will not be possible. Even if you could do this, you should be aware that if you become UK resident again within five years of leaving, gains on assets owned at the time you became non-resident, and sold while you were not resident, would be charged in the year you return to the UK.

It is also worth considering UK IHT. IHT is charged on death at up to 40% of the value of transfers over the nil rate band of £325,000 made during your lifetime within 7 years of death, and at up to 40% on the value of your death estate. While you are not UK domiciled, IHT is only charged on your UK assets. Broadly, these include UK property, shares registered in the UK, or other assets physically located in the UK.

Until now, transfers from you to Josie have been exempt from IHT as you are married and Josie is UK domiciled. They remain exempt until the date the divorce is finalised. Even after the decree absolute, there is an exemption for transfers made for the maintenance of your ex-wife or child. Therefore IHT will not apply to transfers you make in this regard but is worth considering in relation to which assets you should keep within your estate.

5.1 Larkview

You have no choice but to transfer this property and so the tax position will need to be accepted. When you transfer your interest in Larkview to Josie any gain relating to the period you lived there as your primary residence will be covered by Principal Private Residence Relief (PPR) and no CGT will be due.

PPR also covers the last 18 months of ownership, so if you transfer your interest to Josie within 18 months of moving out, no tax will be due.

If a transfer is made more than 18 months after you move out, PPR can still be claimed provided the property remains Josie’s primary residence and provided you do not in the meantime nominate another home as your own primary residence for PPR. This is a tax relief specifically available on divorce.

Transfers of property made as part of a divorce settlement are exempt from Stamp Duty Land Tax (SDLT), so no SDLT will be due from Josie regardless of whether she pays you or takes over any mortgage liability from you in relation to the property.

5.2 Other Assets

In relation to the other assets, you will need to consider the likely gains arising on a transfer or sale.

Rental Properties

Transfers of these properties as part of the divorce settlement are also exempt from SDLT. There are three possibilities in relation to the rental properties:

1. You transfer your interest in the properties to Josie

Given your level of income, gains on the transfer of residential property are subject to CGT at 28%.

As the properties have always been rented out, there is no PPR or Letting Relief available.

Each property is currently standing at a gain of £300,000. Your 50% share of the gain if you were to transfer your interest in both properties to Josie would be subject to CGT at 28% x £600,000 x 50% = £84,000, and you would be transferring £1 million of value.

2. You and Josie exchange interests in the properties

If you exchange your interests in the properties, so that you each become sole owners of individual properties, gains are only charged to the extent that either of you receives consideration valued above the amount that you give. This is the case provided the property does not become the residence of the transferee within six years of the transfer.

As the properties have the same value, if you were to split the ownership so that one of you owns Property 1, and the other owns Property 2, there would be no tax on this transaction as there is no exchange of value. CGT on any future disposal of either Peppercorn Cottage or Saltpot Cottage would be the same as if you disposed of your half of the properties individually.

3. You retain joint ownership

If there is no change of ownership, then there is no CGT charge and no transfer of value.

After the divorce, income from the properties no longer needs to be split 50/50 but can be allocated in whichever proportions you agree. There may therefore be potential to allocate this income directly to Josie, in which case she would be taxed on it rather than you. If her Income Tax rate is lower than yours, profits allocated to Josie will be taxed at a lower rate than those allocated to you. The amount would need to be adjusted to ensure Josie received the same after-tax income, but would save money compared to paying maintenance out of your post-tax income.

The property would remain within the charge to UK CGT and IHT once you become non-resident in 2021/22.

UK Shares

Given your level of income, gains on the transfer of shares are subject to UK CGT at 20%.

Within your portfolio there are £300,000 worth of shares in Jam plc and Butter plc which are standing at no gain and can be transferred to Josie with no CGT due.

Your shares in Honey plc and Marmalade plc are standing at a high gain so would incur a high rate of CGT in comparison to the value transferred.

There is no charge to UK CGT if you sell your UK shares in a future year when you are not UK resident, unless you become resident again within 5 years. Delaying a sale until you are non-resident would mean gains are subject to the lower rate of CGT in Ruritania.

Dividend income is taxed at lower rates than property income. Once you become non-resident, you are treated as having paid tax at the dividend ordinary rate of 7.5%. If dividends are your only source of UK income, no higher rate tax is due. Therefore, from an Income Tax perspective it would be advantageous to retain the shares in preference to the properties.

Oil Painting

The gain of £300,000 on the transfer of your painting to Josie would be taxable at 20%, giving CGT of £60,000 for a transfer of £800,000 of value.

Although your painting does not yield any income, compared to a yield of 10% on your shares and 8% on your rental properties (based on current market values) its value is rising rapidly, and if this rise is expected to continue then you should keep the painting.

There would be no charge to UK CGT if the painting were to be sold in a future year when you are non-UK resident, subject to the temporary non-resident rules mentioned above. Delaying the sale and paying Ruritanian CGT at 15% rather than UK CGT at 20% would save you £15,000 based on current value.

5.3 Conclusion on Asset Transfers

Below is a summary of the CGT due on a straightforward transfer of each of your assets to Josie:

Asset	Value £	Gain £	Tax Rate	CGT £	CGT as % of value transferred
Jam plc	200,000	0	20%	0	0
Honey plc	400,000	300,000	20%	60,000	15
Marmalade plc	300,000	200,000	20%	40,000	13.3
Butter plc	100,000	0	20%	0	0
Painting	800,000	300,000	20%	60,000	7.5
Peppercorn Cottage (50%)	500,000	150,000	28%	42,000	8.4
Saltpot Cottage (50%)	500,000	150,000	28%	42,000	8.4

If you were to make a straightforward transfer of £1.5 million of assets to Josie, the lowest tax rate would be achieved by transferring your painting, your share in either Peppercorn Cottage or Saltpot Cottage, and shares in Jam plc or Butter plc to make up any shortfall. This would result in CGT of approximately £100,000, payable on 31 January 2021 on transfers made in the current tax year.

Alternatively, you could transfer your share in both rental properties to Josie, together with shares in Jam plc and Butter plc, and make up the difference of £200,000 through borrowing cash. Cash can be transferred to Josie with no tax implications. The transfer of the rental properties would result in CGT payable on 31 January 2021 of approximately £80,000. This option may be desirable if you want to obtain a clean break, and do not exchange your interests in the properties.

You should retain your shares in Honey plc and Marmalade plc in preference to the properties because these shares have the highest cost of CGT attached (in proportion to their value), a slightly higher income yield, and because dividends are taxed at a lower rate than rental income.

You should keep assets which have the highest growth potential, due to the lower rates of CGT compared to Income Tax, and should not therefore sell the painting if you expect its value to continue to increase.

Any rise in value of either your painting or your shares can be realised free of UK tax and at the lower Ruritanian CGT rate of 15% after 6 April 2021.

There is a potential IHT advantage in transferring your UK shares and your UK properties to Josie in preference to the painting. This is because while you remain non-UK domiciled, these assets will be subject to IHT on your death, whereas IHT on the painting can easily be avoided by taking it to Ruritania.

Therefore it is recommended that you should transfer your shares in Jam plc and Butter plc, together with your interests in Saltpot Cottage and Pepperpot Cottage to Josie. The shortfall of £200,000 can be borrowed against the painting, which you could sell free of UK CGT after 6 April 2021.

ASSESSMENT NARRATIVE

Structure

A simple pass or fail will be awarded.

Identification and Application

The following are the relevant topics for assessment with their weightings:

1	30%	Identify implications of domicile and residence on income and asset transfers and applying them to Mick.
2	25%	Explaining Remittance Basis and identifying how it applies to Mick.
3	15%	Identifying the position in relation to CGT on asset transfers to Josie.
4	10%	Explain CGT treatment of transfer of main residence.
5	10%	Explain the options in relation to jointly owned rental properties.
6	10%	Explain CGT treatment of transfer of the painting or shares.

A grade of 0,1,2,3, or 4 is awarded to each topic. The weighting is applied to that grade to produce a weighted average grade. This is then converted to a final absolute grade by rounding up or down to the nearest grade. Thus, scores in the range 2.5 to 3.49 will be a grade 3. In this example, the candidate will score a grade 3 overall and secure a pass for this skill.

Relevant Advice and Substantiated Recommendations

The following are the topics for assessment with their weightings:

30%	Advice and recommendations on residence.
20%	Advice and recommendations on the use of the Remittance Basis.
50%	Advice and recommendations on which assets to transfer and why.

The final grade will be determined for this skill in the same way as for Identification and Application.