

Where did my settlement go?

In a heated divorce case, where the focus might be on complex pension issues, it could be easy to overlook the fact that other investment assets have different tax treatments, and each asset might be “pregnant” with different amounts of gain at the point of separation.

It is, of course, the net-of-tax value which is the important figure, certainly where the intention is to dispose of the asset to provide cash, perhaps to purchase a home for one of the parties.

The aim has to be to ensure that the client has clarity about the position of their assets so that they can take action based on net figures, and not on gross figures with an unexpected tax sting some months later.

Financial planners **Neil Brennan**, Director at Fitzallan, and **Richard Wadsworth**, of Carbon Financial Partners, recap on some of the tax and planning points in relation to non-pension assets in a divorce settlement

What do we need to know?

As an example, say Andrew and Katy are separating and hold two investments, a £100,000 investment bond and an £80,000 unit trust. We know the original amount invested into the bond was £75,000, and the unit trust £50,000, but what other information do we need to establish the net-of-tax values?

The information would include:

- Andrew and Katy’s individual income tax positions;
- whether they have made capital gains in this tax year;
- whether they have losses that could offset the gains;
- whether or not the couple are still living together;
- when they separated;

- which funds or structures have been invested in; and
 - what has been withdrawn from the bond and the unit trust in the past.
- Only after gathering this information can we establish what the net-of-tax values would be. Gathering all the relevant information is crucial.

Basic tax points

To recap, the basic tax position of the commonly held assets is as follows.

Matrimonial home – typically the proceeds from the sale of the matrimonial home would be free of tax, due to principal private residence relief.

Investment properties – investment properties do not benefit from principal private residence relief, and any gain made on the sale of the property would be liable to capital gains tax (CGT) at 18% or 28%, depending on the owner’s income tax rate and the size of the gain.

Cash deposits – mercifully simple: cash is cash and no tax arises on withdrawal or closure of an account.

Shares and most “collective investment schemes” (unit trusts and open-ended investment companies (OEICs)) – gains on disposal are treated in the same way as investment properties and are potentially subject to CGT.

Investment bonds – gains on the disposal of an investment bond are taxed in an entirely different manner to the vast majority of other financial assets. What is, on the face of it, a relatively simple structure is, when it comes to the taxation of withdrawals, a minefield, with just some of the points to note including:

- bonds are subject to income tax;
- withdrawals of up to 5% of the original capital can be made “tax-free” (actually tax deferred);
- there are differences in terms of whether a bond is encashed by segment or across segments;
- withdrawals have to be added back into any final encashment;
- something called “top slicing” applies to establish the tax rate at which the gain is payable;

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- “onshore” and “offshore” bonds have different tax treatments; and
- assignments are not usually treated as disposals for tax purposes.

Planning

There are, of course, ways to plan to minimise a tax liability and these include the following:

- The use of exemptions and allowances such as the personal allowance and capital gains tax annual exempt amount, the former providing

scope for some tax-free income or tax-free investment bond gains, the latter allowing some disposals free of capital gains tax.

- The above allowances or exemptions are available in each tax year, and so it may be possible to “drip out” gains or income over two or more tax years to minimise the tax hit.
- Assets could be assigned or transferred to a spouse or family member on certain occasions to allow the use of their allowance or exemption.
- Assets could be assigned or transferred to a lower-tax-rate-paying spouse or family member in certain

occasions before being subsequently disposed of, allowing any gain to suffer a lower amount of tax.

- Most structures can be split so that a combination of strategies could be used to minimise tax.

It should be noted that, while financial planners will tend to have a good tax knowledge, they are not usually tax advisers as such (and, for clarity, neither Fitzallan nor Carbon Financial Partners are tax advisers), and often financial planners will recommend engaging the services of a tax specialist to complement the financial planning.

Collaborative approach

The collaborative approach to divorce perhaps lends itself particularly well to dealing with the tax issues around

the sale or transfer of investments, due to the openness and potentially greater degree of flexibility that can be present in the collaborative process as compared to a more confrontational divorce process.

Going back to the example, this might allow Andrew and Katy, for example, to pass the unit trust between them so that they can both use their annual exempt amounts over two tax years, meaning more than £40,000 of gains could be realised without any CGT, and the investment bond could be assigned to the lower-paying spouse and, again, an amount realised over two tax years, minimising any income tax charge.

Known unknowns?

The key is knowing what information is required and when it may be sensible to bring in financial planning and/or tax expertise. The points above are only some of the basic ones, of course, but hopefully they serve as a reminder, or a reminder of what we don’t know – or as Donald Rumsfeld put it, as a reminder of what the known unknowns are!

It is worth mentioning that adding another professional to the divorce process may not add cost for the client, and could save significant amounts of tax, and avoid any nasty tax surprises down the line.