TAX

Tax: Planning for the future in the present

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Rosalind Fitzgerald and Sofia Thomas discuss the practicalities of 'nesting' child arrangements and the tax issues that may arise

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A nesting arrangement is where the children of separating parents stay in the family home or nominate one main property as a ‘nest’. The parents go to and from the ‘nest’, returning to care for the children and staying alternatively in a second and possibly a third property. The children’s welfare is at the heart of such arrangements, as the disruption of moving regularly between homes falls on the parents not the children. It is used more commonly in the short to medium term and might be deployed by parents who already own another property, perhaps an investment, rental or inherited property, or an additional property may be purchased for the purpose of facilitating the nesting arrangement. A second property may be rented, but this article will look at the tax implications where two properties are owned.

Advantages

The advantages of a nesting arrangement include:

- the children are able to stay in their familiar home with their possessions;
- the family home is likely to be the centre of the children’s interests, childcare, school and activities, and their friends can stay the same;
- the second home may be purchased or rented in a cheaper area;
- the second home may be a smaller and more affordable property, and less expensive than both parents requiring two sets of accommodation that are suitable for the children;
- the second home need only be sparsely furnished for one parent to stay in;
- it is the parents who will need to think about what they need for their days away from the main property, rather than the children;
- as an interim step, nesting allows the children to get used to their parents spending time with them separately rather than together, with minimal disruption to their familiar day-to-day routine; and
- where one parent is nervous about the other’s ability to care for the children alone, or if one parent has rarely cared for the children alone in the past, the children remaining in a familiar environment can be reassuring.

The disadvantages

The disadvantages of nesting include:

- there can be a lack of private space for the parents in the second home;
- there can also be a lack of private space in the main home with the children and there may be frustrations in, for example, coming home to unwashed dishes and undone laundry or misplaced things;
- rental income may be lost if the second home was previously rented out;
- if the parents want completely private space while away from the nest, then three properties will be needed: the nest/family home and a property for each of the parents, at significant cost;
- new partners may not be welcome in the shared family home space, or the second property; and
- the children may find it confusing, and hard to adjust to the concept of their parents being separated, and may see it as one parent at a time simply being 'away'.

Practical considerations

Practical considerations when planning a nesting arrangement include:

- When will the swap-over take place?
- What will be the schedule/routines?
- How will the bills and costs be split?

Tax implications

A nesting arrangement requires careful consideration of the tax implications on the sale or transfer of a second property. By way of example, let's consider a family who during the marriage lived in a family home. Ten years prior to the marriage breakdown, a flat was inherited which was rented out. On separation the parties gave notice to the tenant and decided that they would use the flat as a second home, with the children to stay in the family home full time ('the nest') and the parents to take turns to stay in the flat for half of the week. After around a year of 'nesting', the parties agreed that the flat would be sold, the wife would retain the family home 'nest' and the husband would receive the proceeds of sale of the flat. We will consider below what the tax consequences of this arrangement are.

Capital gains tax

What capital gains tax (CGT) is likely to arise on the sale of the flat in this scenario? CGT arises on a gain from the sale or disposal of an asset. In the case of an investment property used as the second home as in the nest scenario, the potential CGT would be calculated by deducting the following from the sale or disposal value of the property:

- the value of the property when it was purchased or acquired (in the case of an inheritance, the value used is the value of the property at the time of inheritance, which will usually be recorded on any inheritance tax forms);
- the cost of any capital improvements;
- the costs of purchase/acquisition; and
- the costs of sale/disposal.

The net sum is the chargeable gain on which CGT may be payable and the following rates of CGT apply to the chargeable gain for residential property:

Tax year	Tax-free annual allowance for capital gains	Basic rate tax *	Higher rate tax
2021-22	£12,300	18%	28%

*If income is within the basic rate tax band (in 2021-22 for income above £50,200), then basic rate tax is paid on the gains up to this threshold, and above that, at higher rate tax.

Transfers between spouses and civil partners in the tax year of separation

Transfers between spouses and civil partners are treated as ‘no gain, no loss’, which means there is no immediate CGT payable on transfers between married and civil partner couples. This treatment continues up to the end of the tax year in which a couple separated. Transfers between spouses and civil partners in the tax year of separation will not trigger an immediate CGT liability. However, the tax due will arise from the date of original acquisition of an asset. For example, if an inherited property in a wife’s sole name is inherited in 2000, but is transferred to the husband in 2021 in the tax year of separation, CGT will not arise at the point of transfer between husband and wife. However, should the husband sell the property three years later, the gains will be calculated from when the wife inherited the asset in 2000. HMRC considers separation to be as defined in a court order, in a formal deed of separation, or in such circumstances that the separation is likely to be permanent, where the marriage or civil partnership has broken down. If the spouses or civil partners live apart in separate houses but the marriage or civil partnership has not broken down, then they will be treated as still living together for CGT purposes.

In the case of an investment property in one spouse or civil partner’s name, it may be worth considering if this should be transferred into joint names (in the same tax year as separation) before sale, because on a later sale, this allows both to utilise their tax-free allowance. In a nesting arrangement, if both parties are going to utilise the second home for some time, it may well make sense to transfer the property into joint names, so that the annual CGT exemption for both parties can be used if the property is sold in the future. An example is:

Value of flat at the time of inheritance	£200,000
Cost of acquisition (solicitors’ costs for the transfer)	£500
Capital improvements (extension)	£50,000

Cost of disposal (solicitors' costs for the transfer)	£600
Value now	£600,000

The calculation of the chargeable gain is as follows:

> *The value at time of acquisition less [cost of acquisition/capital improvements/cost of disposal]*
>
> *£600,000 less [£200,000 + £500 + £50,000 + £600] = £348,900*

If the flat is in the wife's sole name, as a higher rate tax payer she has a potential tax liability of £94,248, without any reliefs, calculated as follows:

> *Gain of £348,900*
>
> *Less annual allowance of £12,300*
>
> *Remaining gain = £336,600*
>
> *Higher rate tax (at 28%) = £94,248*

Transferring the flat into joint names will allow both spouses or civil partners to utilise their annual allowance, ie:

> *Gain of £348,900 x 50% = £174,450 gain each*
>
> *Less annual allowance £12,300 each*
>
> *Remaining gain £162,150 for each party*

Transferring the flat into joint names then gives the following outcome:

> *Tax for wife as higher rate tax payer (at 28%) = £45,402*
>
> *Tax for husband as higher rate tax payer (at 28%) = £45,402*
>
> *Total tax payable = £90,804*

This is a potential tax saving of £3,444 against keeping the property in one party's sole name (assuming no other capital gains in the year, as the maximum tax-free allowance has been utilised in the above calculations for both parties).

There are even greater savings to be made if one party does not earn income or is a basic rate tax payer. In a case where one party does not work and has no income in that tax year, then the first £50,270 (the basic income tax rate limit) of gain will be charged at the basic income CGT rate of 18%, for example the tax payable if the husband had nil income would be:

> *£50,270 (at 18%) = £9,048.60*
>
> *[£162,150-£50,270] (at 28%) = £31,326.40*
>
> *Total CGT for husband = £40,375*
>
> *Tax for wife (higher rate tax payer) = £45,402*
>
> *Total tax payable: £85,777*

To summarise this example:

	Property not transferred before sale; property remains in wife's sole name as higher rate tax payer	Transfer to joint names before sale; both parties higher rate tax payers	Transfer to joint names before sale; wife higher rate tax payer and husband nil other income
Total CGT payable	£94,248	£90,804	£85,777
Tax saving by transfer	–	£3,444	£8,471

Against this needs to be set the legal fees of transfer and there may be some additional costs charged by a mortgage provider to transfer any mortgage from sole to joint names. This outcome may potentially be achieved by transferring just the beneficial interest in the property as CGT is assessed on beneficial ownership rather than legal ownership, although it is worth noting that it may be a term of the mortgage that consent should be obtained for a change of beneficial ownership.

If the CGT is seen as a debt that is to come out of the entirety of the parties' marital pot before division of the remainder, rather than each being responsible for their own tax, then it makes sense to consider transfer before sale to minimise the overall amount payable.

Principal private residence relief

The above examples are without consideration of the principal private residence (PPR) relief that may be available, which may further reduce the tax payable.

In usual circumstances, PPR relief is available for the last nine months of ownership, in circumstances where the property has ever been lived in by an owner, by way of deemed ownership. Section 223(1), Taxation of Chargeable Gains Act 1992 (TCGA 1992) provides:

> *No part of a gain to which [s222, TCGA 1992] applies shall be a chargeable gain if the dwelling-house or part of a dwelling-house has been the individual's only or main residence throughout the period of ownership, or throughout the*

> *period of ownership except for all or any part of the last 36 months of that period.*

Section 222, TCGA 1992 broadly provides for the provision of the disposal of a private residence. It is worth noting that this nine-month period has been reduced over recent years. Prior to 6 April 2020, and after 6 April 2014, the deemed occupation period was 18 months, and prior to 6 April 2014 it was three years. It is unlikely that practitioners will be looking at historical disposals in the divorce context and so the relevant current available PPR relief for deemed occupation is likely to be the last nine months of ownership. If the individual who has left the home has a registered disability, the deemed occupation period is 36 months.

Importantly, a distinction should be drawn between *actual occupation* and *deemed occupation*, which, as above, will be the last nine-month period of ownership if the owner has *ever* lived in the property.

Generally speaking, a person can only have one principal private residence at one time. In a nesting arrangement, actual occupation will be occurring in both the family home nest and the second property. However if no nomination is made, PPR relief will attach to the property which is the main home when looking at the facts of the case. It is likely that in most cases the former matrimonial home will remain the main home for CGT purposes. This is also likely to be the most advantageous option as this property is usually the more valuable property.

If the second home has been purchased within two years of the nesting arrangement, or if it has been transferred to the other spouse to utilise the 'no gain, no loss' rules, then the parties are in time to make an election to treat the second home as their main home for PPR relief purposes. A cost-benefit analysis should be undertaken to determine if this is the most tax-advantageous option.

By way of example, if spouses or civil partners had 'nested' for three years with a family home and an empty investment property and then decided to sell both properties, the PPR relief would apply in full for both spouses/civil partners to the family home. There would be no tax to pay and no reporting requirements on sale. PPR relief would not apply to the second property unless a spouse/civil partner had started to live in that property as their main home to the exclusion of the family home (and met the occupation tests for a degree of permanence and continuous occupation).

How is actual occupation of a residence defined?

It is not necessary for the main residence to be the home in which a person spends most time as long as there is actual and genuine occupation of the property. HMRC will look at whether there has been actual occupation as a question of fact. There is no guidance as to how long a person must live in a property for; it is the quality of the occupation that matters, not the length of time, and HMRC will look at the individual facts and circumstances of each case. The Court of Appeal said in *Goodwin v Curtis (Inspector of Taxes)* [1998] that whether occupation amounts to residence is a question of fact and degree to be resolved by the tribunal in deciding whether 'the nature, quality, length and circumstances' of the occupation qualifies it as residence.

In a nesting arrangement, one party will spend periods of actual occupation in two properties. Whether the parenting arrangements are a division of equal time or otherwise, they will sleep, eat, and spend leisure time in both properties. They will keep clothes and personal possessions in both properties in all likelihood, and generally not just sleep but live in either property. Where actual occupation exists in both properties, HMRC would look at which property was the main home on the facts of the case. In most cases it is likely that the matrimonial home will remain the main home for PPR relief and therefore the absence periods created by the nesting arrangements will remain covered by the relief.

In *Llewellyn v Revenue and Customs* [2013], the appellant's claim for PPR relief was not allowed as he had not met the tests of necessary degree of permanence, continuity or expectation of continuity. The tribunal stated (at para 36) that it was:

> *… prepared to accept [the appellant's] evidence that he took his chair, sleeping bag and kettle… [but] on its own this is not sufficient to show that he had moved into that property as his only residence.*

Is there a time limit on nesting?

The most important factor in nesting arrangements is that there is actual occupation. There is no time limit on how long the arrangement can go on for.

There are various time limits that will usually apply for PPR relief when a person leaves their main residence. In general, if a person returns to the home after leaving, any period of absence up to three years will qualify as deemed occupation. If the individual does not return to the property then, from 6 April 2020, the last nine months of ownership will still qualify for PPR relief. After those periods have expired, no PPR relief may be claimed and CGT may start to accrue (there are special rules which apply if an individual has left the home for work or if they have moved into a care home).

These rules are particularly relevant in cases of divorce after a long separation where one party has for example moved to rental property or to live with a new partner and has not purchased another home. However, there is no cap on a nesting arrangement. The nesting arrangement may go on for several years, and longer than either 18 months or three years, because the nesting parents continue to live in two properties in actual occupation simultaneously.

Is reporting required?

If the former matrimonial home is the property where the nesting arrangement will take place, then no reporting in advance is required. If the parties want to switch the main home to the investment property (and they have owned the property for more than two years), they will need to be able to demonstrate that they consider the investment property their main home and that they no longer consider the family home the main home.

As limited reporting is required, how can practitioners best ensure that their clients will benefit from the of maximum PPR relief? They need to be sure that their client can satisfy the occupation test as detailed above and that their clients are aware they will need to make the choice either presently or at sale. PPR relief is a major feature of the tax tribunals so consideration may also be given to seeking an opinion from a tax expert who should be able to provide a template election form. This would be useful when preparing the computation on the eventual sale of the property, which is the point when the PPR relief would be claimed.

Conclusion

In summary, as a checklist, in a nesting arrangement family lawyers should:

- advise their client to seek specialist tax advice to compare the possible tax outcomes and ensure that the PPR is claimed where it can most benefit;
- be mindful that transfers from sole to joint names may allow basic rate tax bands and double personal allowances to significantly reduce CGT, and flag these issues as ones to seek specialist tax advice on; and
- ensure that the client will benefit from the maximum PPR relief and that there is factual evidence of actual occupation of all properties used in the nest arrangement.

Cases Referenced

- Goodwin v Curtis (Inspector of Taxes) [1998] EWCA Civ 271
- Llewellyn v Revenue and Customs [2013] UKFTT 323 (TC)

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