

Post Death Variations

This month's CPD will examine how a deed of variation can be used as an effective post death estate planning tool, its uses and why it might be advantageous to alter the distribution of an estate after death. In this paper we aim to provide practical knowledge to allow the will writer to advise on this topic.

WHAT IS A VARIATION?

An instrument of variation, often referred to as a 'deed of variation' or 'deed of family arrangement' is a device used by a beneficiary to alter the distribution of a deceased person's estate. A variation allows a beneficiary to rearrange or redirect the interest that came to him originally from the deceased's estate. This interest may have arisen under the terms of the deceased's will, intestacy or through survivorship. The beneficiary effectively transfers some or all of the interest they have inherited to another.

WHY MAKE A VARIATION?

There are a number of reasons that a beneficiary may wish to redirect assets they are entitled to, but they can be placed into two main categories:

1. To provide for someone else whose needs are greater
2. To save tax (particularly IHT)

A beneficiary who does not wish to take the interest he is entitled to from the estate is free to disclaim provided they have not already accepted the gift. If they were to disclaim though they would have no control over where the interest would pass instead. If they disclaim then the interest will pass to the next entitled under the deceased's will or intestacy, as though the person disclaiming had predeceased. If the beneficiary wishes to make sure that their interest passes to someone in particular they must complete a deed of variation.

An alternative to a deed of variation would be to accept the gift and pass it to the person they would prefer to receive it. This would not be good planning from a tax perspective though, as the original beneficiary would be making a PET. This would have adverse tax consequences for them if they died within the following 7 years. This would also be a disposal for capital gains tax (CGT) purpose and there may be a charge to CGT on any increase in value from the date of death to the date of disposal.

The same tax rules apply if they were to disclaim the gift; they would be treated as making a transfer of value despite never having actually received anything.

These unfavorable tax consequences can be avoided by the provisions of s142 Inheritance Tax Act 1984 and s62 Taxation of Chargeable Gains Act 1992. This legislation provides that any variations made within 2 years of the deceased's death are treated for IHT and CGT purposes as though the deceased had made them himself. There are additional requirements that must be complied with that will be covered later.

If the deed of variation is used to redirect assets from a beneficiary who is non-exempt for IHT purposes to one who is, for example from a child of the deceased to their surviving spouse, then the amount of IHT the estate will pay will be reduced. The effect of a deed of variation then is to write back the provisions of deceased's will or intestacy for tax purposes. The IHT on the estate is then charged on the basis of the amended provisions, and the beneficiary suffers no adverse tax consequence.

REQUIREMENTS FOR A DEED OF VARIATION TO BE EFFECTIVE

The deed of variation must meet various requirements in order to be effective for tax purposes. These requirements are found in s142 IHTA 1984 and s62 TCGA 1992 referred to previously, and have also been helpfully laid out by HMRC in their 'Instrument of variation checklist' form IOV2. Though often referred to as a 'deed of variation' it doesn't have to be done by formal deed. It must be in writing and comply with all of the below requirements:

1. The variation must be completed within 2 years of the date of the deceased's death.
2. Any beneficiaries under the will or intestacy who will be left worse off by the variation must agree to the changes. If a beneficiary is a minor or under a disability that makes them unable to consent then the court must consent to the variation on their behalf. It is not acceptable for the parents of a minor to consent on their behalf. *
3. The variation must clearly state which parts of the estate are being varied and who will benefit from the variation.
4. If the destination of stocks, shares or marketable securities are being varied the variation must contain a Stamp Duty certificate.
5. The variation must state that the parties signing the variation intend it to take effect for tax purposes, including the appropriate statutory references. (s142 IHTA 1984 and s62 TCGA 1992). It is possible to state that they only intend the variation to be effective for IHT or CGT rather than both.
6. The same assets cannot be redirected by variation twice. It is important to get the variation right the first time as mistakes can only be put right with the courts intervention. The courts will only agree to rectify a variation on the basis that it doesn't carry out all parties' true agreement if the supporting evidence is '*strong and irrefragable*' (*Larke v Larke* [1989] STC 865).
7. If the variation passes a legacy to a charity, then that charity will need to be notified of redirection of assets to them. Evidence of the notification will need to be provided to HMRC, but the charity does not need to sign the variation. If the charity are not notified of the legacy then the variation can't be backdated for tax purposes.
8. A variation cannot be effective for tax purposes if the beneficiary who is redirecting their interest is compensated for their loss with assets bought in from outside the estate (see *Lau v HMRC* [2009] STC (SCD) 352). Beneficiaries are permitted to 'exchange' their respective interests under the will however.

9. Where a variation changes the amount of IHT that is payable it must be sent to HMRC within six months of making the variation. The executors or administrators must also sign the variation.

10. Any beneficiaries of a person who has died may make a variation that changes that person's entitlement from an earlier death. The variation must meet all of the same conditions.

* The courts have a power to consent to a variation under the Variation of Trust Act (VTA) 1958. They may consent on behalf of beneficiaries who are minors or mentally incapable. These powers are wide enough to permit the variation of beneficial interests whether they are vested, contingent or discretionary, but it will exercise the powers only where the proposed arrangement is for the benefit of the beneficiary.

EFFECT

The variation allows the beneficiary opportunities to redirect their entitlement to other beneficiaries. These other beneficiaries don't have to be already entitled under the deceased's will or intestacy, it is possible to introduce new beneficiaries.

It is also possible to create a settlement using a deed of variation. The effect of this is that the deceased is treated as the settlor for IHT purposes, and not the person making the variation. The reservation of benefit rules do not apply to the person making the variation as for IHT purposes they are not making the transfer.

If the variation is not used to redirect the property among the family it will often be used to provide charitable payments to attract IHT exemptions.

Although a variation will be effective for IHT and CGT purposes the lack of 'writing back' provisions for income tax can cause difficulties where the original beneficiary wants to vary in favour of their own minor children. These income tax difficulties are considered later in this paper.

Inheritance Tax:

The effect on the IHT liability of the deceased's estate will depend on several factors, for example whether the original or new beneficiaries are exempt. There may be no change, there may be a reduction in IHT or there may be an increase in IHT.

The below examples shows how this works in practice:

Robert dies leaving his £500,000 estate to his wife Jennifer. Jennifer decides to give this to their children.

1. Without a statement that section 142 is to apply:

- a) IHT on Robert's death is nil as the estate benefits from the spouse exemption.*
- b) Jennifer makes a PET and providing she lives 7 years there will be no IHT on this transfer.*

2. With a statement that section 142 is to apply

- a) Recalculate IHT in Robert's estate of £500,000. £325,000 passes free of IHT as his full NRB was available. No RNRB as there was no property. This leaves a taxable estate of £175,000, and £70,000 IHT to pay. (£175,000 @40%= £70,000).
- b) Jennifer avoids making the PET

Capital Gains Tax:

If the original beneficiary makes a disposal for CGT purposes to a new beneficiary there may be a gain or a loss if the asset has increased or decreased in value since the date of the deceased's death. Therefore the new beneficiary will be treated as acquiring the asset at market value at the date of the disposal. If the gain is small it may be covered by the original beneficiary's annual exemption. If the original beneficiary has losses available, these will offset the gain. In neither case will any CGT be paid.

If a deed of variation is carried out there will be no disposal by the original beneficiary and no question of any liability to CGT. The asset will be treated as passing from the estate of the deceased to the new beneficiary direct. The new beneficiary will be treated as acquiring it at market value at the date of death.

Again let's consider how this works in an example

Example 1: Same facts as the previous example. Assume that the £500,000 estate includes quoted shares that have increased in value by £9,000 since Robert's death. Jennifer is not going to make any disposals in this year.

1. Without a statement that section 62 is to apply:

- a) CGT on Robert's death is nil.
- b) Jennifer makes a disposal with chargeable gains of £9000. This is covered by her annual exemption so Jennifer pays no CGT.
- c) The children acquire the shares at the higher current value.

2. With a statement that section 62 is to apply:

- a) CGT on Robert's death is nil.
 - b) Jennifer makes no disposal and pays no CGT.
 - c) The children acquire the shares at the lower value at the date of death.
- In this situation, Jennifer should not make a variation for either IHT or CGT purposes.*

Example 2: Assume in the above example that the £500,000 includes quoted shares that have increased in value by £20,000 since death. Jennifer has already made several disposals showing gains of £9,000 in this year.

1. Without a statement that section 62 is to apply

- a) CGT on Robert's death is nil.
- b) Jennifer, makes a disposal with chargeable gains of £20,000. This is added to her other gains in the year, and the total exceeds her annual exemption so she will pay CGT.
- c) The children acquire the shares at the higher current value.

2. *With a statement that s62 is to apply:*

- a) *CGT on Robert's death is nil.*
- b) *Jennifer makes no disposal and pays no CGT.*
- c) *The children acquire the shares at the lower value at the date of death.*

In this situation, Jennifer makes a variation for CGT purposes but not for IHT purposes.

Income Tax:

There are no income tax provisions equivalent to the IHT and CGT provisions where a variation or disclaimer has been made. Income received before the variation or disclaimer from the property that is varied will be taxed as the income of the original beneficiary. This will apply even if the beneficiary has specifically given up all income from the property since the date of death. For example, if the original beneficiary by variation redirects a specific legacy of shares he remains liable to pay any income tax on dividends paid before the variation.

In most cases, once the rearrangement has been made the original beneficiary ceases to be liable to pay income tax on income produced after the variation or disclaimer. The new beneficiary becomes liable for income tax on income produced by the property concerned. However the position will be different where the new beneficiary is the minor child of the original beneficiary. In such cases the parent will remain liable for income tax on the income even though he does not enjoy it or own the property which produces it. The reason is the income tax anti-avoidance provisions. These are of general application and can apply to pre-and to post death arrangements.

If the variation creates a settlement for income tax purposes from which the original beneficiary may continue to benefit he will still be liable to pay income tax on all the settlement income. To avoid this, the variation must be drafted to exclude the original beneficiary and their spouse or civil partner from all enjoyment from the property which had been redirected, and its income.

The original beneficiary may still be caught by the anti-avoidance rules and so still be liable to income tax on the income produced by the property subject to the variation if their minor children are included as beneficiaries and the income is paid for their benefit and not accumulated.

If the anti-avoidance provisions apply, they will cease to do so once the children have reached their majority or have married; from then onwards their parents will no longer be taxed on the settlement income.

TRUSTS

A common query is whether interests under a discretionary trust can be varied. Technically the beneficiaries of a discretionary trust could vary the destination of property left to a discretionary trust provided they all agreed and they are all adults with capacity. In reality this is rarely the case though, as there will often be minor, unborn or unascertained beneficiaries making a variation impossible. In these cases the trustees could instead make an appointment out of the trust within 2 years of the testator's death. This will be 'read back' into the will and treated as a disposition made by the deceased due to the effect of s144 IHTA 1984.

Property in which the deceased had an interest in possession in immediately before their death, for example where they were the life tenant of a PPT, cannot be the subject of a deed of variation. Although this type of interest forms part of the deceased's estate on death for IHT purposes it cannot be varied for tax purposes as the definition of 'estate' in s142 IHTA 1984 specifically excludes it.

CONCLUSION

The deed of variation is a useful estate planning tool that permits a beneficiary, in the correct circumstances, to vary the deceased's will or the rules of intestacy to alter the distribution. This can be to benefit those who they would rather benefit over themselves, or to make the distribution more tax effective. In all cases where a deed of variation is being considered it is important to consider the implications for IHT and CGT, as well as the income tax consequences especially where minor beneficiaries are involved.