

Varying variation

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Private Client analysis: What does the future hold for deeds of variation (DoV) following the Chancellor's pledge to review their use? Helen Downes, partner in the private client team of Geldards LLP and member of the Society of Trusts and Estates Practitioners, considers the history of DoVs and the risks of removing such mechanisms.

Background

In the Budget 2015 speech delivered to the House of Commons on 18 March 2015, the Chancellor made a number of announcements in relation to tax avoidance. Among those, he announced that HM Treasury will conduct a review on the avoidance of inheritance tax through the use of deeds of variation. The Chancellor said HM Treasury will seek a wide range of views and a report is promised by the autumn. The announcement is confirmed in section 2.91 of HM Treasury's Red Book (page 79).

What is the significance of the announcement that DoVs will be subject to a review?

Apparently Ed Miliband is said to have used a DoV on a property, which could have reduced his and his brother David's inheritance tax (IHT) exposure. Mr Miliband has pointed out that no tax was avoided at any point. At the moment, IHT is levied at the rate of 40% on the value of all estates over the nil rate band (NRB), currently £325,000, with married couples and registered civil partners having a combined threshold of £650,000 at current rates. There are a number of devices that can be used to mitigate IHT such as making a lifetime gift of property to intended heirs--the result is that so long as the donor lives for at least seven years after making the gift (and does not fall foul of the gift with reservation of benefit rules) then IHT is avoided completely. A DoV is another tool that has been used for tax planning.

How have DoVs traditionally been used in the UK?

A DoV can be used by a beneficiary to redirect some or all of his or her inheritance to another person. Parents who are due to receive an inheritance from their own parents may elect instead to redirect it using a DoV. Common substitute beneficiaries under a DoV are children, grandchildren and charities.

Consider this scenario. A beneficiary inherits under a deceased person's will and as the deceased's estate exceeds the NRB, IHT at the rate of 40% has been paid. The beneficiary then dies leaving his or her own estate in excess of the NRB. The beneficiary's estate will also be subject to a 40% IHT charge. In effect, there will be a double charge to inheritance tax. In these circumstances a beneficiary may decide to enter into a DoV of the deceased's person's will (or indeed to vary his or her entitlement on intestacy) so that his or her share can pass to a child, charity or other beneficiary in substitution.

Amendments made to a will or to the intestacy rules by a DoV are treated for IHT purposes as though they were made by the testator and not by the beneficiary. This means that if the beneficiary dies within seven years of the variation, the gift will not be a potentially exempt transfer and will therefore not be bought back into the original beneficiary's estate for IHT purposes.

For a DoV to be effective for IHT purposes, there are certain requirements that must be met:

- o the DoV must be executed within two years of the date of the testator's death
- o correct tax declarations for IHT and capital gains tax must be included on the DoV
- o there must not have been any consideration given as an inducement to any beneficiary that executes a DoV
- o a beneficiary cannot change the destination of an asset more than once, and
- o every actual or potential beneficiary affected by the alteration to his or her detriment must agree to and sign the DoV

A DoV can be executed before or after the grant of representation is issued and it is only where IHT mitigation is of relevance that the two year time limit applies.

Are there genuine concerns that deeds of variation are being misused?

The legacy materials on this all appear to point in the opposite direction.

The Variation of Trusts Act 1958 (VTA 1958) introduced a mechanism that allowed trusts to be varied and for the sanction of the court to be sought for their variation. VTA 1958 accepted the recommendations of the sixth report of the Law Reform Committee (Cmnd 310, 1957) chaired by Lord Justice Jenkins. At para 16 of the report it says:

'It appears to us that the legislature, while taking great care to prevent anyone from escaping payments of taxes or duties by methods of which it disapproves, has shown no interest of adopting a policy of preventing the freer circulation of money and its division between the members of a family....'

The Royal Commission on Taxation of Profits and Income (Cmd 9474) said this at para 1017:

'The treatment of tax avoidance in the United Kingdom would present much less difficulty if it were possible to assert as a matter of general principle that a man owes a duty not to alter the disposition of his affairs so as to reduce his existing liability to tax...But there is no such general principle, and we are satisfied that it neither could nor ought to be introduced.'

How will the announcement around deeds of variation affect advisors who might be considering assisting clients in using a deed of variation?

We are promised a consultation by HM Treasury and a report by the autumn. We don't know who will form the government after the May 2015 general election or what its priorities will be. If there is a real risk that DoVs may be abolished or their effectiveness for mitigating IHT impugned, then the prudent course would be to execute a DoV sooner rather than later, bearing in mind, of course, that future legislation may be declared to be retrospective in any event so that a DoV made ahead of any legislative changes might still fail to achieve its purpose. It is not clear what proposals will appear in the autumn 2015 report on existing DoVs. Any consultation on this will need to be scrutinised and representations will need to be made to HM Treasury before any report is finalised.

What would be the significance for practitioners if DoVs are abolished or their use is restricted?

A DoV is not just a tax planning device. It can ensure that an estate passes to the right beneficiaries where there is no existing will or where family circumstances have changed. For example, where a person dies intestate, a DoV could ensure that his or her surviving spouse or partner can remain in the family home.

It is estimated that over two thirds of people haven't made a will. A DoV can prove to be a lifeline for a testator's heirs. It will be important that any IHT anti-avoidance measures in the autumn paper don't seek to remove this. Something that has been around for generations to enable the straightforward handling of deceased estates is now being questioned unfairly as a mechanism for tax avoidance.

If legislation is enacted in general terms which restricts the power to vary deceaseds' estates, then the unintended consequences could be wide-ranging.

Interviewed by David Bowden.

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