

Varying variation--the future of DoVs

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Private Client analysis: Are deeds of variation (DoVs) being wrongly dragged into the battle against tax avoidance? Helen Downes, member of the Society of Trusts and Estates Practitioners and partner in the private client team of Geldards LLP in Cardiff, comments on the consultation around the use of DoVs for tax purposes and what the future might hold for this established estate-management tool.

Original news

Consultation on use of deeds of variation for tax purposes, LNB News 15/07/2015 68

HMRC is inviting representative bodies and individuals to submit evidence by 7 October 2015 via an online questionnaire on their use of DoV for tax purposes, with a view to better understanding the circumstances in which they are used and whether any changes are needed to the current capital gains tax (CGT) and inheritance tax (IHT) rules. This consultation is only on tax implications. The use of DoVs as an instrument is a matter for the Ministry of Justice and not HM Treasury.

What is the significance of the review?

In the run-up to the election, it was reported that Ed Miliband was said to have used a DoV on a property, which could have reduced his and his brother's inheritance tax 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.

HMT says that any deeds made on or after 1 August 2002 only have to be delivered to HMRC where they result in a change to the amount of tax due. It claims that HMRC has limited information about the use of DoVs. HMT says the purpose of the review is to obtain views about the use and effect of these instruments to gain a better understanding of them and to inform its review. Its questionnaire has been designed with the aim of understanding what role the tax advantages play when a decision is made to vary a will by a DoV.

Is it surprising that DoVs are only being reviewed for tax purposes rather than as a legal instrument?

There are clear legacy materials in relation to trusts that point in the opposite direction to what HM Treasury appears to want to do from a revenue perspective.

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 (Cmd 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.'

What are the issues around DoVs that have sparked this review?

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, inheritance tax 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 CGT 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.

How might this review affect the current approach to DoVs?

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.

Should lawyers be taking any action at this stage in the advice they are giving to clients?

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 deceased's estates, then the unintended consequences could be wide-ranging. Individuals intending to enter into DoVs prior to publication of HM Treasury's report, while not being discouraged, ought to be advised to proceed with caution. Of course, the question mark over the long term future of DoVs underlines the importance of having a comprehensively drafted will in place.

Interviewed by David Bowden.

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