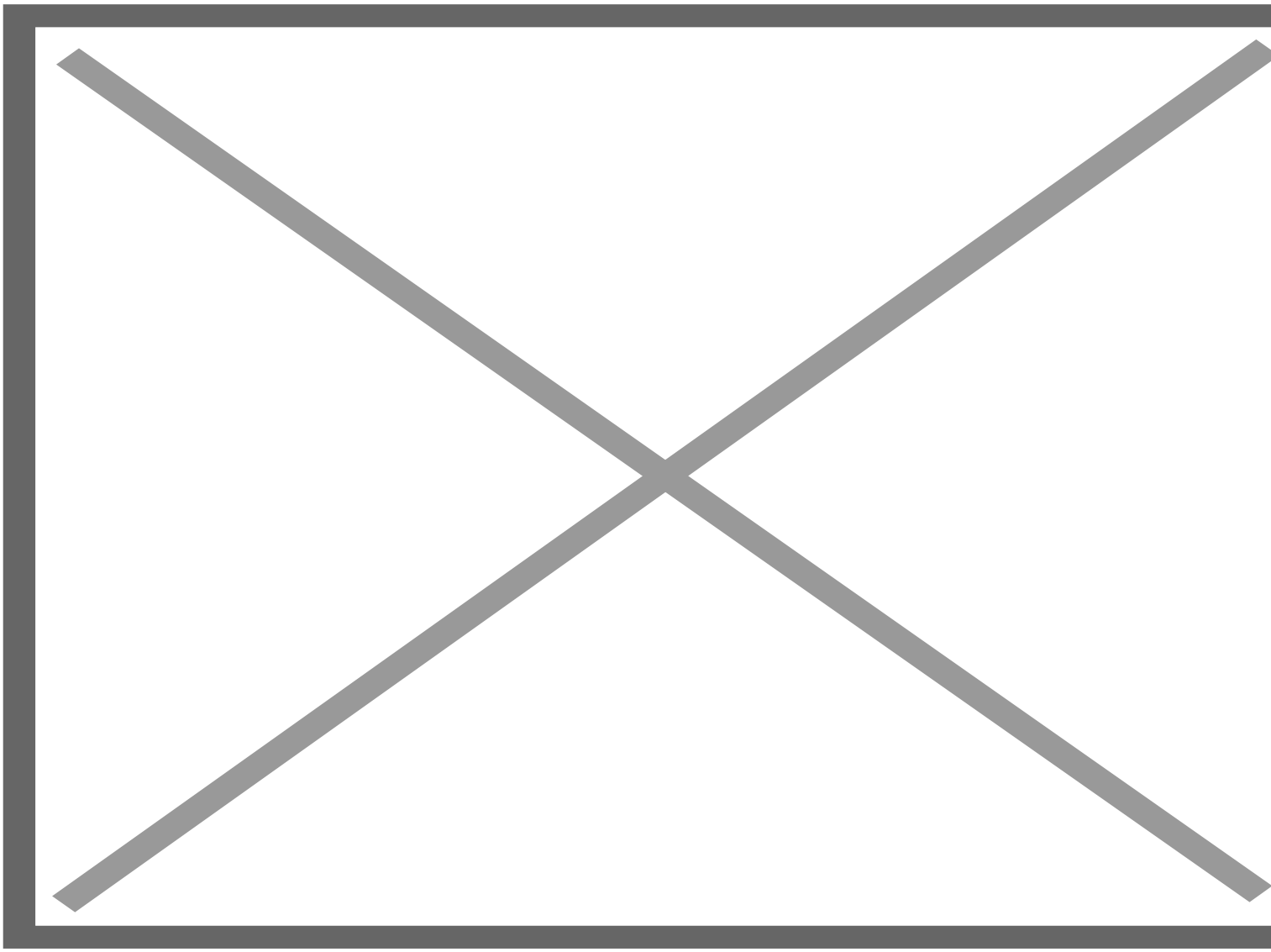
Emotional distress

Inheritance tax and trusts



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Carolyn Bagley examines the use of deeds of variation and the case against their abolition

Key Points

What is the issue?

Deeds of variation are being reviewed this autumn and may be abolished. Should we oppose abolition of this relief? IHT raises £3 billion for Treasury coffers; doubtless any government would like this to increase further

What does it mean for me?

If this relief is abolished, clients will need more complex (and expensive) wills and advice, and will need to review them more regularly. For those who cannot afford this, or are unaware of the consequences, their estates will pay more tax, and for some families emotional distress is likely to increase

What can I take away?

The reasoning behind variations and s 144 trust appointments, using practical examples, and the ethical differences between them

On 19 March the chancellor announced a review of deeds of variation in his crackdown on tax avoidance. Deeds of variation (or deeds of family arrangement) are a binding method for a family to rearrange, after a death, who inherits. A beneficial interest, inherited after a death, is redirected by the beneficiary to someone else. So, in essence, a variation is a gift from the original beneficiary to the new one within two years of death.

What is special about these gifts? IHTA 1984 s 142 provides an election to avoid the normal inheritance tax (IHT) and capital gains tax (CGT) rules which otherwise apply to gifts. In effect, the gift is treated as if made under the will or intestacy.

Surprisingly often, advisers forget a variation is just a gift without tax consequences. Mistakes are made when it is misconceived as changing the will. The variation cannot change purely administrative powers, or executors, or give something away that has ceased to exist. It cannot correct a defective will, but it is a useful tool for IHT planning, for flexible family protection, and sometimes for righting wrongs. Variations are notorious sources of litigation and negligence claims.

Intestacy

Joe dies without a will, leaving a widow, son, and £1.5 million, including the family home worth £1 million. Under intestacy rules, Joe's widow inherits £975,000 (£450,000 and half of the rest), so she does not receive the whole of the family home. The son inherits the rest, but that exceeds the nil rate band (NRB) of £325,000 and so IHT would be payable.

The son has no wish to pay IHT earlier than necessary and wants to provide for his mother. He executes a variation to redirect (gift) his inheritance to his mother. Using IHTA 1984 s 142, he elects for his gift to be taxed as if his father had made a will leaving everything to his widow. Consequently, even if the son does not outlive his gift by seven years, it will not form part of his taxable estate on death and he makes no disposal, so no CGT is due even if assets have increased in value between death and variation.

Generation skipping

A widow dies, leaving everything to her son. He is wealthy and concerned the inheritance will remain unused until he dies, when it will suffer 40% IHT before passing to his daughter. He executes a variation to gift the inheritance to his daughter. The son makes the gift, but for tax purposes it is treated as if it were made by his mother's will, so neither IHT nor CGT is due.

Gift with reservation (GWR)

Variations under IHTA 1984 s 142 are uniquely free of GAAR restrictions, so allowing us to 'have our cake and eat it' when gifting'. The original beneficiary redirects his inheritance into a discretionary (relevant property) trust under which both he and others, such as his family, are potential beneficiaries. He successfully removes the inheritance from his own taxable estate, potentially saving 40% IHT on his future death, yet at the same time he can still access the inheritance. If the sum varied is under the NRB, there may never be any future IHT on that inheritance. It is also useful for beneficiaries who cannot make their decision within the relevant two-year period and in effect buy more time by varying into a trust. The cost implications generally preclude sums under £100,000.

Appointments from a relevant property trust

IHTA 1984 s 144 provides a similar benefit to s 142. Where an appointment from a discretionary will trust is made within two years of death, the trustees can elect for the asset to be treated, for IHT and CGT purposes, as if it had always been left in the will directly to the new beneficiary. The flexibility of a discretionary trust will can thereby be combined with tax efficiency, making this type of will very effective and cost-efficient for those with complex family or financial situations.

Discretionary trust wills, using a s 144 appointment, help:

- balance foreign forced heirship, or lifetime gifts;
- protect disabled, or vulnerable, beneficiaries by enabling the trust wording to be the most advantageous available at the date of death; and
- enable tax-efficient distribution of complex business and farm assets, using the benefit of hindsight about values, relief eligibility and family circumstances.

Section 144 is also used to unwind NRB discretionary trusts in wills made before the availability of transferable NRBs. Currently, many choose to leave their will unaltered, knowing their heirs have the option to unwind the trust within two years of their death. If s 144 is abolished, what of those who are unaware or have lost mental capacity to update their will?

What can be varied?

- Absolute entitlements. A simple legacy or outright share in the residuary estate.
- Life interests. This avoids trust property being aggregated with the free estate of the life tenant. This cannot be done after the death of the life tenant, because by then the interest has ceased to exist. However, if the life tenant dies before taking any benefit from the life interest, then life tenant's executors can 'disclaim' (reject the inheritance) on the life tenant's behalf. The disadvantage of a disclaimer is that you cannot choose who inherits the disclaimed asset.
- Reversionary interests. For example, in the case of a life interest to a widow with reversionary interest to her son, the son knows he will not need his interest and so varies (gifts) it to his daughter. Reversionary interests are excluded assets for IHT, so this does not need a variation for IHT purposes, but the variation election prevents CGT complications.
- Assets owned as beneficial joint tenants. These pass not by the will but by survivorship. It isn't the will that is varied, but ownership of an inherited asset, irrespective of whether that inheritance is by will, intestacy or survivorship.
- Assets already sold. This is because it is the original beneficiary's entitlement to an asset that is redirected rather than the asset itself. Ideally, the variation recites the sale and the proceeds, which are being redirected in effect. The sale is retrospectively treated as made by the executor or beneficiary only as a nominee for the new beneficiary.

- Assets when the original beneficiary has subsequently died. Re-direction of the first estate can be made by the executors and beneficiaries of the second estate.

Double dipping

Don’t rush into a variation. If you get it wrong the first time, that same asset cannot be varied again. The original beneficiary does not get two bites of the cherry.

There can, however, be a double reading-back, through combining s 142 (variations) with s 144 (appointments out of discretionary trust). A discretionary trust might limit the beneficiaries to the widow and issue, but s 144 can be used to appoint an asset from the discretionary trust to the son, who then uses s 142 to redirect the asset to his partner.

Abolition

The 1989 Budget announced variations would be outlawed, however, the government backed down after it was highlighted that variations were often used to correct situations by the less well off, or unsophisticated, who have not taken advice from a solicitor beforehand. But is the current political climate different? Multiple tax avoidance ‘scandals’ include Ed Miliband’s legitimate use of variations.

Gifts by variation are made in that format purely for tax benefits, so it can be argued variations are used for ‘tax avoidance’. However, the use of discretionary trust wills, intended to be varied using s 144, are also, even primarily, for family protection purposes.

In the HMRC manual, variations are a separate sub-section to disclaimers, or to s 144 distributions from relevant property will trusts, or to precatory trusts. However, will the review differentiate? Until we know, solicitors can only continue to advise that in many cases the best solution is a discretionary trust will, with a view to ‘varying’ it after death.