# CHAPTER 18

# DEEDS OF VARIATION & DISCRETIONARY WILL TRUSTS

## 18.1 Variations & Disclaimers

IHTA 1984, s. 142

If a beneficiary receives a disposition either under the will or under the rules of intestacy, he or she is **under no legal obligation to accept** the bequest, and may instead disclaim the gift. If a bequest is relinquished by way of a formal disclaimer, the asset **thereafter passes to the person entitled to the residue of the estate** – i.e. the residuary legatee. If a gift of residue is disclaimed, it divests under the rules of intestacy.

A disclaimer cannot be made if the original beneficiary has already received some benefit from the property being disclaimed. For example, if an individual is left shares under a will and has received some dividend income on those shares, no formal disclaimer can be made in respect of that property.

If a beneficiary does not wish to accept a gift but **instead wishes the property to pass to a nominated person**, this can be achieved by using a Deed of Variation. This differs from a disclaimer in that the **person making the variation will stipulate the new recipient within the Deed**. Only persons relinquishing an interest in an estate may make a variation. In practice, Deeds of Variation are more common than disclaimers.

## 18.2 Conditions

Certain conditions must be satisfied for a valid disclaimer or Deed of Variation to be made; i.e.

- it must be in writing (usually it is made in the form of a Deed, although this is not strictly necessary); and
- it must be signed by the person making the variation or disclaimer; and
- the instrument must be signed no later than 2 years from the date of death.

The Executors or Personal Representatives must consent to the variation if it results in **more inheritance tax becoming payable**. This would be the case, for example, if an exempt beneficiary such as a spouse or charity gave up their right to an asset, and that property thereafter passed to a chargeable beneficiary.

The Executors can refuse to give consent if there are insufficient assets left within the estate to cover the additional tax.

IHTA 1984, s.142(2A)

If additional inheritance tax is payable, the variation must be sent to HMRC within 6 months of it being made.

IHTA 1984, s.218A

## 18.3 Tax effects of a variation

Assume Mr X died on 1 January 2010. In his will, he left a house by specific gift to a chargeable beneficiary, Miss Y.

Miss Y decided that she did not want to accept the gift, and instead entered into a Deed of Variation. For the Deed to be valid, it must be signed within two years of Mr X's death, i.e. by 1 January 2012. Under the variation, Miss Y directed that the property should pass to a new beneficiary, Mr Z.

The effect of the variation is that **Miss Y has given away a house to Mr Z**. If a beneficiary gives up an interest in property by way of a disclaimer or variation, this is treated as a **transfer of value for inheritance tax purposes**. In this instance, as the new recipient is another individual, the gift by Miss Y to Mr Z is a potentially exempt transfer.

Similarly, this gift is treated as a **disposal by Miss Y for CGT purposes**.

Disposal proceeds are equal to the market value of the asset at the date of the gift. Miss Y's base cost will be the value of the asset at the date of Mr X's death – i.e., the probate value. A gain will only arise therefore if the house has **increased in value between the date of death and the date when Miss Y made the variation**. Therefore if variations are made within a short period after the date of death, there is unlikely to be a substantial CGT liability.

## 18.4 IHT statement under S.142 IHTA 1984

The fact that Miss Y has made a PET at the date of the variation is a significant problem, because if Miss Y dies within 7 years of the gift to Mr Z, the PET will become chargeable and tax will be payable by the donee (Mr Z). This problem can be alleviated by including a statement in the variation under s.142 IHTA 1984, that the variation has effect under that section.

If Miss Y includes a s.142 statement, the effect of the statement is that **the transfer of value made on the Deed of Variation is disregarded**.

In the example above, Mr X died leaving a property in his will to Miss Y. Miss Y thereafter made a Deed of Variation such that the property passed to Mr Z. Normally this would be a transfer of value for IHT purposes, but if Miss Y includes a S.142 statement in the variation, we disregard the transfer of value for inheritance tax.

Miss Y will **not therefore be deemed to have made a potentially exempt transfer**.

Effectively a S.142 statement **re-writes the will for inheritance tax purposes**. For IHT, the variation has the effect of pretending that in his will, Mr X left the property directly to Mr Z.

The availability of variations when a statement is included under S.142 means that the window of opportunity for IHT planning does not necessarily shut on the death of a taxpayer. By sensible use of variations, beneficiaries can effectively change the will after death to possibly save IHT and/or CGT.

## 18.5 The effects of "consideration"

Under S.142(3), **a variation will be ineffective for IHT purposes if it is made "for money or money's worth**". Therefore if a person (Mr A) agrees to enter into a Deed of Variation in favour of another person (Mr B), no S.142 election can be made if Mr B makes a payment (by cash or other monetary means) to Mr A in return for the variation.

**Illustration 1**

Fred dies leaving his antique vase (worth £50,000) to his sister Janice. The residue of the estate was left to his wife (Ruth) and his children in equal shares.

Ruth regarded the vase as something of a family heirloom and agreed to buy it back from Janice for £50,000. Janice duly entered into a Deed of Variation under which the vase passed to Ruth. Ruth duly paid Janice £50,000 in return.

In this instance it is **not possible for Janice to make a statement that S.142 is to apply**, because the variation was made for money or money's worth. Therefore **the variation does not rewrite Fred's will**. The transfer of the vase in Fred's will is **not therefore deemed to have been made to Ruth and does not therefore qualify for the spouse exemption**.

Assuming that the amount paid by Ruth to Janice for the vase is a fair reflection of its market value at the date of the transfer, there is no loss to Janice's estate (and therefore no PET).

However, S.142(3) goes on to say that "consideration" in this instance does not include "making a variation or disclaimer to which this subsection applies".

Therefore if two beneficiaries of an estate wish to "swap" assets by means of variations in favour of each other, there is no "consideration" and S.142 elections can be made.

**Illustration 2**

Owen died leaving a house worth £500,000 to his son, Jason, and the residue of the estate to his wife, Eileen. The residue included Owen's shares in Fairfield Builders Ltd, an unlisted building company in which Owen and Jason worked.

As the shares are wholly covered by BPR, the spouse exemption is wasted. Therefore, Jason and Eileen decide to swap assets such that the house passes to Eileen in return for the shares in Fairfield Builders Ltd which pass to Jason. Both Eileen and Jason make variations to this effect.

In both cases, **S.142 elections can be made** to accompany the variations as there is no "consideration" deemed to have been paid. S.142 therefore rewrites the will for IHT purposes. The gift of the shares to Jason is covered by BPR and the gift of the house to Eileen is covered by the spouse exemption.

## 18.6 *CGT election under S.62 TCGA 1992*

IHTA 1984, s. 62

Under normal circumstances, a variation by the donor is a **disposal at market value for CGT purposes**, and could leave the donor with a CGT liability. This can be alleviated by including a statement under S.62 TCGA 1992. This works in a similar way to S.142 for inheritance tax in that it **disregards the disposal at the date of the variation**.

Going back to the example in 18.4, Miss Y gives up a property which in turn passes to Mr Z. This would normally be a disposal at market value by Miss Y at the date of the variation. However if Miss Y includes a statement in the variation under S.62, we **disregard the gift for CGT purposes**. Therefore by including a S.62 statement, the CGT effect of the disposal to Mr Z can be ignored.

Instead, for CGT purposes, **Mr Z is deemed to have acquired the assets directly from Mr X under the terms of the will**. For capital gains tax purposes, Mr Z is deemed to have acquired the asset at the date of death, with a **base cost equal to the asset's probate value**.

Including statements under S.142 or S.62 are not mandatory. For example, it may be in Mr Z's interest for Miss Y **not** to include a CGT statement. If no statement is included, Mr Z acquires the asset with a base cost equal to **its value at the date of the variation**. Miss Y will have a corresponding capital gain. However, in many instances, Miss Y's capital gain will be small and may be covered by her annual exemption. If this is the case, it will be worth Miss Y **not** including a statement under S.62 and leaving Mr Z with a slightly **higher** base cost.

## 18.7 Post death planning using variations

1) Estate to spouse

Post death planning using variations used to be particularly useful where the deceased has left his entire estate to his surviving spouse.

For example, if a husband leaves his entire estate to his wife, the whole of the transfer of value is exempt and there is no inheritance tax. This assumes that the recipient spouse is domiciled in the UK. Whilst having no IHT to pay seems like sensible tax planning, the effect of drafting a will in this way was to **waste the nil band**, and to **leave the surviving spouse with a substantial estate**, the whole of which will be charged to IHT when she dies.

To alleviate this problem, the wife would enter into a Deed of Variation so as to leave an amount **equal to the nil band to chargeable beneficiaries** (e.g. her children).

On making the variation, the wife would include a statement for IHT under S.142, so that the gift to the children is **deemed to have been made by the deceased.**

The effect of the variation was to **increase the chargeable estate from zero to the value of the nil band at the date of death**. Assuming the deceased made no lifetime transfers, the chargeable estate was fully covered by the nil band and no tax was payable. What has been achieved here is to **remove an amount equal to the nil band from the estate of the surviving spouse** for IHT purposes. Therefore when the wife dies, a much smaller amount would be charged to Inheritance Tax.

**The introduction of the transferable nil rate band has made the need for a Deed of Variation redundant** in many cases.

There will however, still be circumstances when the use of a Variation will be useful.

For example, assume Mrs X dies in 2010 and leaves her estate to her husband, Mr X. Mr X's estate will benefit from the transfer of Mrs X's nil rate band on his eventual death.

Suppose Mr X subsequently marries Miss Y in 2011 Mr X then dies in 2012, leaving his entire estate to Miss Y. This will be fully exempt. However, only one nil rate band will be transferred to Miss Y. The amount originally transferred to Mr X from his first wife will be wasted.

In order to avoid this, Mr X needs to have left part of his estate to chargeable beneficiaries. This could be done by a Deed of Variation within 2 years of the death of his first wife.

2) Business property

Assume Mr A dies leaving a specific legacy of cash to his son and the residue of his estate to his wife. The residue included shares in Mr A's unlisted trading company.

In this instance, the spouse exemption will be wasted as the IHT value of the shares will be wholly covered by 100% BPR anyway. It would have been better from a planning perspective to have left;

a) the non-business property to the wife (covered by the spouse exemption); &

b) the business property to the son (covered by 100% BPR).

Leaving business or agricultural property to an exempt beneficiary will waste relief.

This can be solved by using a Deed of Variation under which;

1) the wife gives her shares to her son; &

2) the son gives a corresponding amount of cash to the wife.

Both variations will be accompanied by a S.142 election to make them IHT effective.

As discussed earlier, this swap of assets is not deemed to take place for monetary consideration, so S.142 elections CAN be made.

3) Gifts to trusts

Assume Mr B dies leaving a legacy to his wife, Mrs B. Mrs B enters into a Deed of Variation under which the legacy passes to her children. However, as the children are young, Mrs B does not wish them to have immediate access to the legacy so instead she varies the will in favour of a trust for the children's benefit.

If an election is made under S.142 IHTA 1984, **the settlor of the trust is deemed to be the deceased (ie Mr B)**. Mr B is treated as creating a trust for his children on his death. This is important for the purposes of calculating exit and principal charges as we shall see when we look at IHT on trusts.

As the settlor for IHT is Mr B, even if Mrs B is a beneficiary of the trust, this is **not** treated as a gift with reservation of benefit so **no part of the trust will be charged in Mrs B's death estate**.

In practice, it is common to make the surviving spouse a beneficiary of the trust, so as to ensure that she has **adequate funds at her disposal to maintain her standard of living** after the death of her husband. Any arrangements of this kind should only be entered into after careful consideration of the financial circumstances of the person making the variation.

One problem with this sort of arrangement is that for income tax purposes, the **settlor of the trust is treated as being the person making the variation** - in this case this would be the wife.

Therefore if the wife is a beneficiary of the trust, any **trust income will be taxed in the hands of the wife rather than in the trust**. We shall explore this point in more detail in the trusts section of your course.

## 18.8 S.143 IHTA 1984

This short section is entitled "Compliance with testator's request".

Assume a testator (Mr A) leaves a gift in his will to a beneficiary (Mr B). In his will, Mr A expresses a wish that Mr B should leave his gift to a nominated charity. Even though the testator's wish is not legally binding, Mr B complies with Mr A's request and duly leaves his gift to the nominated charity.

If he does this within 2 years of death, the provisions of S.143 take effect. For IHT purposes, the **gift to the charity is treated as having been made by Mr A in his will**. The legacy will therefore be exempt from inheritance tax, and any IHT previously paid on the transfer to Mr B will become repayable.

In these circumstances, no formal Deed of Variation or elections under S.142 are necessary. Of course it is down to Mr B's conscience whether he does indeed comply with Mr A's request in giving the property to the charity. If he decides to keep the property, IHT is payable by the Executors in the normal way.

The effect of S.143 is to **ignore the gift from Mr A to Mr B and instead pretend that the gift to charity had been made by Mr A in his will**.

However, S. 143 applies for **IHT purposes only**. For **income tax** purposes, the **gift to the charity is treated as having been made by Mr B**. Therefore if the gift is of cash, Mr B can make a Gift Aid declaration and obtain tax relief on the donation via an extension to his basic rate band.

If the gift is of quoted shares or land, the value of the shares can be treated as a deductible payment in Mr B's income tax computation.

If a will leaves a gift directly to a charity, it is not possible for a Gift Aid declaration to be made. However, by using S.143, it is possible to obtain an IHT exemption and income tax relief at the same time.

## 18.9 Discretionary Will Trusts

IHTA 1984, s.144

This is the most flexible way in which a Testator can draft a will. The will simply leaves the **whole of the estate on discretionary trust for a wide class of nominated beneficiaries.** Those beneficiaries will typically include the deceased's wife, children, grandchildren, etc.

The testator will leave instructions to the trustees asking them to **distribute his estate according to the individual needs of the beneficiaries**. The reason for such an arrangement is to prevent the need for the testator to regularly review and amend his will during his lifetime as and when circumstances change. It also circumvents the need for beneficiaries to draw up Deeds of Variation to change dispositions after the testator's death.

If a testator leaves his entire estate to a discretionary trust, this is a **chargeable transfer** for inheritance tax purposes. This will be the case even if the spouse is a beneficiary of the discretionary trust.

As the whole of the estate has been left to a chargeable beneficiary, inheritance tax is payable in full on the normal due date.

Under S.144 IHTA 1984, **any distributions from the trust within 2 years of death, are deemed to have been made by the deceased in his or her will**. This means that if the trustees make a distribution to an exempt beneficiary such as a spouse or charity within 2 years of death, this is treated as having been made by the deceased in his will, and is therefore an exempt transfer.

IHTA 1984, s.144

As IHT would already have been paid on the basis that the whole of the estate is chargeable, such a distribution to an exempt beneficiary will lead to a repayment of some of the inheritance tax.

As we shall see when we study IHT on trusts, a distribution by a discretionary trust will normally give rise to an IHT liability called an "exit charge". Under S.144, if a distribution is made within 2 years of death it is treated as having been made by the deceased, and **it will not give rise to an IHT exit charge**.

It is important that distributions to exempt beneficiaries are **not made within three months of death**. In this instance, S.144 will not apply and the **gift to the spouse or charity will not be treated as exempt** for IHT purposes.

Although this is a very flexible way of drafting a will, there are disadvantages from a capital gains tax perspective. **Distributions of assets by trustees to beneficiaries are treated as disposals by the trustees for CGT purposes**, and a capital gain could arise. S.144 applies for IHT purposes only – it does not deem distributions to have been made by the deceased for CGT purposes.

CGT gift relief would only be available under S.165 TCGA 1992 if the assets leaving the trust were business assets. No gift relief is available under S.260 TCGA 1992 as there is no chargeable transfer for IHT.

This problem is partially alleviated by HMRC Inheritance Tax which has indicated that **any distributions before the end of the Executors' administration period are treated as having been made on death at probate value**. Therefore capital gains will only arise on distributions from the trust once the administration period has been completed.

**Example 1**

**Which of the following conditions does NOT have to be satisfied for a Deed of Variation to be legally valid?**

a) It must be in writing
b) It must be made within 2 years of death
c) It must be made by a person relinquishing an interest in the will.
d) It must NOT result in more IHT becoming payable.

**Example 2**

Philip died on 1 December 2007 leaving a painting worth £180,000 to his son James.

On 1 November 2009, James made a Deed of Variation whereby the painting passed to his daughter, Mary. The painting was worth £200,000 at that point.

A statement was included by James under S.62(7) TCGA 1992.

Mary sold the painting on 1 January 2011 for £250,000.

**Calculate Mary's chargeable gain.**

**Answer 1**

**D is false.**

If a variation results in more IHT being payable, the Executors must give consent to the variation.

**Answer 2**

S. 62 statement;

- gift by James to Mary ignored for CGT
- Mary deemed to acquire painting on Philip's death
- Base cost of painting = probate value

| Gain 2010/11; | £ |
|---|---|
| Proceeds | 250,000 |
| Less base cost | (180,000) |
| Gain | 70,000 |