

## **Deeds of Variation Traps and Opportunities**

The Capital Transfer Tax legislation, as introduced in 1975, contained a specific provision to allow for what is commonly referred to as a deed of variation of a will. The provision, which survives today in very similar form under Inheritance Tax, enables the terms of the variation to be recognised for the purposes of capital taxes. The terms of the amended will are then followed for probate, Inheritance Tax and Capital Gains Tax purposes.

It is something of a misnomer to say that a will is being varied; what is really happening is that a legatee is making a gift out of his or her inheritance, and electing to treat that gift as having been made by the deceased. For this reason one must be careful to ensure that the deed does not adversely alter the entitlements of those under the age of 18, because they do not have the legal capacity to enter into financial arrangements of this type.

The scope of this provision is much wider than that description 'deed of variation of a will' would suggest. It is possible to use this legislation to alter the devolution of jointly held property and intestate estates.

As is widely appreciated, this legislation offers a very useful opportunity to maximise the Inheritance Tax reliefs on the death, where the will has not been drafted in the most tax efficient manner. The provisions were probably designed to allow the bequests under a will to be reorganised in accordance with the wishes of the family whilst allowing the revised devolution of the estate to reflect the appropriate Inheritance Tax treatment. It was recognised that this valuable relief can enable much to be achieved in terms of reducing the burden of death duties, but equally there are traps which must be avoided.

A recent case before the Special Commissioners highlights one such trap. The will provided for a legacy to the son of £665,000, and other legacies to other members of the family, with the residue passing to the surviving spouse. One can immediately see that if the whole estate had been left to the surviving spouse there would have been no Inheritance Tax liability and she would have been free, if she wished, to make gifts out of her inheritance as lifetime potentially exempt transfers. Accordingly, a deed of variation was entered into by which certain of the legacies were deleted.

Unfortunately, the parties went a step further and the widow paid the sum of £1 million to the son within six months of the time when the deed of variation was completed. It will be appreciated that £1 million looks suspiciously like the original legacy grossed up by approximately 40%. There was also some unhelpful correspondence indicating that a payment would be made in return for the variation.

The parties appear to have overlooked one of the necessary requirements for the statutory relief, which is that the variation must not be made for any consideration in money or money's worth. They went so far as to give evidence to the Special Commissioner that the £1 million gift was no more than the fulfilment of a promise made years earlier and nothing to do with the variation. This was rather a bold contention and Counsel for the Revenue seems to have suggested that it bordered

on the dishonest, although fortunately the Special Commissioner found it unnecessary to investigate that particular issue any further.

The question about consideration given for a deed of variation frequently arises, if only because people do not often give away a legacy under a will for little good reason. But as the case highlights, it is not necessary for the consideration to be in legally enforceable terms, or in fact to be closely associated with the variation. The Court will draw its own conclusions from the facts, even if the parties carefully avoid saying anything which suggests that a secret bargain was struck when the variation was entered into.

However, it is interesting to speculate what HMRC could have done if the parties in this case had, instead, provided that the legacy of £1m be held in an initial life interest trust to the surviving spouse, to be terminated after three years with the funds then being automatically distributable to the son. This would achieve much the same result as they wanted, but without any issues of consideration arising.

It is often the case that short-term will trusts for surviving spouses, lasting for a carefully devised period of time, offer a much better tax planning scenario than outright gifts.

Another possible tax planning route to consider with deeds of variation is the formation of an offshore trust under the terms of the document. One of the main problems which normally arises with the transfer of funds to an offshore trust is a Capital Gains Tax liability on assets disposed of to the trustees, but this problem will not normally cause any difficulty when the trust is created by deed of variation.

Estates with shareholdings in family property or investment companies can, in certain circumstances, be reorganised by means of a deed of variation to reduce the tax liabilities going forward on the shares, particularly where they form a majority shareholding or a substantial minority holding. The tax liabilities on breaking up shareholdings of this magnitude can be quite onerous where lifetime gifts are concerned, but careful restructuring of the gifts under the will by means of a deed of variation can offer significant tax planning advantages.

Another suitable situation for a deed of variation is where the estate includes assets qualifying for Inheritance Tax agricultural property or business property relief. Where these assets pass to the surviving spouse under the terms of the will, the Inheritance Tax relief is wasted. It may therefore be beneficial to redirect these assets either to other beneficiaries or to a discretionary trust formed under a deed of variation, and to arrange for an equivalent amount from the other assets in the estate to go to the spouse.

Now that much tax planning through trusts during the lifetime has been curtailed by the provisions of the Finance Act 2006, the use of suitable will trusts for tax planning purposes has become all the more important. An expert review of the provisions of the will relating to any sizable estate can often prove to be advantageous, with a carefully devised deed of variation being used to enhance the tax efficiency of estate in the longer term.

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