The Personal Tax Planning Review

# POST-DEATH VARIATIONS: SOME INHERITANCE TAX ASPECTS

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## Introduction

Post-death variations may occur for a number of reasons. A curious yet familiar feature of our tax system is the partial and random way in which the legislation makes provision for such variations. The three taxes likely to be most commonly at issue are inheritance tax, capital gains tax and income tax. As the tax practitioner would readily expect, and as the logician would not, the three taxes treat post-death variations in significantly different ways. Thus the hard pressed tax adviser has to proceed with great care in arranging such variations: what seems like a good idea from the inheritance tax point of view may bring dire consequences from the income tax or capital gains tax point of view.

## When Variations are Used

There are a number of circumstances where post-death variations might be desirable. They are usually tax-driven, though they need not be. They include the following:

1 To redirect benefits given by the will. This could enable younger beneficiaries to be given appreciating assets and older ones depreciating assets. It could also enable the personal representatives to make a more sensible use of reliefs, as where they could avoid wasting a nil rate band or business or agricultural property relief on a widow.

2 To compromise claims under the Inheritance (Provision for Family and Dependants) Act 1975.

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3 To alter the powers of executors, administrators and trustees. This is particularly important where there are trusts which will continue after the administration of the estate is complete.

4 To alter beneficial interests under settlements or to bring settlements to an end.

5 To resolve a defect in a will.

6 To reserve a benefit for a legatee in circumstances where the reservation of benefit provisions in s.102 Finance Act 1986 will not apply.

**The Inheritance Act Provisions**

Perhaps the most commonly invoked provision in the field of post-death variations is s.142 Inheritance Tax Act 1984. Of considerable importance in an appropriate case, however, is s.142's sister section, s.144. Section 144 provides:

> "(1) This section applies where property comprised in a person's estate immediately before his death is settled by his will and, within the period of two years after his death and before any interest in possession has subsisted in the property, there occurs -
>
> (a) an event on which tax would (apart from this section) be chargeable under any provision, other than sections 64 or 79, of Chapter III of Part III of this Act, or
>
> (b) an event on which tax would be so chargeable but for sections 75 or 76 above or paragraph 16(1) of Schedule 4 to this Act.
>
> (2) Where this section applies by virtue of an event within paragraph (a) of subsection (1) above, tax shall not be charged under the provision in question on that event; and in every case in which this section applies in relation to an event, this Act shall have effect as if the will had provided that on the testator's death the property should be held as it is held after the event."

The section therefore applies where :

1 Property comprised in a person's estate is settled by his will; and

2 Within a period of two years after the death and before any interest in possession has subsisted in the property; and either

3 An event occurs on which an exit charge would have arisen under Chapter III of Part III of the 1984 Act (other than s.64 or s.79); or,

4 An event occurs on which a charge would have arisen but for s.75 or 76 or para 16(1) of Schedule 4.

If conditions 1, 2 and 3 are satisfied then two consequences follow. First, no tax will be charged on the event in question under the regime applicable to settlements without an interest in possession. Thus distributions and appointments from such trusts may usually be made without falling foul of the exit charge (usually under s.65). Second, the inheritance tax legislation is applied as if the will had itself provided that the property is to be held as it is held after the event.

If conditions 1, 2 and 4 are satisfied, only the second of the consequences in the last paragraph applies.

**Section 144's Advantages and Disadvantages**

Both s.144 and s.142 are designed to provide for post-death flexibility. Both provide for IHT-free rearrangements of property. Both treat the rearrangement as made by the deceased.

But s.144 differs from s.142 in a number of respects. The differences include the following:

1 Section 144 only applies where there is a will. Section 142 applies to "dispositions ... whether effected by will, under the law relating to intestacy or otherwise".

2 Section 144 applies to property settled with no interest in possession as from the testator's death. Section 142 is not so limited: it applies to a far wider range of property.

3 Section 144 may apply to settled property in which the testator had an interest in possession before his death and which was settled by will, for example, pursuant to a general power of appointment. Section 142 cannot apply to such property.

4 Section 144 applies automatically, whereas s.142 is elective. This may cause timing problems in practice since the variation under s.142 must be made within two years of the death of the testator or intestate in question and the election for s.142 treatment must be notified in writing to the Board within six months after the date of the instrument of variation. The automatic application of s.144 means that if a taxpayer falls into the error of making a precipitate appointment from a discretionary trust within three months of the relevant death hoping to obtain interspousal transfer relief or relief for charitable gifts the relief will be lost (see below) and no method of avoiding the application of s.144 will be available.

5 Section 144 does not require the consent of affected beneficiaries, whereas s.142 does. This means that s.144 is more useful where the beneficiaries are minors or uncooperative than s.142.

6 A beneficiary affected by a s.144 appointment does not thereby become a settlor for the purposes of the income tax and capital gains tax anti-avoidance provisions relating to settlements. It is not clear, however, whether a beneficiary who joins in a variation under s.142, falls within the ambit of those anti-avoidance provisions. In *Marshall v Kerr* [1993] STC 360, a case dealing with the similar though not identical capital gains tax provisions contained in what was s.24(11) of the Finance Act 1965, a beneficiary who varied the will of a testator by deed of family arrangement so as to create a settlement was held not to be a settlor in relation to that settlement for the purposes of the anti-avoidance provisions contained in ss.80-85 of the Finance Act 1981. It may be that this reasoning holds good for the similar provisions of s.142 IHTA as well. The point remains unresolved, however, particularly in the light of the fact that leave has been granted by the House of Lords to the Inland Revenue to appeal against the Court of Appeal's decision in *Marshall*.

7 Section 144 does not contain any provision corresponding to s.142(3) which prevents the relief from applying in cases where extraneous consideration is provided for a variation.

8 Disadvantageously, s.144 has no corresponding provision in the capital gains tax legislation whereas s.142 has such a provision. Thus care needs to be taken upon making a s.144 appointment since this could trigger an unrelievable capital gain. Care needs to be taken even when proceeding

under s.142 however, since the terms of the corresponding capital gains tax provision (s.62(6) - (9) Taxation of Chargeable Gains Act 1992) differ in significant ways from the inheritance tax provisions.

9 Again disadvantageously, s.144 may only operate to relieve an appointment to a member of the class of objects of the trust in question. Section 142, however, is considerably wider in its ambit and may be used to benefit anyone in the right circumstances.

**The Expeditious Distribution Trap**

One particular problem for the zealous trustee may arise where a trust exists within the terms of s.144 and the trustee makes a payment out to the spouse of the testator intending to obtain interspousal transfer relief. If this payment out is made within three months of the date of the death of the testator then the relief will in fact be lost because of the relation between s.144 and s.65(4). Where s.142 applies it deems the distribution or appointment of property to have been made by the testator in his will. Hence a distribution or appointment to a spouse should attract interspousal transfer relief under s.18. However, before this treatment applies, it must be the case, according to s.144(1)(a), that "there occurs an event on which tax would (apart from this section) be chargeable under any provision, other than sections 64 or 79, of Chapter III of Part III of this Act...". Principally this means that if a charge arises under s.65(1), then the relief is available. However, no s.65(1) charge will arise according to s.65(4) if "the event in question occurs in a quarter beginning with the day on which the settlement commenced...". Since, therefore, a distribution or appointment within three months of death would fall within s.65(4) no charge would arise in respect of it. Thus, in the case of such a distribution the requirement of s.144(1)(a) is not satisfied. The distribution in question will therefore not attract s.144(2) treatment and will not be treated as having been made under the will of the deceased. Curiously and anomalously therefore, a distribution made to a wife within three months of death which would have attracted relief had the trustees acted more tardily, and which would have attracted relief had the testator merely left the property distributed directly to the wife in his will, will not attract relief.

This stumbling block is very regrettable since it can hardly be what Parliament intended. It makes a mockery of the interspousal transfer exemption and places a needless pitfall in the way of efficient and expeditious trustees and their advisers.