STRUCTURING COMPROMISES

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1. Structuring compromises of family provision claims and contentious probate claims will generally involve a consideration of the appropriate form of structure and procedure and it may also involve taxation considerations. The answer will differ according to whether proceedings have already been commenced.

Inheritance Act Claims

Before issue of proceedings

2. A compromise which has been agreed before issue of proceedings could potentially be carried into effect by

   2.1 a backdating Deed of Variation if it is less than 2 years before the deceased died

   2.2 a Deed or Compromise Agreement if it is more than 2 years since the deceased died

   2.3 a Deed of Appointment if the Will includes a discretionary trust.

Deed of Variation

3. A Deed of Variation is a deed which alters the devolution of an estate at death and it will have backdated effect for inheritance tax and capital gains tax purposes if appropriate statements of intent are included in it for the purposes of *section 142(1) of IHTA 1984* and *section 62(6) TCGA 1992.* Each of those sections provides that the variation shall take effect as if had been effected by the deceased. Such a Deed is not backdated for income tax purposes. *Section 62* is narrower in effect so, if a trust is created in a Deed of Variation, for capital gains tax purposes, the person making the variation is

the settlor. Using such a Deed will not be an option in every case because it can only be used where the beneficiaries affected consent, are adult and are sui juris.

4. A major advantage of using a backdating Deed of Variation is that if, for example, assets are redirected to a surviving spouse, then a refund of any inheritance tax paid can be claimed. Any costs of the spouse should be rolled into the sum redirected to them so that a larger refund can be claimed. If an asset has increased in value since death, use of a Deed of Variation will prevent a disposal occurring for capital gains tax purposes. Also, where statements of intent are included in a Deed of Variation, no issues can arise with the gift with reservation rules.

5. Who should be the parties to such a Deed? The usual principle is that the Deed must be executed by the persons who benefit under the original disposition to which the item of property is subject on the death. The recipient of a benefit under the Deed of Variation need not sign. The personal representatives do not need to be parties unless the Deed has the effect of increasing the inheritance tax payable. However usually they are included as parties and the Deed can then include a provision that the estate will be administered in accordance with the Deed. Where the inheritance tax is being increased, the personal representatives can decline to join in the Deed if they have no or insufficient assets to pay the tax (see *section 142(2)*). However, if the Deed of Variation is being used to compromise a dispute, all parties to the dispute will sign it.

6. What is the position if one of the beneficiaries of the estate is a child? If their entitlement is not affected or being improved there is no problem. If the Deed adversely affects their entitlement, a Deed of Variation can only achieve total validity if approved by the Court. A parent cannot sign on their behalf. HRMC's practice is that they may allow the Deed to have a limited effect insofar as the child is not affected. They will draw the defect to the taxpayers' attention and, if they decline to accept that the Deed has a limited effect but they do accept that it is totally void, then HMRC will accept it is void (see *IHTM35045*).

7. A instrument of variation can be used to vary provision made under a Will, on intestacy ,or, in relation to property which has passed by survivorship. A Deed of Variation cannot be used to vary entitlement to property to which the deceased was treated as entitled by virtue of *section 49(1)* or to in which the deceased had a reserved benefit at the time of death. It appears that the intention is to prevent variations in relation to settled property over which the deceased had no control at death. The position is different if the deceased exercised a general power of appointment over the property by Will. In such a case the deceased is then regarded as beneficially entitled to the settled property under *section 5* rather than *section 49(1)*.

8. The following general points apply :

8.1 the variation must be made by an instrument in writing. It need not be a Deed and HMRC will accept a letter or note from the beneficiary redirecting their inheritance if the provisions of *section 142* are met. Having said that a Deed should always be used in practice.

8.2 the variation must be made within 2 years of the date of death. There is no ability to extend time in that regard.

8.3 the Deed must contain statements that *section 142* and *section 62* are to apply if backdating effect is required

8.4 a variation can be entered into before the grant of representation has been obtained.

8.5 where the subject matter of the redirection is expressed as a cash sum or legacy, it does not matter if there were insufficient liquid assets at death. Where property originally comprised in the deceased's estate has been sold, a variation should succeed so long as the property in existence at the time of the Deed represents and can be traced back to the original property which is the subject of the variation.

8.6 there is no principle that the person redirecting the property must not have benefited from it in contrast to the position in relation to disclaimers.

9. It is provided by *section 142(3) of the IHTA 1984* (with a similar provision in the CGT legislation) that the section shall not apply to a variation made for any consideration in money or moneysworth other

than consideration consisting of the making in respect of another of the dispositions of a variation to which that section applies. HMRC consider that, if a beneficiary under a variation agrees to pay the costs of the other party, this will be such consideration, as will be an understanding between the parties outside the Deed as to the future redirection of the assets involved. Whilst the provision was enacted to prevent the manipulation of the spousal exemption, the wording of the subsection is very wide. HMRC do not object to a Deed of Variation being used to compromise a family provision claim (see *IHTM35100* which states that "*a disclaimer or variation made to avoid or compromise a claim under the Inheritance (Provision for Family and Dependants) Act 1975 is accepted as not caught by IHTA84 s142(3) unless the deceased dies domiciled outside the UK.*"

10. There is a short term interest trap. It is provided by *section 142(4) of IHTA 1984* that, where a variation results in property being held in trust for a period which ends no more than 2 years after the death, the interest of the beneficiary under the trust is effectively ignored in determining the inheritance tax consequences of the variation. Thus the disposition that takes effect on the ending of the trust interest is read back to the beginning of the period. For example, if children entered into a Deed of Variation in favour of the surviving spouse and the widow's interest in possession was drafted to end within two years of the deceased's death, the benefit of the spousal exemption would be lost. HMRC have stated that they will scrutinise Deeds where a period slightly longer than 2 years has been selected (see *IHTM35095*). In *Kevern v Ayres* [2014] EWHC 165, rectification proceedings were brought where a period of only 24 months was selected and HMRC argued that this infringed the subsection.

11. It seems that HMRC's view is that the section only applies where any immediate post death interest is drafted as a short term interest and that it does not apply where an interest is not limited to end in the two year period and it ends because of the death of the life tenant. It is unclear whether the subsection applies where an interest in possession is ended within the relevant period by the exercise of a power of appointment by the trustees. It is safer, if such a Deed of Variation is entered into, that nothing is done in relation to the interest in possession created under its terms until the two year period has ended.

Deed of Compromise

12. The time limit for making a valid Deed of Variation of 2 years from death is absolute and this route cannot be used if the time limit has expired. Therefore, if more than 2 years have expired since the deceased died, the parties could either use a Deed or Agreement of Compromise (without backdated effect), or, issue proceedings in order to secure an Order which has backdated effect (see below).

13. In any event, if the compromise affects the interest of a minor or a protected party, proceedings have to be issued in any event.

Deed of Appointment

14. In a case where a Will includes some form of discretionary trust, there is the additional option of the trustees using their overriding powers to appoint an agreed level of provision to the claimant. If this is done within 2 years of the death of the deceased, this will have backdated effect for inheritance tax purposes. So, if such an appointment is made in favour of a surviving spouse, then this will be backdated to death and a transferable nil rate band may become claimable on their death.

15. It is provided by *section 144 of IHTA 1984* that the effect of an appointment, in relation to a trust in respect of which no interest in possession has arisen, will be read back for inheritance tax purposes to the date of the testator's death provided that the appointment occurs within 2 years of death. The so called *Frankland* trap has been closed with effect for deaths on or after 10th December 2014 so that, if an appointment is made within 3 months of death, then reading back will still occur.

16. Where the relief does apply, insofar as such appointments are made in favour of the surviving spouse, the spousal exemption may be claimed in relation to the estate of the deceased and, if an interest in possession is appointed in favour of the surviving spouse, it will be an immediate post death interest (which will also attract the spouse exemption).

17. There is no equivalent back-dating provision for capital gains tax purposes. If trustees make an appointment out of such a trust after the assets have been assented to them, then there will be a

chargeable disposal for capital gains tax purposes. There was some uncertainty as to whether an appointment could be made before there had been an assent to trustees. In *CG31430* it is stated that, if an appointment occurs before an assent, the assets remain in the hands of the personal representatives and that, when the assets vest, they should be treating as passing directly to the appointee. The assets appointed should be treated as never becoming subject to the trust. In effect the appointment is read back into the Will and it is treated as if the deceased had intended the assets concerned to pass directly to the legatee. The appointee takes those assets at probate value under *section 62(4) of the Taxation of Chargeable Gains Act 1992.*

18. HMRC had taken the view that trustees could not exercise a power of appointment before the administration of the estate was completed unless the Will said so or an assent had occurred. They now consider that it is a matter of construction of the Will. It is stated in *IHTM35181* that "*A power of appointment under a will is vested in the executors/trustees as from the death and is exercisable over all residue whether ascertained or not unless as a matter of construction the will clearly demonstrates a contrary intention*." Relevant matters are whether the trust period runs from death and whether the same people are trustees and Prs.

19. Once 2 years have passed since the deceased died, a Deed of Appointment can still be used to provide for the claimant but it will have taxation implications. When property is appointed from a discretionary trust, an exit charge arises for inheritance tax purposes (unless the assets are relievable property). The way in which the charge is calculated is complex but it cannot exceed 8%. There will be holdover relief for capital gains tax purposes.

19. There are practical problems with using this route to affect a compromise being

19.1 whether the trustees are prepare to use their overriding powers to facilitate a compromise and whether they are concerned about complaints from other beneficiaries now or in the future. This will be a particular concern for professional trustees.

19.2 use of such a Deed does not actually preclude the claimant bringing a claim. However, if it is clear that the amount being appointed represents a proper compromise of their claim, it is improbable that they would risk suing.

After issue of proceedings

20. It is often overlooked that, once proceedings have been issued, there is no need to use a Deed of Variation to affect a compromise. A provision claim will usually be compromised by use of a Tomlin Order. This has the advantage of allowing enforcement of its terms without the need to issue fresh proceedings.

21. Drafting Tomlin Orders (particularly after a long mediation) requires careful consideration. The following matters should be thought about

21.1 make it clear precisely how the existing Will or intestacy position is being altered as a whole. Simply overlaying new provisions can be confusing.

21.2 do not forget about the capital gains tax and SDLT implications of what is agreed. Inheritance tax is less of a concern (see below). Even so, avoid agreeing anything which could lead to grossing up for inheritance tax purposes.

21.3 are minors, protected parties or represented parties affected so Court approval will be needed?

21.4 if a Heads of Terms is to be used make it absolutely clear whether or not it is to have any legal effect. Do not assume that it is not legally binding unless it expressly states this.

21.5 do not forget about the chattels or the ashes. This can derail matters at the last moment.

21.6 think about what additional documents will need to be signed to perfect the compromise.

21.7 if the claimant is to be given a limited interest in a property, make it clear whether it is a right to reside or a full life interest. There will generally need to be the ability for the claimant to be able to direct the purchase of a substitute property. Consideration needs to be given as to what burdens are to be placed on the claimant in relation to issues like repair and

insurance. There is a great difference between an obligation to keep a property in repair or merely to keep it in a tenantlike manner.

21.8 if a spouse is being given a limited life interest in order to secure the spouse exemption, think about providing for term insurance to be taken out to deal with the position if the spouse dies within 7 years of its termination and to protect the loss this will cause to the spouse's nil rate band on death. Who is to pay for the insurance?

21.9 if new trusts are to be created, who are to be the trustees and have they already agreed to act?

22. Orders under the 1975 Act are given beneficial tax treatment. It is provided by *section 19(1)* of the 1975 Act that "*Where an order is made under section 2 of this Act then for all purposes including the purposes of the enactments relating to inheritance tax, the will or the law relating to intestacy, or both the will and the law relating to intestacy, as the case may be, shall have effect and be deemed to have had effect as from the deceased's death subject to the provisions of the Act*."

23. Despite the wide wording of the section, the position is different as between inheritance tax and other taxes. *Section 146(1) of the Inheritance Tax Act 1984* provides that where an Order is made under *section 2* of the Act, this will have backdated effect for inheritance tax purposes. It is further by *section 146(8) that "Where an order is made staying or dismissing proceedings under the 1975 Act on terms set out in or scheduled to the order this section shall have effect as if any of those terms which could have been included in an order under section 2 or 10 of the Act were provisions of such an order*."

24. Therefore, *section 146* is expressed to apply to Orders made by the Court but *subsection (8)* extends its effect to a Tomlin Order. However, it only applies to Orders which could have been included in a *section 2* Order.

25. The capital gains tax and income tax positions are different because there is no similar provision to *section 146*. In relation to capital gains tax, it is stated at *CG31810* that a Tomlin Order has backdated for CGT purposes if (i) it is made after a full hearing, or, (ii) if there has been an approval hearing on behalf of minors and there is a requirement in the Order that the parties carry out its terms. Therefore, where the Order has been approved by the Court on behalf of a minor, this will have backdated effect for capital gains tax purposes. In that regard, it is worth remembering that where the Court has made a representation Order to bind beneficiaries of a trust under *CPR Part 19.7*, any compromise will also always require the approval of the Court (see *CPR 19.7(5)*).

26. Therefore, the effect of *section 146* is that, if a Tomlin Order is entered into which could have been made under the Act, its effect will be automatically backdated to death for inheritance tax purposes. This applies whether or not two years have passed since the deceased's death.

27. It is worth remembering the ambit of *section 146(6) of IHTA* where the deceased's Will conferred a life interest. That subsection provides that, if anything is done in compliance with an Order or occurs on the coming into force of the Order which would otherwise be an occasion on which tax would be chargeable, then it shall not constitute such an occasion. It is further provided that, where an Order, provides for the variation of a settlement and tax would otherwise be charged under *section 52(1)* of the 1984 Act, that section shall not apply. *Section 52(1)* is the section which leads to a deemed PET occurring on the termination of a qualifying interest in possession, where there are no continuing trusts.

28. The effect of *section 146(6)* appears to be that, if an IPDI is terminated on the coming into force of an Order, there will be no transfer of value. Therefore, no deemed PET would occur. *Whitehouse and King : A Modern Approach to Wills* confirms that "*if an order results in the variation of a settlement there shall be no charge under IHTA 1984 section 52(1) which deals with inter vivos termination of interests in possession (section 146(6)). For instance if an IPDI for a spouse is varied in favour of a child that spouse will make neither a PET nor a chargeable transfer*." *IHTM35208* confirms that a consequential tax charge which would otherwise arise under *section 52(1)* when the Order comes into force is negatived by the subsection. However, it does not negative a charge on the termination of an IPDI which is created/ substituted by the Order itself.

29. This beneficial result only occurs if the IPDI ends on the making of the Order. If it ends afterwards, then the life tenant makes a deemed PET in the usual way. So, if an Order were made whereby the IPDI ended later and the life tenant died within 7 years, a charge to inheritance tax would arise in respect of which the life tenant's nil rate band would be applied but any tax would be paid by the trustees of the settlement.

30. This all raises a question as to whether HMRC will allow the spouse exemption for inheritance tax purposes where an Order is being structured to achieve a tax advantage. For example, the spouse might be given a limited life interest to secure the spouse exemption. The Court of Appeal stated in *Re Goodchild* [1991] 1 WLR 1216 (in a case where a short term IPDI was created) that, if the Order made is properly made within the jurisdiction of the Court, the fact that it is sought with the motive of achieving a better tax position is usually irrelevant. However, if the effect of the Order is to confer a substantial tax advantage at the expense of HMRC, it is important that the Court is satisfied that it is within its jurisdiction and one which can properly made. Therefore, it is possible that the Court could refuse to approve such an Order as involving artificial tax planning in relation to a weak 1975 Act claim. My experience is that the Court generally does not.

PROBATE CLAIMS

31. The issues relating to the compromise of contentious probate claims are different. Whilst the terms agreed may have independent taxation consequences, there is no opportunity to achieve a taxation advantage by backdating the effect of any compromise.

32. Therefore, the issues in relation to the compromise of probate claims are mainly procedural.

Before issue of proceedings

33. If a compromise is reached, a Deed or Agreement of Compromise would usually be used. As set out above, HMRC have only confirmed that a Deed of Variation does not involve the giving of extraneous consideration in relation to the compromise of a family provision claim. A Deed of Variation could

potentially be used in this context but it should not state explicitly that it is compromising a probate claim or include a full and final settlement clause.

34. When agreeing a compromise, it needs to be remembered that the parties cannot agree to treat the last known Will of the deceased as of no effect and agree to prove an earlier Will. Under the terms of any compromise, the last Will would still need to be proved although the parties can agree whatever they want in relation to the division of the deceased's estate as between themselves.

After issue of proceedings

35. *CPR 57.6(1)* refers to three possible methods of compromising probate proceedings being

35.1 by a Trial on written evidence before the High Court Judge

35.2 by using the discontinuance procedure under *CPR Part 57.11*

35.3 by using the procedure under *section 49 of the Administration of Justice Act 1985.*

36. The first issue to consider is whether the compromise involves setting aside the last known Will of the deceased. If it is does, then either the a Trial must take place (which would be on written evidence only and then proceed unopposed) or use would need to be made of the procedure under *section 49 of the Administration of Justice Act 1985.*

37. If the former option is used, a Trial takes place on written evidence only before a Judge and not a District Judge. This is what used to be called a hearing in the Short Probate List. If successful, this will lead to a grant in solemn form of law. The Judge needs to be satisfied that it is proper to make the Order sought. In the most recent short Trial I have conducted we produced evidence of incapacity from the deceased's daughter and extracts from the deceased's medical records. The Judge was satisfied with that evidence.

38. Under *section 49*, the High Court can pronounce for or against the validity of one or more Wills if the consent of all relevant beneficiaries has been obtained. "*Relevant beneficiary*" is defined as being

(a) a person who under any such Will is beneficially interested in the deceased's estate, and,

(b) where the effect of the pronouncement would be to cause an intestacy or partial intestacy or to prevent it from so devolving, a person who under the law of intestacy is beneficially interested in the estate.

39. This form of application can be dealt with by a District Judge. What must be filed is evidence identifying all of the relevant beneficiaries and exhibiting their written consents to the Order sought. This will include beneficiaries who take the same interest under all of the relevant Wills and all legatees, however small their interest. There is no need to provide substantive evidence about the issue of validity. There is an issue as to whether this procedure can be used where there are minors interested in the estate. Interestingly *Form CH26* on the Gov.co.uk website provides for such an Order to be made where the District Judge is satisfied that the Order is for the benefit of any minor beneficiaries. I have managed to obtain a *section 49* Order in those circumstances. However, in that case, it would be prudent to produce sufficient evidence on the merits to satisfy the Judge that the compromise is beneficial to those who cannot consent.

40. If a grant in common form of law would be sufficient, then the dismissal or dicontinuance procedure in *CPR 57.11* can be used. A probate claim cannot simply be discontinued in the usual way. *CPR 57.11* provides that, at any stage in a probate claim, the Court can, on the application of any party who has acknowledged service, order that the claim be discontinued or dismissed on such terms as to costs as it thinks fit and that a grant of representation be made to the person entitled to the grant. This means that this procedure is limited to cases where the last Will is to be admitted to probate.

41. When the application is made, the question for the Judge is whether, viewed objectively, there is at the time of discontinuance a serious issue to be resolved in relation to a Will. Where there is a serious dispute then the Court can refuse to allow the proceedings to be discontinued (see *Green v Briscoe* [2005] AER (D) 96). My experience is that Judges will make this form of Order readily.

42. If the District Judge makes the Order, the form of Order will be "*that probate in common form of the Will of X be granted to Y the executor named therein if entitled to."* The reason why the Order refers to the grant being made "*if entitled thereto*" is because the Order itself does not constitute the grant. The executor must then apply to the Probate Registry for a grant in the usual way. It is possible for the parties to agree additional terms which can be attached to the Order as a schedule.

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