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Being charitable may reduce IHT

Background

In the Budget on 23rd March 2011, the Chancellor announced various measures to encourage charitable giving and to reduce the administrative burdens on charities. The most significant of these is that for deaths on or after 6 April 2012, a reduced rate of Inheritance Tax (IHT) of 36% will apply where 10% or more of a deceased's net estate (after deducting IHT exemptions, reliefs and the nil rate band) is left to charity. The Government has now published its consultation which closes on 31st August 2011.

Example

This example shows how the calculation is made in a simple case where the full nil rate band of £325,000 is available:

Gross estate	£1,000,000
Nil rate band	£325,000
Net estate	£675,000

10% of the net estate is £67,500 so a legacy of this amount or greater would mean that the 36% rate applies to the estate.

Effect of the 36% rate

If exactly 10% of the net estate is left to charity, the marginal cost to the other beneficiaries of the charitable gift falls from 60% to 24%. This is shown in the following example comparing the current position where the IHT rate is 40% to the proposed position with a 36% IHT rate.

	<u>Now at 40%</u>	<u>April 2012 at 36%</u>
Gross estate	1,000,000	1,000,000
Less nil rate band	325,000	325,000
Net estate	675,000	675,000
Less charitable gift	67,500	67,500
Taxable estate	607,500	607,500
IHT @ 40%/36%	243,000	218,700
Distribution to non-charitable beneficiaries	689,500	713,800
Distribution to non-charitable beneficiaries if no charitable legacy	730,000	730,000
Reduction in amount to non-charitable beneficiaries	40,500	16,200
As proportion of charitable legacy	60%	24%

Considerations and Consequences

1. As can be seen in the table above, a charitable legacy will always result in a cost to the non-charitable beneficiaries, when compared with no provision at all for a charity. The cost to the non-charitable beneficiaries is reduced, but not to such an extent that the reduction in IHT will exceed the amount of the charitable legacy.
2. To benefit from the reduced rate of IHT, it will be important to ensure that at least 10% of the net estate passes to charity. Care will therefore be needed in the drafting of wills. Some of the problems that might arise are set out below and are issues that will form part of the consultation. Individuals will however need to keep their estates under review as changes in the value of assets will be relevant if a fixed legacy to charity has been made or if assets change their form and become exempt from IHT.
3. Lifetime gifts may reduce the nil rate band available on death. If this applies, then the baseline for the 10% test will increase. In the first example above, if the nil rate band had been used in full, then the minimum charitable legacy needed to satisfy the 10% test

would be £100,000.

4. Where the deceased had jointly held assets that pass by survivorship, or had an interest in a trust that has to be brought into account, then the net estate will be increased even though those assets do not pass under the will. It may be possible to use a deed of variation to redirect jointly held assets so that the 36% IHT rate applies. This may mean that it will become necessary for HMRC to have sight of a deed of variation to be certain that the lower rate of IHT should apply.
5. The 10% test will be based on the value of the estate at the date of death. This may not reflect the value of assets in the hands of the charity as a result of natural movement in values of assets, eg. shares and land.
6. Where an estate includes legacies that are free of tax or where there are assets that qualify for business property relief or agricultural relief, further difficulties will arise in calculating the whether the 10% test has been reached. This would also apply where some of the estate passes to the surviving spouse.
7. In order to qualify for the proposed relief, the legacy must be for a charity for UK tax purposes. This means that it is a charity or other organisation in the UK, European Union Member State, Iceland or Norway that would be a charity under the law of England and Wales (if it were so located), or is settled in trust to be used for charitable purposes only, or is left to a Community Amateur Sports Club.

The Government currently estimates that only about 3% of estates each year pay IHT. Therefore this change will only apply to a small number of estates and probably much fewer than 3%.

However, if an individual was already intending to leave part of their estate to charity, then this may be an incentive as it will enable them to leave more to charity without taking away from the amount that they are leaving to their non-charitable beneficiaries. It seems unlikely that this proposal will significantly increase the amount of charitable giving and it does little to address the funding shortfalls that charities currently face.

If you would like to talk to us about the issues raised by this note, please contact:

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