



## Leaving 10% of an Estate to Charity to Benefit from Lower IHT Rate

## BRIEFING

### Introduction

Legislation has been included in the Finance Act 2012 to provide for a reduction of inheritance tax (IHT) from 40% to 36% in cases where **10% or more** of a deceased person's estate is left to one or more charities. This will apply to deaths on or after 6 April 2012.

### IHT Charge

Briefly, following a person's death, IHT is charged at 40% on:

- A) The "free" estate (i.e. on assets owned by the deceased person alone or jointly as a tenant in common);
- B) Assets jointly owned as "joint tenants" which pass by survivorship (eg a joint bank account);
- C) Certain trusts in which the deceased had an entitlement to income, i.e. a qualifying interest in possession; and
- D) Assets which the deceased gave away during his or her lifetime within 7 years of death or, at any time, whilst continuing to benefit

after deducting or excluding (1) funeral expenses and debts in the estate, (2) the nil rate band (if

available) of £325,000, (3) the transferable nil rate band (if available), (4) any exemptions such as the spouse exemption or charity exemption, (5) any reliefs such as business property relief (BPR) and agricultural property relief (APR).

### Changes introduced by the new law

In cases where 10% or more of an "estate" is left to charity, IHT will be charged at 36% (instead of 40%). This is a "cliff edge", i.e. if the 10% requirement is not met the 40% rate will apply. The legislation contains detailed rules for the application of the new law. In order to qualify, estates are divided into three components:

- 1) **General component** (ie:- the free estate (see (A) above), but not including assets in which the deceased had reserved a benefit unless an election is made).
- 2) **Survivorship component** (see (B) above)
- 3) **Settled property component** (see (C) above)



The 10% test can be met for **any** of the above individual components in the “estate” and for each component the test compares two amounts:

- 1) **Donated amount:** i.e. the total value of assets given to charity (which qualify for charitable exemption under the Inheritance Tax Act 1984)
- 2) **Baseline amount:** i.e. the net value of the assets included in **that component** for IHT purposes after deducting
  - Any available nil rate band (including any available transferred nil rate band)
  - Exemptions other than the charity exemption
  - Reliefs (eg BPR/APR)

#### Default position and election(s)

The default position is that the lower (36%) rate of IHT applies to any component which meets the 10% test and **does not** apply to any component for which the 10% test is not met.

This may be changed by an election (by the “appropriate persons” within two years of death) to merge components in which case they are treated as a single component. Therefore if a charitable bequest is large enough it may, for example, be possible to merge the general and settled components so that they both

benefit from the 36% tax rate. Consideration may need to be given by a testator and the adviser to the possibility of a merger election becoming available and the implications for beneficiaries under the various components. (Please refer to the example in Appendix C to this note.)

It will be possible to obtain the 36% rate as a result of retrospective treatment following death. Therefore if the testator leaves his or her estate on discretionary trust and the executors’ appoint funds to charity (under the powers of the trust and almost certainly in accordance with the testator’s (unbinding) wishes) meeting the 10% condition then the reduced rate of 36% would apply.

#### Position if no IHT is payable

If no IHT is due it cannot be possible to take advantage of the 36% IHT rate.

#### Consideration for spouses/civil partners

In cases of spouses or civil partners that wish to take advantage of the 36% rate, consideration may need to be given to benefitting charities only on the second death.

#### Persons not domiciled in the U.K.

The baseline amount for a non-UK domiciliary will be limited to assets on which that person is liable to IHT.



Examples of the application of the lower 36% IHT rate

There are examples in the attached Appendices A, B and C

General advice

If testators wish to consider taking advantage of the lower IHT rate by leaving 10% or more (or indeed 4% or more) to charity in their will, there will be various ways that this can be achieved. There is a formula that can be used in wills to provide for 10% (or more) to pass to charity (or charities). Careful consideration will need to be given in individual cases to any technical problems caused by the inter action of the remaining provisions of the Inheritance Tax Act 1984 which could result in large administration costs.

The simplest course will almost certainly be to leave the residuary estate (or part of it) on discretionary trust with a letter of wishes requesting that 10% or more passes to charity. It

would be possible to name the charities as discretionary beneficiaries or to give the executors power to nominate charities. If this is done and the executors exercise their powers within 2 years of death there is provision in the legislation for the lower 36% rate to apply.

Please refer to our other briefing note on “Estate Planning – An Investment” if you have not already done so.

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## APPENDIX A

Simple example of IHT liability if 0%, 2%, 4%, 8%, 10%, 25% or 50% passes to charity in a case where the “baseline amount” (i.e. the net estate liable to IHT) is £1,500,000 and all those assets are within the “general component”.

Percentage passing to charity	0%	2%	4%	8%	10%	25%	50%
Amount passing to charity “ <u>donated amount</u> ”	0	30,000	<b>60,000</b>	120,000	<b>150,000</b>	375,000	750,000
Amount passing to non-charitable beneficiaries	900,000	882,000	<b>864,000</b>	828,000	<b>864,000</b>	720,000	480,000
IHT	600,000 (40% x 1,500,000)	588,000 (40% x 1,470,000)	<b>576,000</b> (40% x 1,440,000)	552,000 (40% x 1,380,000)	<b>486,000</b> (36% x 1,350,000)	405,000 (36% x 1,125,000)	270,000 (36% x 750,000)
TOTAL “ <u>baseline amount</u> ”	1,500,000	1,500,000	<b>1,500,000</b>	1,500,000	<b>1,500,000</b>	1,500,000	1,500,000

The following should be noted from the above example:

- The figure of £1,500,000 is taken on the basis that the nil rate band (of £325,000) is not available and therefore it is not included in the amount passing to non-charitable beneficiaries.
- The IHT charge is 40% where the amount shown above passing to charity is between 0% and 8% inclusive and 36% where the value passing to charity is 10% or more.
- Figures in the columns under the 4% and 10% figures are in bold. This draws attention to the important arithmetical fact that the “cost” to non-charitable beneficiaries of a 10% legacy will be the same as the “cost” of a 4% legacy. It will be seen in these examples that each of the non-charitable beneficiaries receive £864,000.
- With reference to the point immediately above, it should be noted that non-charitable beneficiaries will receive a smaller amount if the charity receives an amount between 4% and 10% than if the charity receives 10% with the estate thereby qualifying for the reduced 36% IHT rate.

## APPENDIX B

### Example of calculations following death and the effect of the nil rate band on the amount donated

Horatio dies and the value of his assets in the **general component** are £1,000,000.

The following table shows the amount that would need to be left to charity in order to qualify for the reduced 36% rate of IHT if: (1) no nil rate band is available, (2) a single nil rate band is available and (3) both Horatio's nil rate and band and the transferable nil rate band are available.

	<b>No nil rate band (£)</b>	<b>Single nil rate band (£)</b>	<b>Double nil rate band (£)</b>
Estate	1,000,000	1,000,000	1,000,000
Available nil rate band	0	325,000	650,000
Baseline amount	1,000,000	675,000	350,000
Minimum donated amount required to benefit from reduced 36% rate	100,000	67,500	35,000

It will be noted in the above example that for an estate of the same value that the amount required to be donated to charity to benefit from the reduced 36% rate can vary enormously subject to the available nil rate band and therefore care will be required if a stated amount is inserted into a will that is intended to take advantage of the reduced rate.

## APPENDIX C

### Example of calculations following death where there is more than one component

Hannah, widow of Horace, died on 1 April 2012. Her will provides for a legacy of £200,000 to her favourite charity: "The Rescue Home for Distressed Puppies and Kittens". As a result of Hannah's death IHT is payable (ignoring the nil rate band etc) on the following:

	Value (£)
General component – free estate	1,000,000
Settled component – Trust set up under the terms of Horace's will (capital value)	750,000
Survivorship component – Holiday house held as joint tenant with her son, Hubert (1/2 share)	500,000
<b>Total</b>	<b>2,250,000</b>
<b>IHT (For deaths before 6 April 2012)</b>	<b>820,000</b>

*Example continues on the following page....*

Under the new law (ie: if Hannah died on or after 6<sup>th</sup> April 2012) the position is:

		IHT(£)
<u>General component</u>		
Baseline amount	1,000,000	
Less donated amount (20%)	200,000	
Total	----- 800,000	
IHT @ 36% x 800,000		288,000
<u>Settled component</u>		
IHT @ 40% x 750,000		300,000
<u>Survivorship component</u>		
IHT @ 40% x 500,000		200,000
<b>TOTAL IHT</b>		<b>788,000</b>

It would be beneficial to merge some components to treat them as a single component and therefore an election could be made to merge the general component and the settled component in which case the IHT would be:

		IHT(£)
General component	1,000,000	
Settled component	750,000	
Baseline amount	----- 1,750,000	
Deducted: donated amount	200,000 -----	
Total	1,550,000	
IHT at 36% x 1,550,000 =		558,000
Survivorship component		200,000
IHT @ 40% x 500,000		200,000
<b>TOTAL IHT</b>		<b>758,000</b>

Note that if the election covered all three components (total value £2,250,000) the value of the charitable legacy would not meet the 10% relief requirement and IHT would be charged on the total value of all three components (less the value of the legacy) at £820,000 (as shown above).