

Inheritance Tax Update

20 December 2012

REDUCED RATE OF INHERITANCE TAX FOR INDIVIDUALS LEAVING 10% OR MORE OF THEIR NET ESTATE TO CHARITY

INTRODUCTION

In the 2011 Budget the Government announced plans to introduce a lower rate of Inheritance Tax (IHT) for those leaving substantial charitable legacies. Following consultation, draft legislation has been published to be included in Finance Act 2012.

From 6 April 2012, where qualifying conditions are met, that part of the estate that would otherwise be charged to IHT at 40% will instead be charged at 36%. The reduced rate applies when at least 10% of the net estate is left as a qualifying legacy.

QUALIFYING CHARITABLE LEGACY

A qualifying legacy is one left to any UK registered charity or Community Amateur Sports Club, or equivalent bodies in certain other states. The other states include any EU member state and, presently, Norway and Iceland. A qualifying charitable legacy would include settling property on a charitable trust.

HMRC have accepted that the risk of tax evasion through manipulation of asset values is low and no restrictions are to be placed on the type of property which can be left as a qualifying legacy.

CALCULATING 10% OF THE NET ESTATE

The net estate (or baseline amount) is the value that would otherwise have been charged to IHT at 40%, plus the value of the charitable legacy. It is calculated as follows:

- Determine the total value of assets comprised in the estate, less liabilities;
- Deduct available IHT reliefs and exemptions other than the charitable legacy itself, including business property relief, agricultural property relief and the value of property left to a UK domiciled spouse;
- Deduct the available nil rate band, which includes any nil rate band transferred from a spouse.

Example

An unmarried person has an estate valued at £1 million including business property eligible for 100% relief of £250,000 and an unused nil rate band of £325,000. The baseline amount will be £425,000 [$£1 \text{ million} - £250,000 - £325,000$] so to qualify for the lower rate of IHT the charitable legacy will need to be at least £42,500. The effect of making that minimum donation on the estate would be:

Charitable legacy (% net estate)	0	5	10
Left to charity (£)	-	21,250	42,500
IHT (£)	170,000	161,500	137,700
Left to other beneficiaries (£)	830,000	817,250	819,800

A point to note is that where the nil rate band has been used up by previous transfers then the baseline amount will increase and a greater charitable legacy will be required in order to qualify for the reduced rate of IHT.

COMPONENTS OF THE ESTATE

Eligibility is calculated by reference to items held directly on death (the free estate) but also to other amounts on which IHT is payable on death, including certain trust interests. To avoid the situation where the value of the other chargeable assets (which it may not be practical to leave to charity) prevents the 10% requirement being met, property in the estate is divided into components.

The components are:

- (1) Survivorship component: jointly owned property passing by survivorship;
- (2) Settled property component: settled property in which the deceased had a beneficial interest in possession
- (3) General component: property not included in the other two components, including the free estate but excluding the

value of property previously gifted in which the deceased reserved a beneficial interest for IHT purposes.

Gifted property in which the deceased reserves a benefit cannot benefit from the reduced rate in any circumstance, and is not included when calculating the net estate.

The 'baseline' amount is calculated separately for each component with the nil rate band apportioned between them. If at least 10% of a particular component is left to charity, the reduced rate of IHT then applies to that component.

Where the 10% test would be met for one component but not for one or both of the others, then if the 10% requirement would be met in aggregate an election can be made to treat the relevant components as one.

The reduced rate of IHT then applies to the whole of the merged components. The division into and election to merge back components allows flexibility to maximise the property to which the reduced rate will apply.

Example

The deceased has a free estate of £600,000 (general component), an interest in a joint property valued at £200,000 (survivorship component), an interest in settled property valued at £200,000 and an unused nil rate band of £325,000.

To qualify for the reduced IHT rate on each component separately £40,500 of the free estate and £13,500 of each of the joint property and the settled property would need to pass to charity.

Instead £67,500 of the free estate could be left to charity and an election made to treat the three components as one. The 10% requirement would then be met for the whole estate and the reduced rate of IHT would apply to all components.

WHO WILL THIS BENEFIT?

The relief is intended to encourage increased charitable legacies by mitigating the cost to other beneficiaries. Particular incentive is offered to those who presently intend to leave between 4% and 10% of their net estate to charity.

In these cases, if the legacy is increased to 10% then the non-charitable beneficiaries will also benefit, since the additional charitable legacy will be exceeded by the reduction in IHT.

ACTION

The reduced rate will apply automatically (subject to an opt out), including if the charitable legacy is effected by deed of variation. However individuals planning to leave charitable legacies should consider reviewing the terms of their wills to ensure the legacy will be at least 10% of their net estate.

For couples, if the estate on the first death may be exempt from IHT (for instance where it will be spouse exempt) then the charitable legacy should be made on the second death in order to maximise tax savings.

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