

Less Inheritance Tax to Pay . . . Today's Announcement

The Government announced in the 2011 Budget that individuals who leave at least 10% of their estate to charity would qualify for a reduced rate of Inheritance Tax of 36% on the rest of their estate. These new rules will apply in respect of deaths occurring after 5 April 2012.

A Consultation Document on the changes was released today which provides us with some indication of how the new rules will apply.

At present, a gift to charity under a will is exempt from inheritance tax. Therefore a gift to charity 'costs' the estate 60% of the amount received by the charity. These new rules will mean that qualifying gifts to charity will only 'cost' the estate 24% of the amount received by the charity.

'10% Test'

This is a 'cliff edge' test. The only estates that will qualify will be those that leave at least 10% of the net estate to charity. There is no reduction available if the charitable legacy does not pass the 10% test, although the gift itself will continue to be exempt.

The 10% is applied to the 'net estate'. That is the estate after the deduction of the nil rate band (currently £325,000), spouse exemption and any other reliefs such as business or agricultural property reliefs have been deducted.

What is the estate?

Inheritance tax is potentially payable on assets owned by the deceased which pass under his/her will (the 'free estate').

Inheritance tax may also be payable on other assets on the death of the deceased. Examples of this are joint property (where the asset passes automatically to the joint owner e.g. a joint bank account), assets in which the deceased had a qualifying interest in possession and assets which the deceased had given away but retained a benefit.

The Government is consulting on whether the value of the net estate used to assess whether the 10% test is passed should only be the free estate or whether it should include these additional items.

The Government are considering whether beneficiaries should be entitled to make an election to include taxable items outside the free estate in applying the 10% test in return for a reduced rate of tax on all property taxable on the death of the deceased. The option to do this would give greater flexibility and more potential to reduce Inheritance Tax, especially if an election can be made on an asset by asset basis, so this option would be warmly welcomed.

Gifts made prior to death

If gifts have been made in the seven years prior to death, the value of these will be deducted from the nil rate band and only the balance will be available to deduct from the estate on death.

In this situation, the 10% test will be applied to the value of the estate after deducting the reduced nil rate band, hence a larger charitable legacy would be required. The excess of any gifts over the nil rate band will not be taken into account in the 10% test, but any tax payable by the beneficiaries on those gifts will not benefit from the reduced rate of tax i.e. the recipient of the gift will still pay inheritance tax at 40% (less any tapering relief).

Valuations

Until now the value of non-cash assets which pass to charity has been immaterial. The asset would not be taxable so its value would not be considered by HMRC. When applying the 10% test, the value will be significant. This could present executors with a problem if a hard to value asset is left to charity.

Executors may therefore be allowed to disclaim the reduced rate so that they do not need to spend funds obtaining valuations. This is useful if the cost of obtaining valuations is likely to outweigh the benefit of the reduction in tax.

The Government may seek to restrict the types of assets that can be used to make up a qualifying charitable legacy to items that are easy to value, such as cash, quoted shares and real estate.

There are likely to be anti-avoidance provisions introduced to prevent exploitation of the rules by using assets which have been manipulated to have a high value on death which subsequently plummet.

Variations to wills

The Government accept that charitable legacies made by way of a variation to the estate after death can be included in the 10% test.

The terms of the will

No doubt a standard approach to including gifts intended to qualify an estate for the reduced rate will develop over time. In the meantime, testators need to be careful with the wording as shown in the following example:

A widow Joan dies, leaving an estate of £1,000,000. She leaves £250,000 free of tax to her lifelong friend Mary. She wished to take advantage of the reduced rate so leaves 10% of the residue to charity and the remainder to her two children.

On the face of it, we may think this estate qualifies for the relief. After deducting the gift to the friend, the residue is £750,000. 10% of this is £75,000. The minimum amount required to secure the reduced rate is £1,000,000 – 325,000 (nil rate band) x 10% = £67,500.

However, due to the complexities of how the inheritance tax is actually calculated, the charity is actually only due to receive £67,384. This fails the 10% test and the tax payable out of the children's share is £243,046, and they would receive £439,570.

If the gift to Mary had only been £245,000, the gift to the charity would increase to £68,039. This would pass the 10% test and the tax payable out of the children's share would be £218,506 and they would receive £468,455, £28,885 more!

A deed of variation could be used to rectify the problem, but it is unlikely Mary would want to give up £5,000 of her legacy. Any recompense made to Mary by the children for reducing her gift would make the variation of the will invalid!

It is therefore essential to fully consider the tax consequences of the way gifts are made under the will.

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