Richard Honey

Inheritance tax and the charity exemption

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Hello, my name is Richard Honey, and I am a Senior Associate in the tax, trusts and succession team at Charles Russell Speechlys LLP. I have 7 years' experience in wills and estate administration and am a full member of the Society of Trust and Estate Practitioners.

Today, we will be covering inheritance tax (IHT) and the charity exemption. By the end of this webinar, you should be able to:

- Recall the basic principles of IHT
- Understand the charity exemption from IHT
- Understand how to calculate whether the reduced rate of IHT applies to an estate – the so-called "10% rule"
- Spot opportunities to maximise charitable bequests within an estate administration
- Understand and identify the difference between a Re Benham and Re Ratcliffe split of residue
- Calculate IHT in a Re Ratcliffe estate and apportion it appropriately.

Let's start at the beginning. What is IHT?

It is important to note that this is not just a tax on death, or inheritances. It used to be, since IHT is the mutated product of estate duty from many years ago. IHT is a tax on transfers of value. That is to say when you make a transfer (usually by gift) which reduces the value of what you own.

The law behind IHT is primarily contained in the Inheritance Tax Act 1984 (IHTA). In the words of the IHTA, IHT is charged on the "value transferred by a chargeable transfer", under section 1. IHT is broader than just a tax that applies on death, and applies to certain types of lifetime transfer as well. What it essentially looks at is the difference in value of a transferor's estate before and after a transfer. Which is why sales of assets (for their full market value) do not attract IHT.

A transfer of value occurs in a number of situations, but today we are looking at the transfer that occurs on death. For IHT purposes an individual is treated as having made a transfer of his or her assets to the beneficiaries of his will, under section 4 of the IHTA. It also applies on intestacy, but we are focusing on charities today and they can't get anything unless there is a will!

So what are you treated as having given away? Broadly speaking everything which you own. The scope is broad an includes your house, bank accounts, investments, cars, personal possessions – people are often surprised at just how much they need to value when looking at either their own or a deceased's IHT liability.

Your estate also includes certain items which you are treated as beneficially owning. This is particularly relevant for interests which you have in trusts. If you have an interest in possession in a trust (certain types of "life interest") then that will be included in your estate for IHT purposes too.

Unless an exemption or allowance applies, IHT is charged at 40%. We will look later at two relevant ways this might be avoided through charitable gifts.

IHT is an important source of revenue for the government. In the 2021/22 tax year, it raised just over £6bn. The amount IHT raises has gone up steadily in recent years as asset values have risen (particularly property prices), and the tax free allowances it offers have been (and are) frozen.

It is also an important tax in that it combines the two certainties that Benjamin Franklin cheerily pointed out that we all face – death and tax.

Some assumptions that I should mention for today's webinar, to allow us to focus on the main areas:

- Individuals are domiciled in the UK for IHT purposes, so that IHT is charged on their worldwide estate. Domicile is complex and outside the scope of this webinar.

- There are no settlements.

- There are no gifts with reservation of benefit.

- The individuals mentioned have not made any transfers of value during their lifetime, so they have a full 'nil rate band' available. The nil rate band is £325,000 for the 2022/23 tax year and is fixed at this amount until April 2026.

- The law covered is correct as at 6 April 2022.

- Spouse in this webinar refers to both spouses and civil partners.

NEW SLIDE: THE CHARITY EXEMPTION

Outright gifts to charity are broadly speaking exempt from IHT under section 23 IHTA. For tax purposes a body of person or trust is a charity if:

- It is established for charitable purposes only (as defined in section 2 of Charities Act 2011)
- It is subject to the control of a relevant court in the UK or a corresponding jurisdiction outside the UK in the EU or a specified relevant territory (currently Norway, Iceland and the Principality of Liechtenstein).
- Being an organisation in England and Wales, it has complied with any requirement to be registered in the register of charities maintained by the Charity Commission.
- Being an organisation outside England and Wales, it has complied with any requirement set out in the law of the relevant territory requiring charities to be registered in that territory.
- Has managers who are fit and proper persons.

This is clearly quite an important exemption for individuals leaving assets to charity under the terms of their wills. But there is a further benefit that may be available, depending on the amount they leave.

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THE REDUCED RATE OF IHT: THE 10% RULE

Since 6 April 2012 a very important change to IHT legislation has been in force. Broadly speaking this states that if someone leaves 10% or more of their estate to charity, then the rate of IHT charged on their estate (assuming their estate is over the nil rate band) drops from 40% to 36%. The full details are set out in Schedule 1A to the IHTA.

In theory this sounds very simple and straightforward, and really ought to have been. The Government managed to make this in fact quite complicated.

The formula more or less boils down to this:

If the donated amount (i.e. the amount given to charity) is more than ten per cent of the baseline amount (i.e. the value of assets transferred under the will taking account of any exemptions and allowances, such as the spouse exemption, and the nil rate band – but ignoring the residence nil rate band) then the rate of IHT drops to 36%.

Let's work through an example. For this purpose, we continue to assume we are just dealing with the individual's free estate (what is known as the 'general component' for IHT purposes) so the calculation is simplified.

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Rocky makes a gift to charity in his Will. He has not made any gifts in the last 7 years. His estate is worth £1m, made up of £50,000 cash at the bank, £50,000 of personal possessions, £350,000 of investments, and a house worth £550,000. Rocky leaves a will which reads as follows:

I give my personal possessions and my house to my husband, £25,000 to charity and residue to my daughter.

We know that £25,000 passes to charity. But does this satisfy the 10% rule? The donated amount is the amount given to charity - £25,000. The baseline amount is the value of the assets transferred under the will, ie £1m, less assets passing by way of an exemption – here, the spouse exemption applies to the personal possessions of £50k and the house of £550k, less any available nil rate band, which we assume for this purpose is £325,000. We ignore the RNRB and the amount to charity for the baseline amount. 25/75 is 33% - which is more than 10%, and so the reduced rate of IHT at 36% applies.

It does not mean 10% of the whole estate which is what a lot of testators sometimes find difficult to understand – it can be much less.

How do you spot this in practice? Either working through like in this example, or there might be a special clause under the terms of the will leaving a gift equal to 10% of the net estate to charity.

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So let's look at when there might be an opportunity to save IHT. Take this slightly amended example. Here, Rocky only leaves £5,000 to charity. The baseline amount remains the same, but 5k/75k is only 7% of the net estate going to charity, so IHT is sadly 40%.

NEW SLIDE

Working through the IHT calculation, we deduct the charity and spouse exemption from the value of the free estate, which leaves a chargeable estate before the nil rate band of £395,000. After applying the available nil rate band of £325,000, the taxable estate if £70,000. IHT is charged at 40%, so £28,000 is payable to HMRC. The daughter receives the residue of the estate (£395,000) less the IHT payable of £28,000 (as IHT is paid as a testamentary expense before calculating residue), receiving a total of £367,000.

Take a second to think – is there anything that could be done here to achieve a better outcome for Rocky's daughter and the charity?

The answer is yes. Broadly speaking, where a testator has left between 4% and 10% of their net estate to charity under their will, and there is no residence nil rate band in play, it is often advisable for the beneficiaries to consider a variation of the estate under s142 IHTA. This is because the saving in IHT from reducing the rate from 40% to 36% often eclipses the additional money passing to charity. Let's look at how this might apply to Rocky.

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So if Rocky's beneficiaries (here, the daughter) varied his estate to ensure it met the 10% rule, they would need to increase the legacy from £5,000 to £7,500, as shown in the example on screen. That would satisfy the 10% rule and the reduced rate of IHT of 36% will apply. So how much IHT might be saved? Perhaps you might want to pause the webinar here and work this out yourself, before continuing.

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Here, working through the same example, you will see that the chargeable residuary estate (after deducting assets passing to charity and the spouse exemption) is £392,500. After deducting the nil rate band, the taxable estate is £67,500. Remember, the estate qualifies for the reduced rate of IHT of 36%, so IHT is £24,300 in this estate.

The daughter receives the residue of the estate (£392,500) less the IHT payable of £24,300, receiving a total of £368,200. That is £1,200 more than she did in the previous example, and the charity also receives £2,500 more – sharing the £3,700 saving in IHT between them. A "win win" for all involved!

As practitioners, we should remain alive to opportunities to save IHT in these scenarios and consider whether a variation is appropriate. I should just mention that HMRC expect the personal representatives to demonstrate that the charity has been notified that the estate has been varied in their favour to avoid fraudulent claims.

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How do you claim the charity exemption? This is made on IHT430 within two years of the testator's death.

We have discussed the "general" component here, ie the 'free estate'. The same test would also apply individually to any settled property (such as a life interest trust, called the settled property component) or any survivorship property (such as a property held as joint tenants, called the survivorship component), the value of which is aggregated with the deceased's free estate for IHT purposes on death.

Another possible way to save IHT on those components might be to merge them. Let us assume instead that Rocky had a free estate – ie the general component – worth £8m, and the whole of that estate is left to charity. There would be no IHT on that as all would be charity exempt. If Rocky was also the life tenant of a trust (a qualifying interest in possession trust) worth £1m, and on his death the trust passes to his children absolutely, that would (after any available exemptions and allowances) be subject to IHT at 40%. However, when we add both components together, it is clear that overall Rocky has left more than 10% of his net estate to charity. His PRs and the trustees of the settlement could elect to merge those two components together for IHT purposes – treating them as one whole component. As this still clearly meets the 10% rule, the trustees would only be charged 36% IHT on the taxable value of the trust, even though none of the trust assets pass to charity.

Claims must be made by the appropriate persons – so for estates, that would be the personal representatives, and for trusts, that would be the trustees. This calculation can be complicated, particular where the nil rate band must be apportioned between different components of an estate – so consider HMRC's guidance and their IHT calculator to assist you.

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One particular issue arises when a will is drafted so that the residuary estate is divided between exempt beneficiaries (such as charities), and non-exempt beneficiaries (such as children of the deceased). In these circumstances, it is important to consider what the IHTA says, and how the will is drafted.

The basic principles on IHT are as follows:

- Where IHT is payable on a deceased's UK free estate, it is treated as a general testamentary expense of the estate (section 211(1)). That reduces the amount passing to beneficiaries named in residue.

- However, where a specific gift or residuary gift is made to an exempt beneficiary (eg a charity), none of the IHT attributable to the value of the estate can be deducted from that exempt gift (section 41). That provision cannot be overridden by the terms of the will.

In isolation, where you have a gift of residue which is divided between charity beneficiaries and chargeable beneficiaries, this seems to cause a conflict. Although section 41 cannot be overridden, testators can draft wills in two different ways to meet the terms of this section, both producing very different results. Two cases in the 1990s determined this point, as follows and detailed on the slides.

The first option is for the estate to be divided after tax is calculated. This is the most complicated option, where the shares due to the respective exempt and non-exempt beneficiaries are calculated after IHT is calculated on the residuary estate. This requires a grossing up exercise to ensure that the gift does not breach s41 – so the shares due to the chargeable beneficiaries have to be grossed up so IHT is calculated on their gross values, such that all of the beneficiaries receive their respective shares net of IHT. Grossing up is outside of the scope of this webinar. The net effect is that there is more IHT payable overall, but is usually the most favourable option for the chargeable beneficiaries. An example of this was in Re Benham, where the testator's will stated that the residuary estate would be calculated:

to pay the same to those beneficiaries as are living at my death and who are listed in List A and List B hereunder written in such proportions as will bring about the result that the aforesaid beneficiaries named in List A shall receive 3.2 times as much as the aforesaid beneficiaries named in List B.

Here, the court decided that the only way this could be established was for all of the various beneficiaries to receive their respective shares after IHT was calculated.

The second – and easier – option is for the shares due to those beneficiaries to be calculated before considering IHT. This usually means the exempt beneficiaries will get proportionately more than the chargeable beneficiaries (who pay IHT on their share) but would often result in less IHT overall. That is the more favourable option for charities. An example of this was in Re Ratcliffe, where the will stated that the trustees:

after payment thereout of my debts and funeral and testamentary expenses to stand possessed of the residue as to one-half part thereof for John Hugh McMullan and Edward Brownlow McMullan (the sons of my cousin Helen McMullan) in equal shares absolutely and as to the remainder of my estate upon trust for the following [four] charities in equal shares.

So how do you spot this in practice? The default position accepted by HMRC is that unless there is specific, clear wording from the testator to indicate that Re

Benham should apply (such as equivalent wording in the will, or a direction to apply Re Benham), the estate should be divided in accordance with Re Ratcliffe – ie the shares of residue are divided before you think about IHT.

If it is unclear from the face of the will, what could you do?

- Obtain the will file to see whether there is any evidence of the testator's instructions.

- Explore the possibility of reaching an agreement with all of the beneficiaries. Of course, this is only possible if they all have legal capacity, and bear in mind that charity trustees are under strict duties – so this is not always straightforward.

- Instruct counsel, and potentially apply to the court for directions.

Further examples can be found at the IHT manuals as mentioned on the slides.

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Have a think about this example. Would you apply Re Benham (calculate the IHT first, including grossing up, and then divide the shares) or Re Ratcliffe (divide the shares first, then calculate IHT)?

Again, as far as you are aware, there is no specific direction in the will – so the shares are calculated first, and then IHT applies – as in Re Ratcliffe.

Now how is that calculated in practice? There is often a point which can be easy to miss. Have a look at the estate accounts provided with this webinar, prepared by Time Warp Legal LLP, the solicitors dealing with this estate.

Turn to the notes page. You will see that the residue is divided correctly between exempt beneficiaries (10 shares) and non-exempt beneficiaries.

Turn to the capital account on page 3. The net residuary estate for IHT purposes is calculated at £826,115. This is the value on which IHT is calculated. Now, remembering that we are dividing the estate before calculating IHT, and taking into account the "10% rule", spend some time working out what the IHT due is in this estate.

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Pause the webinar here before continuing to see the answer.

NEXT SLIDE:

As the shares are calculated before IHT is worked out, you divide the net residuary estate in two first. £413,057.50 goes to charity and is charity exempt – no IHT is payable. The remaining £413,057.50 is chargeable to IHT. Again, assuming a full nil rate band is available, the taxable estate is £88,057.50. Here, it is obvious that the 10% rule applies as half of the estate passes to charity (feel free to work it out using the earlier examples as a guide), so IHT is charged at 36%. This brings us to a total IHT bill of £31,700.70.

If you turn to the administration expenses page of the accounts (page 5), you will see that Time Warp LLP have calculated the IHT correctly. Hurrah! The hard bit is complete.

However, the bit that is often missed is taking the IHT into account on a distribution. Because the estate has been calculated under Re Ratcliffe, and you remember that s41 states that the gift to the charities cannot bear IHT, the IHT should be deducted from the chargeable beneficiaries. Have a look at the distribution account on the back page. Can you see any issues?

You will see that the charities and the chargeable beneficiaries are each receiving an equal share of the residuary estate after the administration expenses have been deducted. This is often missed and can be easy to forget in practice. What Time Warp Legal should have done is add the IHT back into the distributable estate (as they calculated the shares of residue before IHT is calculated), then divided residue, and deducted the IHT from just the chargeable beneficiaries. The obvious way to spot this was that the chargeable and non-chargeable beneficiaries should not be receiving an equal share of the estate here if it was calculated under Re Ratcliffe.

NEXT SLIDE:

Take a second to add the IHT back to the distributable estate of £719,657.30 and calculate what each beneficiary should have received.

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You will see the answers on the slides provided.

I should mention that this example has not included any other gifts within the will, which might include grossing up. The calculations would also be different if there were assets qualifying for agricultural or business property relief, for example. Again, you should consult HMRC guidance before proceeding.

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CONCLUSION

Having completed this webinar, you should now be able to:

- Recall the basic principles of IHT
- Understand the charity exemption from IHT
- Understand how to calculate whether the reduced rate of IHT applies to an estate – the so-called "10% rule"
- Spot opportunities to maximise charitable bequests within an estate administration
- Understand and identify the difference between a Re Benham and Re Ratcliffe split of residue
- Calculate IHT in a Re Ratcliffe estate and apportion it appropriately.

I hope you found this informative, and thank you for listening.