

Briefing document

IHT – Reduced rate due to gifts to charity

Introduction

The rate of Inheritance Tax (IHT) is reduced to 36% where 10% or more of a deceased's taxable estate is left to charity. The amount left to charity is exempt from IHT and the reduced rate applies to the taxable estate, rather than the normal 40% rate. The provisions are designed to encourage people to leave part of their estate to charity on death. The term 'charity', aside from the more traditional and recognisable charitable organisations, (as defined), also includes registered community amateur sports clubs and certain organisations. In both cases, equivalent bodies in the European Union (EU), Iceland, Liechtenstein and Norway that meet the relevant requirements will also qualify.

In order for assets in your estate to be left to charity, and more widely, to pass to beneficiaries of your estate in accordance with your wishes, it is essential to have an appropriately drafted will. Therefore, in addition to tax advice, legal advice should also be taken.

Components of the IHT estate

When considering whether the 36% IHT rate is available, the estate is divided into 'components' and the reduced rate of IHT is available where at least 10% of the amount of a particular component on which IHT is payable is left to an appropriate charity. IHT is payable to the extent the value transferred is ineligible for IHT reliefs or exemptions and exceeds the available nil rate band. This is considered further and an example provided in the 'Calculating what property qualifies' section below. For the purposes of the reduced IHT rate there are three components of an estate:

The settled property component – All settled property within the estate in which there existed, prior to the deceased individual's death, an interest in possession to which the individual was entitled prior to death.

The survivorship component – All property comprised in the estate that, prior to the deceased individual's death, was jointly owned and passed by survivorship (England, Wales and Northern Ireland), under special destination (Scotland) or by anything that corresponds to either survivorship or special destination in a country outside the United Kingdom.

The general component – The remaining property within the estate, which does not fall under the above two components, and is not covered by the 'gift with reservation' legislation (which applies in certain cases where legal ownership of an asset is given away but the donor retains use of or otherwise continues to benefit from the asset given away).

When considering whether the deceased's IHT estate would qualify for the reduced rate, each component needs to be looked at separately, so one or more components may be taxed at the reduced rate of 36% whilst the others may be taxed at the normal rate of 40%.

Property which was the subject of a 'gift with reservation' (see above) is normally out of the scope of the reduction rules and therefore the value of the asset(s) subject to a gift with reservation is usually subject to 40% IHT (assuming IHT reliefs and exemptions and/or the nil rate band are unavailable). However it is possible to 'merge' this property with a qualifying component which can enable the 36% IHT tax rate to be available. This is covered in more detail later in this note.

Calculating what property qualifies

In order to calculate whether a component of the deceased's estate qualifies for the reduced rate both the donated amount and the baseline amount need to be calculated. Each component of the deceased's estate is looked at individually and the available nil rate band (currently £325,000) is apportioned between these components relative to the amount of each component's total chargeable transfer.

The donated amount is the value of the charitable transfer which is attributable to property within each component, e.g. £20,000 left to a specific charity from the residue of the estate.

The baseline amount is worked out using the three steps listed below;

- Step one – The chargeable transfer is the total value of the estate component on death after deductions of reliefs and exemptions less the relevant legacy to charity.
- Step two – From this amount deduct the available proportion of the nil rate band. The nil rate band is apportioned based on the chargeable transfers in each component of the total estate, as mentioned previously.
- Step three – add back the legacy to charity to give the baseline amount.

If the donated amount is greater than 10% of the baseline amount then the component qualifies for the reduced IHT rate of 36%. A basic example with a single estate component is given below.

Stephen died on 17 June 2019 leaving an estate valued at £750,000 after deduction of liabilities. He leaves a legacy of £50,000 to the RSPCA. The donated amount is £50,000. The baseline amount is calculated as follows;

	£
Estate on death	750,000
Legacy to charity (donated amount)	(50,000)
Chargeable transfer	700,000
Less: nil rate band	(325,000)
	375,000
Add back legacy to charity	50,000
Baseline amount	425,000

To meet the charitable giving condition the donated amount must be at least 10% of the baseline amount. As the donated amount (£50,000) exceeds 10% of the baseline amount (£42,500), the estate qualifies for the reduced rate. Therefore the tax due on the estate is 36% of £375,000 – i.e. £135,000, a saving of £15,000 in addition to the tax exemption applying directly to the charitable donation.

Elections

Merging election - Given that one or more of the components of an individual's estate may qualify for the reduced rate (qualifying components), and that the other(s) may not, an election is available to merge components into one. The result of this is that the reduced rate can be extended to those components that would not normally qualify (e.g. where a relatively large charitable legacy is attributable to one component within the estate). It is important to note that if two or more components are merged then the baseline needs to be recalculated and the donated amount must remain higher than this new baseline figure.

The merging election is itself flexible in that two, three or even four components can be merged in a way which provides that the 36% IHT rate is available to as much of the estate as possible. Property which is within the deceased's estate due to the application of the gift with reservation of benefit provisions can only qualify for the reduced rate of IHT if it is merged with a qualifying component.

Opting out election – If the conditions for the reduced IHT rate to apply are met, the reduced IHT rate applies automatically, albeit appropriate forms must be completed in respect of the estate following the individual's death. It is possible that the tax position of some individual's estates would be more favourable if the reduced rate of IHT is not applied. An example of this would be where the tax saving obtained from the reduced rate is

smaller than the cost of formally valuing the property in question. Where preferred, it is possible to opt out of the reduced rate of IHT applying to the estate, in which case the usual 40% IHT rate would apply.

In general, IHT returns are due within twelve months of the end of the month of death, but any IHT due must be paid within six months of the end of the month of death.

A longer time limit applies to both the merging and opting out elections, which must be made in writing to HMRC within two years of the individual's death. Elections must be completed by all persons who are considered to be 'appropriate persons', in relation to the component(s) subject to the election, which is, broadly, the person(s) to whom legal ownership of assets passes on death (i.e. the trustees in the case of settled property, the survivor where jointly owned property passes on death and the personal representatives in respect of the 'general component', as set out above).

Elections can be withdrawn as long as the withdrawal is made in writing to HMRC by those who are entitled to make such an election and no later than two years and one month after the date of the individual's death. In effect therefore this is one month after the last possible date that a merging or opting out election could be made.

It should also be noted that in some circumstances an officer of HMRC may agree to extend the time limit for these elections to be made, but this is at the officer's discretion and will depend on the facts of each case.

Other matters

Variations and post death considerations – After the individual's death it may be calculated that the estate could benefit from the reduced rate of IHT if an existing charitable legacy was increased or a new gift was made, which may in some cases increase the net amount receivable where bequests received by non-charitable beneficiaries are received net of a lower rate of tax. Therefore an instrument of variation could be used to alter the disposition of the estate. An alteration instrument must be made, in writing, within two years of death, for it to be treated as if it had been made by the deceased, and it must be entered into by all persons whose inheritance would be altered by entering into the deed of variation. In addition there is a final requirement for the charity which is to receive the property to be notified of the additional gift or alteration.

Tax free legacies – When an estate is partially exempt and the will contains other legacies to either individuals or charities that are left free of tax, it is necessary to 'gross up' the legacies by the IHT payable in order to complete the baseline calculations. In order to avoid these grossing up calculations causing the estate component to fail the 10% test, there is a concession in place whereby the lower rate of 36% may be used when grossing up rather than the normal rate of 40%.

Quick Succession Relief (QSR) – QSR is available in certain cases where IHT is payable on the death of an individual who inherited property within the previous five years, where IHT was payable in respect of the previously inherited property. Consideration needs to be given as to how the QSR and reduced rate of IHT interact.

Find out more...

This note reflects the law in force as at 8 April 2020 Please be aware that it does not cover all aspects of this subject. To find out more about any aspect of the above, please discuss with your usual Deloitte contact. If you do not have a usual contact, please contact Patricia Mock (pmock@deloitte.co.uk).

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