

## AF1 IHT 2022/23

### Part 4: Charitable legacies.

The milestones for this part are to understand:

- When the lower rate of 36% can be applied to the deceased's estate.
- How to calculate an IHT liability when a charitable legacy has been made.
- The three potential components involved in calculating whether the lower rate applies

A gift to a charity is exempt from IHT in life and on death. If a charitable legacy made on death it can reduce the rate of tax from 40% to 36%.

To qualify it must be a bequest to:

- A Charity for UK tax purposes. (This will include a charity in the EU, Iceland or Norway that would qualify as a charity if it was established in the UK)
- A charitable trust
- A community amateur sports club

AND

The legacy is at least **10% of the baseline amount** which is calculated as follows.

- Deduct the legacy from the estate This is the **chargeable estate**
- Next deduct the available NRB. This is the **taxable estate**
- Finally add back the gift to get £425,000. This is the **baseline amount**.

Fran was divorced and left an estate of £750,000. He left £50,000 to the NSPCC and the remainder to his children

Estate	£750,000
Less Charitable legacy	<u>£50,000</u>
<b>Chargeable estate</b>	£700,000
Less NRB	<u>(£325,000)</u>
<b>Taxable estate</b>	£375,000
Add legacy	<u>£50,000</u>
<b>Baseline amount</b>	£425,000

The legacy is more than 10% of the baseline amount so the 36% rate applies

£375,000 (taxable estate) @ 36% =£135,000

If the NRB is different to £325,000 because of outstanding PET or transferable NRB this figure will be deducted.

Louisa was divorced and died leaving an estate of £750,000. She left a legacy of £50,000 to the RNIB. Four years earlier she gave £150,000 to her daughter.

Estate	£750,000
Legacy	<u>£50,000</u>
Chargeable estate	£700,000
Less reduced NRB	<u>£175,000</u>
Taxable estate	£525,000
Plus legacy	<u>£50,000</u>
Baseline amount	£575,000

In this case the legacy (£50,000) is below the 10% of the baseline amount (£57,500) so the estate does not qualify for the 36% rate. The beneficiaries could execute a deed of variation to increase the gift by £7,500 to meet the 10% test. This would reduce the liability at full rate from £210,000 to a reduced rate of £186,300.

In practice, it may be easier for a will to state that the charitable legacy is to be a percentage of the net assets and HMRC have published wordings that would be acceptable to them.

If the deceased's estate left £200,000 to a spouse, £50,000 to a charity and the remainder to his children, the baseline amount would have been calculated as follows.

Estate	£750,000
Less legacy	£50,000
Less legacy to spouse	<u>£200,000</u>
Chargeable estate	£500,000
Less NRB	<u>£325,000</u>
Taxable estate	£175,000
Add legacy	<u>£50,000</u>
Baseline amount	£225,000

£175,000 @ 36% = £63,000

Spouse receives £200,000

Charity £50,000

Children £500,000 less £63,000 = £437,000

RNRB cannot be deducted from the estate in calculating the baseline amount. Therefore if the subject of a question had both an RNRB and a charitable legacy you would have to calculate whether it qualified for the 36% rate without the RNRB. You then calculate the taxable estate with the RNRB and then apply the 36% rate,

Hannah was widowed and her husband left all his estate to her.

When she died her estate consisted of a house with a value of £600,000 and other assets of £800,000. Apart from a charitable legacies of £100,000 everything was left to her two children

Step 1 Check if it qualifies for the 36% rate

House	£600,000
Other assets	<u>£800,000</u>
	£1,400,000
Less legacy	<u>£100,000</u>
Chargeable estate	£1,300,000
Less NRB (x2)	<u>(£650,000)</u>
Taxable estate	£650,000
Plus legacy	<u>£100,000</u>
Baseline amount	£750,000

The £100,000 legacy is 13.33% of the baseline amount so it qualifies for the 36% rate

Step 2. Apply the 36% rate to the taxable estate including the RNRB

House	£600,000
Other assets	<u>£800,000</u>
	£1,400,000
Less legacy	<u>£100,000</u>
Chargeable estate	£1,300,000
Less NRB (x2)	(£650,000)
Less RNRB (x2)	<u>(£350,000)</u>
Taxable estate	£300,000

Tax due £300,000 @ 36% = £108,000

This is probably all you need to know to answer a typical AF1 question. The remainder of part 4 covers some of the more complex area

If there is jointly owned property or property in trust. HMRC splits the deceased's estate into three groups and these are treated separately. These are:

- Assets owned outright or on a tenants in common basis (general component)
- Assets owned on a joint tenancy basis (survivor component)
- Assets in trust. (settled component)

If there are more than two components the baseline amount for each must be calculated separately and it is likely that the reduced rate will only apply to one component.

### Survivor component

If property is owned on a joint tenancy basis it is automatically passed on to the survivor. To calculate the baseline amount the NRB is apportioned between the two components.

Sam's estate consisted of personally owned assets with a value of £750,000 and in addition he had a joint account with his partner with a balance of £60,000.

His will stated that he wanted to leave £75,000 to the RSPCA with the remainder to his partner

The general component is £750,000.

The survivorship component is £60,000. Sam's share of this is £30,000

Solely owned property	£750,000
Less legacy	<u>£75,000</u>
Chargeable transfer	£675,000

NRB is apportioned

$$£675,000/£675,00 + £30,000 \times £325,000 = £311,170$$

Chargeable Transfer	£675,000
Less NRB	<u>£311,170</u>
Taxable estate	£363,830
Plus legacy	<u>£75,000</u>
Baseline amount	£438,830

Tax liability £363,830 @ 36% = £130,978.80

### Tax on survivorship

Remaining NRB £30,000/£675,000 + £30,000 = £13,380

	£30,000
Less NRB	<u>£16,170</u>
	£13,830 @ 40% = £6,468

The process can be summarised as follows:

- The legacy is deducted from the general component (solely owned property) to give the chargeable transfer.
- The NRB is apportioned between the two components using this formula,

#### General component

Chargeable transfer/chargeable transfer + deceased's share of the jointly owned assets x NRB

#### Survivorship component

Share of jointly owned assets/Chargeable transfer + deceased's share of jointly owned assets x NRB

- Calculate the tax due on both components in the normal way.

In the previous example the general component qualified for the 36% rate whereas the survivorship component did not. It's possible for the executors to merge these components and get the reduced rate on the jointly held property. To do this the legacy must be more than 10% of the general component and the co-owner of the jointly owned property agrees to the merger. The NRB still needs to be apportioned between the two components and separate calculations should be carried out.

Merged estate	£780,000
Legacy	<u>£75,000</u>
Chargeable transfer	£705,000
Less NRB	<u>£325,000</u>
	£380,000
Add back legacy	<u>£75,000</u>
Baseline amount	£455,000 (both components qualify for the 36% rate)
Tax on general component	
General component	£750,000
Less legacy	<u>£75,000</u>
Chargeable transfer	£675,000
Less NRB	<u>£311,170</u>
Taxable estate	£363,830
Tax liability £363,830 @ 36% = £130,978.80	
Tax on survivorship component	
	£30,000
Less NRB	<u>£16,170</u>
	£13,830 @ 36% = £5,821.20

## Settled component

This will normally apply when the deceased was a life tenant of an Immediate Post Death Interest (IPDI) trust or a life interest trust. On their death the property will revert to the remaindermen but the property will be part of their estate and the trustees will be liable for their share of any IHT that is due.

The procedure is similar to the survivorship component and the NRB is apportioned between the two components.

Gwen died with solely owned property of £800,000. She was the life tenant of her late husband's IPDI trust which had a value of £250,000. She left £55,000 to Oxfam.

Estate	£800,000	
Less legacy	<u>£55,000</u>	
Chargeable estate	£745,000	
Less NRB	<u>£243,341</u>	(£745,000/£745,000 + £250,000 x £325,000)
Taxable estate	£501,659	
Plus legacy	<u>£55,000</u>	
Baseline amount	£556,659	(qualifies for 36% rate)

£501,659 @ 36% = £200,397 (payable by executors)

Trust property	£250,000	
Less NRB	<u>£81,659</u>	(£250,00/£745,000 + £250,000 x £325,000)
Chargeable estate	£168,341	

£168,341 @ 40% = £67,336 (payable by trustees)

That concludes this part so you should now know

- When the lower rate of 36% can be applied to the deceased's estate.
- How to calculate an IHT liability when a charitable legacy has been made.
- The three potential components involved in calculating whether the lower rate applies

## Sources and further reading

<https://www.gov.uk/hmrc-internal-manuals/inheritance-tax-manual/ihtm45009>

<https://www.cii.co.uk/learning-index/articles/charitable-trusts-and-wills/47446>

<https://www.gov.uk/hmrc-internal-manuals/inheritance-tax-manual/ihtm45003>

7/4/22 Page 1. Amendment to clarify that the RNRB cannot be deducted from the chargeable estate in calculating the baseline amount