

A new incentive for charitable legacies

A lower rate of inheritance tax when leaving 10% of an estate to charity

Grant Thornton UK LLP (Grant Thornton) welcomes the opportunity to respond to the consultation document released on 10 June 2011 by HM Revenue & Customs (HMRC) in connection with the proposed introduction of a lower rate of inheritance tax (IHT) when leaving 10% of an estate to charity. Our general comments in respect of the proposals are set out below, followed by our responses to the specific questions raised in the consultation document.

General comments

The overall aim of these proposals, to encourage charitable gifts, is welcomed and is likely to be broadly appreciated by the British public and the charities themselves. However, we have several concerns about the detail of these proposals and how they will be put into practice. Our main concerns stem from the inherent complexity of the provisions.

Establishing the value of the estate will be key to the successful application of the reduced rate. Attaining an accurate valuation of the assets comprised in the estate will, we believe, in many cases, lead to a significant additional administrative burden and cost. This will particularly be the case where an estate holds assets whose valuation may be contentious. This will undoubtedly add further delay to the administration of the estate as the personal representatives will be conscious of the need to show accuracy in such cases. It would be undesirable for a personal representative to find him or herself exposed to future claims if it turns out that the 10% limit was not achieved. Such further costs relating to administration will reduce the assets available to the beneficiaries.

It follows that claiming the relief will effectively require the engagement of a suitably informed professional adviser. While the majority of individuals who find themselves subject to IHT are likely to employ such an agent it does again drive towards potential additional costs.

We also have some concerns that the measure could inadvertently discourage some individuals from making lifetime charitable gifts and/or subsequently limiting a charitable legacy to the requisite 10% of their estate. Our calculations (found in Appendix 1) evidence the fact that the optimum position is achieved by making a 10% donation. As can be seen from the graphic provided, the effective rate of saving decreases at an exponential rate as donations increase over the 10% figure.

While there may be instances where a legatee would opt to increase a donation to meet the 10% figure, we question the number of occasions where this would be the case. Further scrutiny of our figures confirms that increasing the amount of a charitable legacy to 10% will only be desirable, from a beneficiary's point of view, if a donation of more than four per cent was to be provided for. As our figures show, the net effect on an estate that provides a four per cent legacy is the same as an estate that opts to take advantage of the reduced rate of IHT by making a 10% donation, albeit, the charities themselves would be much better off under the new proposals ie there is a clear 'win' for charities but not for all beneficiaries. While this information would no doubt be passed on to the personal representatives, given the additional costs and complications involved in claiming the relief, and the fact that only three per cent* of estates are subject to IHT in the first place, these details may well reduce the overall take up of this initiative.

* In accordance with figures quoted at paragraph 1.10 of the consultation document

Anecdotal evidence would appear to suggest that for every individual who opts to increase their donations to meet the 10% requirement, another may decide to reduce their legacy, in order to benefit from the most tax efficient position. While the vast majority of individuals choose to make charitable donations for reasons other than saving tax, for those who would consider these facts, the numbers are convincing. Furthermore, in order to take advantage of the relief, many individuals will need to revisit their Will. While this may not be a significantly onerous exercise, the requisite amendments will add yet another layer of cost and administration.

Ultimately, we have reservations as to whether this measure will achieve the desired aim and have no basis to believe that the introduction of this measure will encourage the making of a charitable legacy where a donation would not otherwise have been made.

Although the consultation document does not offer other options, we would have liked to have seen these considered. For example, the policy to introduce a reduced IHT rate rather than a non-refundable credit is not up for discussion, although the credit approach may better achieve the aim of increasing charitable legacies.

We cannot find any evidence in the document of the policy options that were considered at Stage 1 of the consultation process. We believe it would have been beneficial to evaluate those policy options at Stage 2 of the consultation process in order to identify the best option rather than just considering the finer details of a policy that has already been largely decided.

We appreciate that the credit approach mentioned above does not fall strictly in line with the Government's wish to promote the relief as a reduced IHT rate. While it would undoubtedly be difficult for the Government to renege on its pledge, it is a shame that alternative policy options have not been opened to broader consultation.

It would appear that the choice of policy has been influenced significantly by an apparent assumption that the relief could be open to abuse. This viewpoint has arguably added to the complicated nature of the measures, with too much emphasis placed on providing sufficient anti-avoidance measures. It is Grant Thornton's experience that such charitable endeavours are rarely taken advantage of for tax avoidance purposes. We would suggest that such abuse would be rare, especially given the relatively low numbers of individuals subject to even a basic level of IHT.

The consultation document mainly centres around how one is to arrive at the requisite 'baseline' upon which to calculate the required 10% donation. While further analysis is provided below, in our direct answers to the questions asked throughout the document it would seem unsatisfactory to limit the reduced rate to only certain 'components' of one's estate. Indeed this brings with it further complication. We would agree with the statement at paragraph 2.13 of the consultation document that it would be sensible that there is, "a correlation between the value on which the 10% test is based and assets that benefit from the reduced rate of IHT". However, as pointed out in our answer to question 2c) below, there is no logical solution to this alternative as the calculation required to achieve this proves an impossible equation.

We would suggest that the period of consultation be extended in order to further consider the alternative policy options that are available.

Specific comments

We set out our comments on the specific questions raised in the consultation document below.

The 10% test and application of the reduced IHT rate

1. Should the reduced IHT rate be available only to assets within the free estate; or should it be possible to extend its availability, by election, to other assets on which IHT is due following a death?

If the measures are to be introduced as a true '36% IHT rate' it would seem contrary to the policy objective if the reduction should not apply to all assets subject to IHT on death.

We would agree with the comments made at 2.15 of the document in that, "limiting the application of the reduced rate to assets within the free estate could be seen as discouraging potentially larger charitable legacies". It would seem appropriate, therefore, to extend the reduced rate, by election, to all other assets held, including a qualifying interest in possession.

However, the charities themselves will no doubt harbour concerns that they could be left with an asset that holds a value that would be difficult, in practice, to realise.

2. If the reduced rate can be applied to assets outside the free estate,

a) should all other components of the IHT estate be considered eligible for the reduced rate or should eligibility be limited to particular components (for example, joint property) only?

As above, if the supposed objective is to be achieved, the reduced rate should be available to all assets. However, see our answer to part c).

b) who should be party to any election to extend the application of the reduced rate?

The respective personal representatives should be party to any election. If interests in possession are included, the personal representatives and the trustees should be party to the election.

c) how should the benefit of the reduced rate be applied in cases where charitable legacies were sufficiently high to successfully pass the 10% tests for more than one component of the estate, but not high enough to pass the 10% test for all components?

It is logical that a correlation exists between the base value upon which the '10% test' is based and those assets able to benefit from the reduced rate. It would seem equally reasonable to base the test on any 'components' of the estate elected for by the respective taxpayers.

However, the calculation required in order to facilitate the apportionment of the nil rate band, as demonstrated by example 5, would appear to be inherently flawed in that there are too many unknown variables in the equation. If a 10% donation is hoped to be achieved, the apportioned nil rate band must be known. This number is dependent on the amount of donation, however, creating a circular reference.

Reaching the optimum solution may be achieved, as the nil rate band will simply be pro-rated based on the size of each 'component' of the estate. However, in any other scenario (ie one where any particular component does not have a charitable legacy attributable to it) the calculation of the minimum donation required in order to achieve the requisite 10% for a specific component is an impossibility, disregarding the 'trial and error' method of calculation. This is not satisfactory.

Nature of the legacy

3. Should the new charitable legacy incentive encourage all forms of legacy for the purposes of the 10% test, or would charities prefer to encourage legacies of more easily realised assets (such as cash, quoted shares or real property)?

It is likely that the charities would not be averse to the stipulation that a qualifying legacy be made up of only cash and quoted securities, as they would no doubt prefer to receive assets whose value may be realised more readily. Charities will undoubtedly want to comment further on this aspect.

However, limiting the types of eligible asset may discourage the making of gifts from asset rich but cash poor estates. While it is not unfeasible that the respective personal representatives could borrow against the value of certain assets in order to satisfy this restriction, this will add another layer of complication, not to mention cost, to the measures.

4. How could the administrative burdens to personal representatives and HMRC be minimised where a charitable legacy includes assets other than cash, quoted shares and real property?

Unfortunately, the increased administrative burdens would appear to be largely inherent in the proposals. If the relief is open to all 'components' of an estate, there will undoubtedly be valuation issues to consider, regardless as to what assets make up the charitable legacy.

5. Should the entitlement to the reduced rate of IHT where there is a charitable legacy of 10% be automatic, or should provision be made for personal representatives to disclaim any entitlement to the reduced IHT rate?

In the interest of simplification, the reduced rate should be awarded automatically. The vast majority of cases are unlikely to require the disapplication of the rules. However, for the reasons summarised in paragraph 3.10 of the consultation document, the potential to disclaim the entitlement should be provided for.

Presumably, where the reduced rate is disapplied, the existing charity exemption will still apply?

6. What is the potential extent of avoidance based on manipulation of the value of charitable legacies, and what is the nature of any particularly risky assets or arrangements?

As alluded to above, the potential scope for avoidance here is perhaps overstated in the consultation document. There would be little scope for manipulation, none more than is current, as any amount bequeathed to a charity under a Will becomes a legal entitlement.

Furthermore, it is the opinion of most professional advisers that the utilisation of a charity exemption in any way other than as intended would not be viewed as an acceptable method of tax avoidance.

7. Where do respondents see the balance lying between ensuring that as wide a range of assets as possible count towards the 10% test and the possible need for anti-avoidance rules to prevent manipulation of asset values?

It is Grant Thornton's belief that advisers are unlikely to recommend the manipulation of asset values for these purposes. We would anticipate that such instances would be rare.

Indeed we would like to hope that the majority of professional firms would seek to distance themselves from any scheme reliant on the abuse of a charitable exemption. Any connection with such a scheme would be likely to damage the reputation of that firm.

Instruments of Variation (IoV)

8. Where the reduced rate is dependent on the execution of an IoV, should it be conditional on HMRC receiving confirmation that the charity is aware that the IoV has been effected? How should such confirmations be given to HMRC to minimise administrative costs?

The issuing of a letter of receipt by the charity would seem the most straightforward solution here. However, a question of timing must be raised, especially where there is more than one charity benefitting from the donation.

Administrative issues

9. Although the drafting of Wills and professional advice are not areas where HMRC have a direct interest, will there be any significant difficulties in drawing up Wills or advising clients on how to benefit from the reduced rate which might affect take up or influence policy design?

The crux of the new provisions appears to rely on the assumption that a number of philanthropic individuals will subsequently be encouraged to increase their charitable legacies to the requisite 10%. In many cases this will mean having to amend an individual's Will. This should not prove significantly onerous, as a general clause stating a wish to satisfy the 10% requirement could easily be included. However, the requirement to make such an amendment, coupled with the complicated nature of the proposals, will further limit the likely take up.

Other issues

10. Would basing the 10% test and applying the reduced rate to the non-deferred part of the estate and IHT charge be the most suitable method for dealing with deferred IHT liabilities? If not, what alternative approach is preferred?

We would agree that the solution offered in these circumstances is a sensible measure in the interests of simplification.

11. HMRC expects that existing processes to deal with amendments to the IHT liability will apply to the new policy. Would this approach give rise to any issues?

It is essential that any new provisions are consistent with the existing IHT regime. Accordingly, it is right that the existing processes would apply here.

12. Would limiting the basis for the 10% test for non-UK domiciled people to assets on which they are liable to IHT present any difficulties?

In accordance with general opinion considered above, it is logical that the 10% test is based only on assets liable to UK IHT.

We should welcome clarification, however, as to whether a 'qualifying' charitable legacy for these purposes will need to be made from UK assets, as inferred at paragraph 3.24 of the consultation document. Would the reduced rate not also be available if a non-domiciled individual wished to donate non-UK assets, at a value equivalent to the requisite 10% of their chargeable UK assets?

13. Where grossing up applies and the outcome of the 10% turns on the rate at which the chargeable assets are grossed up, the most favourable way to apply the 10% test to a share of the residue passing to charity appears to be to gross up at the reduced rate of IHT. Are there any problems anticipated with using this method?

We do not foresee any particular problems here.

14. Where interaction applies, would basing the 10% test on the actual value of the legacy before the application of those rules present any difficulties?

We do not foresee any particular problems here.

Taxes Impact Assessment

15. The Government is interested in receiving comments from people who have information that may help refine or improve those assumptions, and on what metrics could be used to assess the effectiveness of the policy.

See our earlier comments on the measure.

16. The Government would welcome information from advisers or their representative groups about how likely they are to promote this measure and what they expect the take up will be.

As with all new measures, tax advisers would want to keep relevant clients informed and in fact as part of good client service this would be expected. However, the objective of these measures is to encourage charitable giving and not the introduction of a new opportunity for an adviser to charge a fee to their clients, which they would undoubtedly have to do, given the complexity of the provisions.

We have no basis to believe that the introduction of this measure will encourage the making of a charitable legacy where a donation would not otherwise have been made. In our experience, charitable donations are made for many reasons, tax saving very rarely being one of them.

17. The Government would welcome information from charities about how likely they are to promote this measure and what they expect take up to be.

Not applicable.

Conclusions

Grant Thornton's opinion is that the inherently complicated measures proposed are, ultimately, unlikely to achieve the intended objective. In addition, with several other consultations currently on-going that purport to improve and simplify their respective areas of tax, the introduction of such measures would appear to be the antithesis of the Government's stated desire to simplify an already overcomplicated tax administration.

That said, the overall objective of encouraging donations to charities is unquestionably worthy and so it is in the best interests of all to try to reach a satisfactory solution to the issues highlighted above. It is our belief that a better compromise solution may yet be achieved if time be granted to fully consider the merits of the alternative methods put forward.

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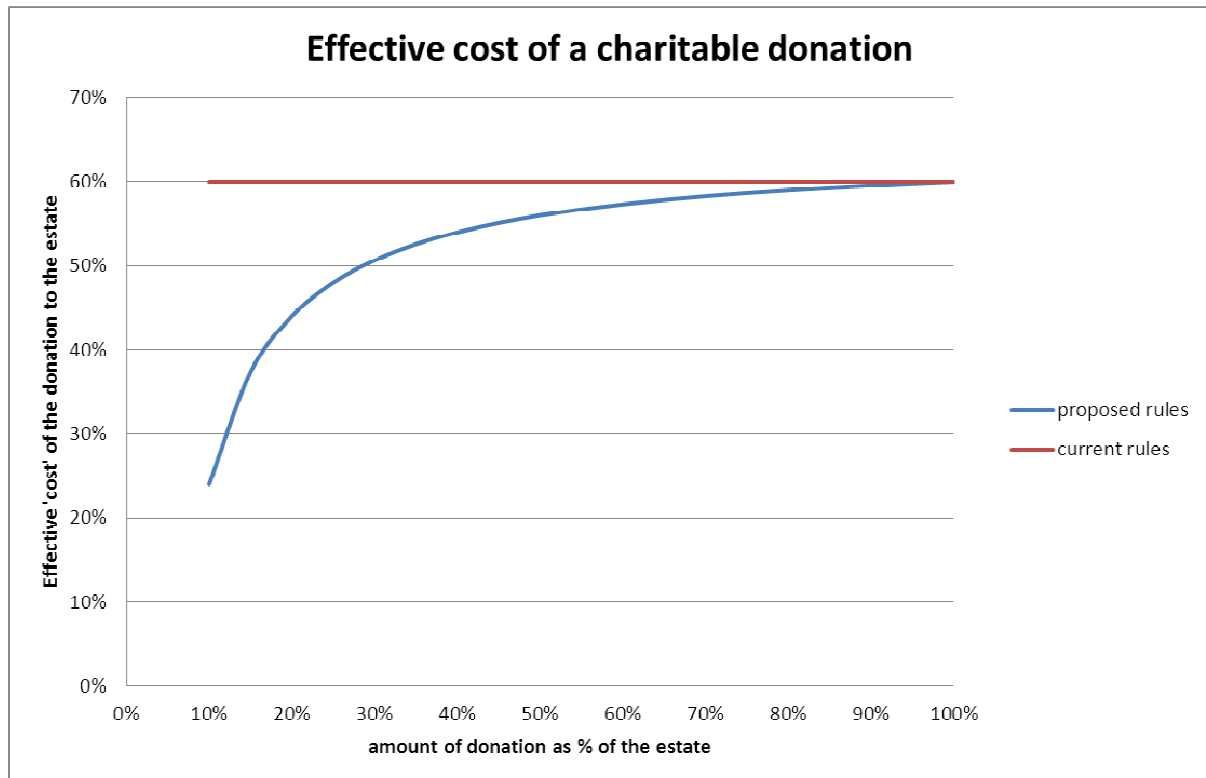
Appendix 1

The examples in the tables below adopt a 'baseline' figure of £675,000, based on an estate of £1 million, less the nil rate band. In this scenario, if no charitable legacy is made, an amount of £730,000 would be left for the beneficiaries.

Table 1 shows the effect on the remaining estate value if a charitable legacy of 10% or more is made. These examples demonstrate that the proportionate benefit drops quite rapidly for gifts in excess of the optimum 10% gift to charity. The relationship between the size of the donation and the 'effective cost' of the legacy to the estate is further evidenced by the graph below.

Table 1

	No gift	Proposed rules - 10% gift	Proposed rules - 12% gift	Proposed rules - 15% gift	Proposed rules - 20% gift	Proposed rules - 40% gift	Proposed rules - 75% gift
Estate value	£ 1,000,000	£ 1,000,000	£ 1,000,000	£ 1,000,000	£ 1,000,000	£ 1,000,000	£ 1,000,000
Less: available NRB	£ 325,000	£ 325,000	£ 325,000	£ 325,000	£ 325,000	£ 325,000	£ 325,000
Less charitable gift	£ -	£ 67,500	£ 81,000	£ 101,250	£ 135,000	£ 270,000	£ 506,250
Taxable estate	£ 675,000	£ 607,500	£ 594,000	£ 573,750	£ 540,000	£ 405,000	£ 168,750
IHT rate	40%	36%	36%	36%	36%	36%	36%
IHT liability	£ 270,000	£ 218,700	£ 213,840	£ 206,550	£ 194,400	£ 145,800	£ 60,750
Remainder of estate	£ 730,000	£ 713,800	£ 705,160	£ 692,200	£ 670,600	£ 584,200	£ 433,000
Cost of charitable legacy after IHT saving		£ 16,200	£ 24,840	£ 37,800	£ 59,400	£ 145,800	£ 297,000
effective cost of charitable gift (% of actual gift)		24%	31%	37%	44%	54%	59%



The overall cost to the estate of a four per cent gift under the current rules is the same as a 10% gift where the balance of the estate benefits from a 36% tax rate, albeit with vastly different amounts subsequently paid over to the respective charities.

The table below (table 2) confirms that the proposed reduction in IHT rate will benefit any estate that includes a charitable legacy in excess of four per cent of the taxable estate. However, where a donation of less than four per cent of the taxable estate is to be provided for, the respective individual is unlikely to be influenced by the measures, as increasing the legacy to reach the requisite 10% under the proposals would reduce the remainder of the estate left for other beneficiaries.

Table 2

	No gift	Proposed rules - 10% gift	2% gift (current or proposed rules)	4% gift (current or proposed rules)	6% gift (current or proposed rules)	8% gift (current or proposed rules)	Current rules - 10% gift
Estate value	£ 1,000,000	£ 1,000,000	£ 1,000,000	£ 1,000,000	£ 1,000,000	£ 1,000,000	£ 1,000,000
Less: available NRB	£ 325,000	£ 325,000	£ 325,000	£ 325,000	£ 325,000	£ 325,000	£ 325,000
Less charitable gift	£ -	£ 67,500	£ 13,500	£ 27,000	£ 40,500	£ 54,000	£ 67,500
Taxable estate	£ 675,000	£ 607,500	£ 661,500	£ 648,000	£ 634,500	£ 621,000	£ 607,500
IHT rate	40%	36%	40%	40%	40%	40%	40%
IHT liability	£ 270,000	£ 218,700	£ 264,600	£ 259,200	£ 253,800	£ 248,400	£ 243,000
Remainder of estate	£ 730,000	£ 713,800	£ 721,900	£ 713,800	£ 705,700	£ 697,600	£ 689,500
Cost of charitable legacy after IHT saving		£ 16,200	£ 8,100	£ 16,200	£ 24,300	£ 32,400	£ 40,500
effective cost of charitable gift (% of actual gift)		24%	60%	60%	60%	60%	60%