



The Law Society

A new incentive for charitable legacies: A lower rate of inheritance tax when leaving 10% of an estate to charity

Comments of the Tax Law Committee of the Law Society of England and Wales

Introduction

1. The Law Society is the representative body for over 140,000 solicitors in England and Wales. It negotiates on behalf of the profession, and lobbies regulators, Government and others.
2. This response has been prepared on behalf of the Society by members of the Capital Taxes Sub-Committee, which is made up of senior and specialist lawyers practising in this field.
3. The Law Society welcomes this opportunity to comment on the consultation paper 'A new incentive for charitable legacies' (published 10 June 2011) which concerns the reduced rate of IHT for those leaving 10% or more of their estate to charity.

General Comments

4. While it is noted that the overall policy of introducing a reduced rate of IHT to encourage charitable legacies is not part of the consultation, the Law Society is concerned that the new rules will be complex and that they are likely to be widely misunderstood. For the first few years after the new legislation comes into force it is likely that the incentive will principally influence and be used by beneficiaries entering into Instruments of Variation within section 142 IHT Act 1984. This will be because
 - (a) The wills taking effect during this period will have been made before April 2012 and not altered since, and
 - (b) Testators are likely to be cautious about leaving inflexible wills leaving specific amounts to charity because of the possible effects of changes in the value of the estate e.g. due to changes in property and investment values, or the testator's own needs between the making of the will and the death
5. The Government has stated that it wants to support philanthropy and these changes are designed to enable it to share the cost of testamentary donation to charity with the donor. The consultation document specifically excludes debate on whether what is proposed will actually achieve this purpose or whether it is an intrinsically workable idea. The Law Society is not convinced that the proposal will encourage testamentary charitable giving and believes that the administrative burden and the amount of cost involved for HMRC, practitioners and therefore private clients and charities in

implementing workable changes to the IHT system may outweigh the perceived benefit of supporting philanthropy. It is thought that it would be more useful to charities to reinstate the repayment of dividend tax credits and make gift aid easier.

6. It is worth remembering that the proposed changes will have no impact at all on the majority of estates which cannot benefit from the reduced rate because they:
 - (a) are not subject to the payment of IHT as the chargeable transfer on death is within the available nil rate band (NRB) and any transferable NRB;
 - (b) include only gifts which are included in the NRB or are covered by another exemption or relief such as spouse exemption or charitable exemption e.g. a gift of the NRB to nephews and nieces and the residue to charity. Even if the residuary estate is worth millions of pounds the estate will be non-taxable.
7. For some estates which are taxable but which give less than 10% of the net estate to charity is there any evidence that the 4% reduction in the IHT rate from 40% to 36% is a sufficient incentive to reduce the amount of the residuary estate which may be earmarked for the donor's family in order to achieve a marginally lower rate of tax?
8. The cost of introducing the relief is said to be £170 million in lost IHT per annum. It is not known how this impact has been assessed but even if it is correct it does not include the extra costs of applying the rule change in practice. There is also no link between the reduction in IHT take and additional charitable donations. It is possible that this initiative may simply encourage the already philanthropic to stop lifetime giving in favour of testamentary giving. If wills are not prepared or estates have been reduced by the time of death to make the relief inapplicable the ultimate charity take will be reduced. Charities need lifetime giving incentives to meet current shortfalls in income.
9. Given the uncertainty as to when people will die at the time of making a will; the impact of care costs and other expenses between the date of the will and the date of death and the needs of the donor's family and other dependents, it is likely that many private clients will not include provision in their wills to take advantage of this change but will rather leave it to their residuary beneficiaries on death to assess the merits of making a post death Instrument of Variation (IOV).
10. Despite a lack of enthusiasm for this change the Law Society offers its specific comments on the questions included in the consultation document.

Specific Comments

Question 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?

11. The IHT reduced rate should be available in relation to both assets within the free estate and other assets on which IHT is due following death which are outside the free estate, such as the capital of a trust fund which is treated as beneficially owned by the deceased under Part III Chapter II IHTA 1984.
12. Private clients often do not understand the distinction between their free estate and property passing by survivorship. To limit the 10% test to the free estate may mean

that clients who think they have left a legacy large enough to amount to 10% will in fact have not left sufficient. Not everyone is well advised and those who choose to make their own wills or who fail to receive appropriate advice and are therefore unaware of what is included or excluded from the 10% rule will only be disappointed.

13. In many cases where the reduced rate of IHT is likely to be relevant the testator will probably wish the decision to be deferred until after his death when it will be taken by those affected. As such it would be perverse to deny the opportunity for those not inheriting directly under a will to take advantage of the new rules.

Question 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?**
 - (b) Who should be party to any election to extend the application of the reduced rate?**
 - (c) How should the benefit of the reduced rate be applied in cases where charitable legacies were sufficiently high to successfully to pass the 10% tests for more than one component of the estate, but not high enough to pass the 10% test for all components?**
14. (a) It is common for a twice married testator to give the second spouse an immediate post death interest in possession ('IPDI') in the estate with the remainder interests passing to the testator's children (often from the first marriage) on the second spouse's death. Those children ought to have the same opportunity to make charitable gifts out of what they are to receive as a beneficiary who receives an outright gift.
- (b) There is no justification for providing the relief to one part of the estate, namely the free estate, because beneficiaries of another part of the estate (such as the remainder beneficiaries under a qualifying IIP trust) qualify for the charity exemption and therefore provide the opportunity for the reduced rate to apply on the free estate.

Separate IHT assessments are already issued for the free estate, property passing under a qualifying interest in possession and joint property etc. The new rules can be applied to each segment, title by title, to achieve fairness between what will often be different beneficiaries of each title. Consideration should be given, however, as to how the reduced rate will apply in the context of joint tenancies and gifts with reservation of benefit. For example, will a surviving joint tenant or transferee of property subject to a reservation be able to fund the relevant charitable gift from his own resources or must the charitable gift come from the property passing by survivorship/property subject to the reservation? What would be the time period in which the charitable gift must occur?

Entitlement to the reduced rate should automatically apply to each title in the estate but the beneficiaries of each title who are liable for the tax on their element should be able to disclaim..

- (c) Section 142 IHTA 1984 should be extended to allow a redirection of property by a remainderman following the death of the person with a qualifying interest in possession in the settlement. Remaindermen inheriting after the death of a person with a qualifying interest in possession trust are at a disadvantage

compared to those who benefit from an outright gift under a will or from inheriting joint property in that they have no current opportunity to use s.142 IHTA 1984.

Question 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)?

15. It is acknowledged that where someone leaves something to charity at present the valuation of that asset does not give rise to any practical problems – irrespective of the nature of the assets the gift is IHT free. However, this will not be true with the new proposal because the value of the specific charitable bequest may affect the IHT due in relation to the estate.
16. Having to agree valuations may incur the PRs in costs; take up HMRC resources and effectively potentially reduce the amount available for charity. However there are already issues with valuing assets on death and there are ways of arriving at solutions on valuations. The complexity which the new rules will introduce is whether there are assets that are relatively hard to value which affect whether the 10% threshold has passed. Whilst it is possible that some private company shares may be left to charity if they are part of a general winding up of a person's affairs, for the majority of estates this would not be a mainstream issue and it would make no sense to make processes and procedures for exceptional cases. If in a particular case a charity does not wish to incur any such costs it may always disclaim its interest.

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

17. It is not thought that there will be many cases of this type to justify excluding particular assets from the new rule.

Question 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?

18. The entitlement to the reduced rate of IHT should automatically apply to each title in the estate to ensure that in straightforward cases the personal representatives do not overlook claiming the relief. However, there should be the opportunity for those beneficiaries of any particular title to disclaim the new reduced rate on their title for whatever reason.

Question 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?

19. Given our response to questions 3 and 4 above it is not anticipated that there is any particular risk of avoidance with most assets. The concern about value-shifting would apply primarily to private company shares in investment companies and few estates

would be involved in leaving these to charity but if they did some charities may choose to disclaim their interest because of difficulties of valuation.

Question 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?

20. The Law Society does not see the need for any special provisions for particular asset types.

Question 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 confirmation be given to HMRC to minimise administrative costs?

21. It would appear that the Government expects gifts which qualify the estate for a reduced rate to IHT to be included in wills, the Law Society believes that the use of IOVs will be the main way the new proposed rule will be used. It is acknowledged that HMRC are concerned that certain unscrupulous people may seek to manipulate the situation given that IOVs are not policed in the same way as wills, since they are private documents which do not become public in the way that wills which have gone through probate enter the public domain and by doing so put any charity mentioned on notice to anticipate receipt of the legacy.
22. However, passing gifts to charity by an IOV is not a new concept. It already happens and the effective rate of IHT on the rest of the estate is already reduced, even though by not as much as under the new rules.

Question 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?

23. The drafting of wills to include provision for a gift which might provide an entitlement to the new reduced rate of IHT will inevitably have to be on the basis of a formula clause rather like those which have been developed to use the NRB and transferable NRB.
24. It therefore means that the policy should make it clear which estates need to adopt an approach which utilises such a clause and therefore encourages an individual to obtain appropriate advice from trained and regulated professionals. Any guidance must make it clear that the reduced rate will be of no relevance to many estates and should provide examples so as to manage individual expectations and minimise possible misunderstandings which always are costly to identify and remedy in professional advice terms.
25. It should be noted that providing advice to family beneficiaries as to whether to make an IOV compared with the making of a gift aid donation by them during lifetime and potentially getting income tax relief at what might be 50% if they are higher income earners, means that it is likely that beneficiaries might be disinclined to proceed to enter into an IOV but will have incurred significant professional costs in reaching this decision.

26. It is also felt that there is a possibility that the introduction of the new reduced rate for IHT might encourage more litigation on the basis of a lack of validity in marginal cases with families arguing that the workings of the new relief are too complex for the deceased to have known and approved at the time the Will was prepared because had he understood the impact on the family which it produced he would not have made the will he did.
27. As indicated above, any changes should permit the remaindermen following the death of the person with a qualifying interest in possession in a settlement to make a post death IOV to take advantage of the new reduced rate of IHT. This will necessitate the amendment of s.142 IHTA 1984. If the provisions of s.142 are amended will HMRC also consider amending s.144 IHTA 1984 to remove the so called 'Frankland trap' which arises when Deeds of Appointment are undertaken in the first three months following the testator's death when the appointment is made absolutely to a beneficiary; whereas the appointment to an IPDI trust does not suffer a charge to IHT in the same way.

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

28. Yes.

Question 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?

29. Not so far as the Law Society can see in the absence of any detailed proposals.

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

30. The Law Society welcomes the idea of excluding offshore property of non-domiciled persons for the purposes of meeting the 10% requirement.
31. It enables the new rules to apply to particular 'titles' within an estate as appropriate – in this case the assets of a non-domiciled person that fall within the IHT net.
32. However it should be permissible for a non UK domiciliary to fund the charitable gift from assets which are not liable for IHT (ie non UK assets).

Question 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?

33. This proposal appears to the Law Society to be a sensible way to apply the new rules, which would otherwise be over-complex and much misunderstood.

Question 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?

34. This proposal appears to the Law Society to be a sensible way to apply the new rules, which would otherwise be over-complex and much misunderstood.

Question 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.

35. No comment.

Question 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.

36. If the measure is introduced it will be necessary for professional advisers to acquaint relevant clients with the proposals and how they will affect their estate. For some this will result in a formula clause in their will but for the majority this will not be taken up for the reasons given above and the Law Society believes that most solicitors will have to raise it again in the administration of estates where the change by IOV would make a difference to the estate.
37. In addition, many law practices include in their marketing mix literature for clients and free information on websites for the public to access. It is inevitable that such firms will include information about the new rules when they are finalised.
38. The take up will, in the opinion of the Law Society, be low since most families put their spouse, children and grandchildren first and only if they have adequately provided for them would they consider a gift to charity or introduce a gift to charity as a longstop gift in the event of all members of their family being lost. We can however see that testators who do not have close family could find the incentive of interest.
39. Whenever an individual is already inclined to leave a legacy to charity which amounts to more than 4% of his taxable estate but less than 10% the knowledge that increasing the charitable legacy to 10% will potentially give a considerable boost to the amount given to charity without disadvantaging their other beneficiaries and in some cases provide a gain to the non-charitable beneficiaries by reducing the IHT rate on the chargeable estate, may encourage them to make a change but this will not be every relevant client's choice.
40. It is not possible for the Law Society to quantify the likely take up.

Question 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.

41. The Law Society is concerned that over publicising the new rules will result in it being inappropriately targeted to intending testators for whom the new rules are not applicable which will create more work for solicitors in explaining to intending testators why the new rule will not apply to their estate.

Contact details:

If you have any questions concerning these representations or would like to discuss anything contained in them, please contact the Chair of the Capital Taxes Sub-Committee, Penelope Williams (tel: 020 7597 6093, e-mail: Penelope.Williams@withersworldwide.com) or Gill Steel (tel: 01962 776442, e-mail: gill.steel@lawskills.co.uk).