

A new incentive for charitable legacies Response by the Chartered Institute of Taxation

1 Introduction

- 1.1 The Chartered Institute of Taxation (CIOT) sets out below its comments on HM Revenue & Customs' (HMRC) consultation document 'A new incentive for charitable legacies: a lower rate of inheritance tax when leaving 10% of an estate to charity' issued on 10 June 2011.
- 1.2 We note that this proposal was announced on 23 March 2011 Budget day. The scope of the consultation is highly restricted as the key principles of the incentive have been predetermined. Accordingly, the fundamental defects in these misguided proposals will, unless proper notice is taken, become enacted.
- 1.3 We are disappointed that all the steps set out in the Tax Consultation Framework, which was also issued on Budget day, were not followed in this case.
- 1.4 We suggest, yet again, that a simple and workable solution to the difficulties inherent in the way the current proposals are structured would be to attach a 10% non-repayable IHT credit to all charitable gifts on death.

2 Executive summary

- 2.1 We object to the proposals on the bases fully set out in paragraphs 3 to 7 following. Our objections are:
 - The proposals are complex and run entirely counter to the tax policy objective of simplification;
 - The Consultation process is flawed: it fails to meet the criteria set out in the Tax Consultations Framework;
 - By giving an effective 76% relief from IHT, the proposals may act as a perverse disincentive to lifetime giving;
 - The Consultation completely ignores the burden of additional valuation and compliance costs, which any estate around the 10% threshold will be forced to bear; and
 - The Consultation does not address issues raised at pre-consultation, particularly the possibility of enacting the ability to vary a remainder interest

in a settlement.

- 2.2 We suggest, as an alternative, that the objective of encouraging charitable giving on death could be achieved far more simply by attaching a 10% non-repayable IHT credit to all charitable gifts on death. This is expanded in section 8 below.
- 2.3 Given our fundamental objection to the proposals as currently structured, our response to the Consultation is brief, and appears from section 9 onwards.

3 Complexity

- 3.1 In the HMT/HMRC document 'Tax policy making: a new approach' (June 2010) predictability, stability and simplicity were stated as being the cornerstones of the new approach. We regret that this proposal fails on each count, but especially on the third.

Paragraph 2.19 states:

'In designing new tax policy, the Government will give weight to simplicity, alongside other policy objectives. This will ensure that, as far as possible, reforms minimise transitional costs on business and the burden of complying with the tax system.'

Paragraph 2.20 of 'A new approach' states:

'The creation of reliefs or exceptions in the tax system can add to complexity. Consistent with the broader regulatory reform agenda, the Government will consider proposals for new reliefs carefully, and will want to satisfy itself that there is a strong and proven case.'

There is no evidence to support this commitment in the Consultation Document.

- 3.2 There are two elements of complexity: first in ascertaining the aggregate 'estate' and second in calculating the 10% threshold.
- 3.3 The Consultation recognises that it would be appropriate to regard the 'estate' as comprising the aggregate of all the elements which are taxable by virtue of death. Thus the concept includes not only the free estate of the deceased, but also joint property, qualifying interests in possession, and property subject to reservation of benefit. For there to be any logic and consistency in the proposals, the tax reduction should apply to all elements, without distinction.

However, the Consultation seems to suggest that each component (as well as the aggregate) should reach the threshold.

- 3.4 The second element of complexity is far more serious. The subtitle to the Consultation 'A lower rate of IHT when leaving 10% of an estate to charity' is highly misleading. The reduced rate does not apply when 10% of an estate is left to charity, but only when meeting a threshold of 10% of a notional figure upon which, by happenstance, IHT is ultimately borne.
- 3.5 Example 1 (paragraph 1.15 of the consultation) provides an example where a £52,000 legacy out of an £850,000 estate will qualify. On such figures one is hard-pressed to explain where the principle of 10% comes from.

- 3.6 The Consultation provides examples of increasing complexity – and difficulty of comprehension. This is the antithesis of simplicity.

Example 5 (paragraph 2.17) requires each component of the aggregate estate to meet the 10% notional threshold, yet overall the charitable legacies represent 10.3% of the aggregate threshold. Is this really what one would expect?

- 3.7 The depth of complexity, and difficulty for taxpayers if the proposals become law, is revealed by Example 7 (paragraph 3.30). The initial version was wrong and was re-issued in corrected form on 17 June 2011. If HMRC who have been developing the policy get it wrong, what hope is there for the taxpayer?
- 3.8 The arbitrary way that the 10% threshold has been structured means that a larger legacy obtains a lesser proportionate benefit. This acts as a perverse disincentive to giving over the 10%.
- 3.9 The Consultation makes no attempt to convince us that the supposed benefits outweigh the complexities of the proposed relief. We fear that the very complexities, uncertainties and costs inherent in the proposals as to whether the relief would apply may well act to dissuade would be testators from embracing it.
- 3.10 Given the small number of estates which actually suffer IHT, and small amounts which (even on the Consultation's uncorroborated assertions) might be raised, the proposals represent tinkering on the very extremities of the system. One contributor described them as a 'gimmick'.

4 Consultation process flawed

- 4.1 Paragraph 2 of the Tax Consultation Framework, published contemporaneously with the announcement of this incentive on Budget Day 2011 sets out the five stages for the effective development and implementation of tax policy:
- Stage 1: Setting out objectives and identifying options.
 - Stage 2: Determining the best option and developing a framework for implementation including detailed policy design.
 - Stage 3: Drafting legislation to effect the proposed change.
 - Stage 4: Implementing and monitoring the change.
 - Stage 5: Reviewing and evaluating the change.
- 4.2 Stages 1 and 2 have been truncated in that the objective of the policy 'to encourage charitable giving' (paragraph 1.1) is stated but there is no scope to consider practical options. Consideration of the structure of the incentive is restricted to the matters set out in paragraph 1.21 and wider aspects (paragraphs 1.22 and 1.23) 'are not being considered under this consultation'.
- 4.3 With the announcement of the intention to introduce a relief to encourage charitable legacies on Budget day, there was plenty of time to go through all the stages set out in the Policy Making document. Doing so would have avoided all the practical difficulties highlighted in the Consultation document –

assuming that consultation responses were properly considered.

- 4.4 CIOT were pleased to take part in a pre-consultation following the Budget announcement, but are disappointed to see that few, if any, of the suggestions put forward by the professional bodies to improve the incentive have appeared in the published document.
- 4.5 This does not follow the vaunted (and generally welcomed) 'new approach' tax policy making, but sadly, reveals that the lessons provided by the previous administration of the dangers of not taking proper consultation seriously have still to be learned.

5 Discouragement to income giving during lifetime

- 5.1 Many elderly taxpayers are asset rich but income poor. As pointed out at 1.16 of the Consultation, where exactly 10% of the net estate is given to charity, each £100 of charitable legacy reduces the IHT on the estate by £76. 76% relief on death may well appear more attractive to donors, than at best, 50% under Gift Aid. For the basic rate taxpayer, the temptation to stop lifetime giving may be irresistible. We understand that overall legacies represent only 3% of charities' income. It would be disastrous if the far larger stream of lifetime giving were reduced. We wonder whether these presumably unintended consequences behind the present proposal have been fully explored and whether charities appreciate the possible impact.
- 5.2 The Consultation (page 22) sets out the additional revenue that charities are expected to derive from the proposed measure. Estimates by the legacy specialists Smee and Ford put total UK charitable legacies at £1.9bn in 2009. In the Consultation the lowest estimated increase in 2012-13 of £15m represents less than 1% of that. However by 2015-16 the projection has grown remarkably by a factor of 10.

Despite this, the Consultation (inevitably) admits that 'we do not know how many [of the 300,000 charities in the UK] will be left additional legacies' (page 23) and again (on page 22) 'the number of estates where the amount that is left to charity is changed as a result of this measure is highly uncertain [specific figures then follow] ... The average increase in the amount left to charity is assumed to eventually be around £60,000'.

- 5.3 Since the Consultation provides no rational explanation for the benefits the proposals are supposed to provide, and does not address the possibility of donors diverting lifetime giving (with the attendant cash-flow disadvantages to charities) we can only assume that the figures are purely speculative. It follows that there can be no justification for imposing a further complex relief, which will (see section 6 below) be burdensome to administer.

6 Compliance costs ignored

- 6.1 The Consultation states (page 22) that 'no impacts on businesses are expected. Solicitors and other professional advisers are acting as agents for individuals, so any impact on them is captured under the impact on individuals

above'. However, in the preceding paragraphs, there is no cost given of the impact on individuals.

- 6.2 The Consultation further admits that the one-off costs to professionals of familiarisation and training are unknown. What the consultation blindly fails to recognise is the cost which will arise in any estate where the arbitrary 10% threshold may be at issue. Complex enquiries will have to be made and valuations obtained where that might otherwise not have been the case [although this is recognised at paragraphs 3.4 and 3.5 in the Consultation it is ignored in the Impacts section].

Then the complicated calculations, evidenced by the examples in the Consultation, will have to be undertaken. Where the charitable legacy falls marginally below the 10% threshold, the non-charitable beneficiaries may face pressure from the charity to increase the legacy by way of variation. The conduct of the administration will, whatever the outcome, be prolonged, with adverse costs implications.

- 6.3 It is patently wrong to have ignored the ongoing, and not insubstantial, costs of complying with these proposals, when calculating whether there may be an overall benefit.

7 Suggestions from professional bodies ignored

- 7.1 At the pre-consultation stage the professional bodies pointed out the limitations inherent in utilising a deed of variation to increase charitable giving to the requisite 10%. In particular, where the bulk of the aggregate IHT estate comprises a qualifying interest in possession (arising from the death of the first spouse or civil partner) and the free estate is insufficient to fund a variation to leave 10% to charity, it was suggested that a form of statutory 'variation' be allowed in respect of the remainder interest. This proposal, which is in our opinion eminently sensible, has not even been addressed.
- 7.2 Of greater significance perhaps, the suggestion developed in section 8 below, was ignored.
- 7.3 The difficulties and complexities outlined above would be substantially reduced if our suggestion for a non-repayable 10% IHT credit were adopted.

8 A solution? A non - repayable 10% IHT credit

- 8.1 We have identified two elements of complexity: first in ascertaining the aggregate 'estate' and second in calculating the 10% threshold. Instead of the current proposals, the objective of encouraging charitable giving on death could be achieved far more simply by attaching a 10% non-repayable IHT credit to all charitable gifts on death.
- 8.2 We suggest that, in addition to the existing IHT charitable exemption, every £9 left to charity attracts as an incentive a £1 non-repayable IHT credit. The concept is simple to grasp: it is immediately attractive and is understandable by the public, given its similarities with Gift Aid. The mechanism, as outlined below, would mean that there is no 'cliff-hanger' or *de minimis* effect.

- 8.3 If the (aggregate) estate was not subject to IHT, then the IHT credit would not be available. If the credit exceeded the IHT bill on the estate, the excess would not be repayable. And if the IHT bill on the estate was greater than the credit, then the balance would be collected in the normal way. We would prefer that this relief is granted automatically through submission of the IHT account, rather than as a further claim in addition to the claim for charitable exemption. Clearly it should be possible to invoke the relief when paying over the estimated IHT to obtain probate.
- 8.4 Our proposal provides an incentive for the larger, IHT-bearing estate, and it encourages even higher amounts of charitable giving, since, unlike the Consultation proposals, the incentive does not reduce with a larger gift.
- 8.5 Our proposal does away with both levels of complexity in the Consultation. However, the greatest benefit would be removal of the need to calculate the entirely arbitrary 10% threshold.
- 8.6 If it is still thought necessary to give specific encouragement to larger amounts of giving, the credit could be increased (to 15% or 20%?) where the charitable legacy exceeds a given threshold, perhaps £100,000. It has been suggested that a variant of this model might be used to encourage substantial lifetime giving through Gift Aid.
- 8.7 An additional variant, which more closely parallels Gift Aid for income tax, would be to allow the charity to claim (or be awarded by HMRC) the additional 10% credit, to the extent that it has been offset against the IHT estate. It could be argued, however that this 'supplement' is not necessary, since there is already the incentive of reduced IHT on the estate to encourage greater charitable giving.
- 8.8 Any costings of our proposals should be compared with a far more detailed analysis of the impact of the Consultation proposals, bearing in mind the points we raise at section 6 above.
- 8.9 We urge that, before the arbitrary, complex and illogical proposals in the consultation are further proceeded with, serious consideration be given to our simple and practical alternative.

9 Consultation Questions: CIOT's response

- 9.1 Given our fundamental objection to the proposals as currently structured, we do not believe it is sensible use of our limited resources to submit comprehensive responses; our responses are therefore not fully considered.

10 Q1: 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?

10.1 By election it should apply to all taxable estates.

10.2 As mentioned at 7.1 above, it would be appropriate to enact a statutory
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extension to IHTA 1984 section 142 so that a remainder man benefitting from a qualifying interest in possession trust fund could elect to donate 10% to charity.

- 11 Q2 : If the reduced rate can be applied to assets outside the free estate:**
- 11.1 **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?**
- 11.2 The reduced rate should apply potentially to all components, but see (b).
- 11.3 **b) who should be party to any election to extend the application of the reduced rate?**
- 11.4 Subject to election, the benefit should follow the burden of tax; those who benefit should be the parties to the election.
- 11.5 **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?**
- 11.6 By election of the payer(s). Each payer can elect up to the amount of their charitable legacies. If any payer pays too little to meet the 10% then that can be topped up by other payers. Those other payers can decide how the top-up gets apportioned.
- 12 Q3: 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)?**
- 12.1 For simplicity every type of property should qualify. It would be the choice of the testator (by specific legacy) or the executors (by appropriation). Restricting the choice of assets would only add even greater complications.
- 13 Q4: 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?**
- 13.1 Normal procedures should apply for the IHT return, with the legacy (despite being to charity) being treated as if it were taxable. The imposition of the arbitrary 10% threshold means that valuation issues are at least as difficult for assets *not* left to charity as for those passing to charity.
- 13.2 The imposition of the 10% test brings valuation issues to the fore. Suppose a testator whose nil rate band is absorbed by lifetime transfers leaves a free estate represented only by a 100% shareholding in a property investment

company which is valued at £1m. He leaves 10% of his shareholding to charity. Clearly a 10% shareholding would only in exceptional circumstances (such as known imminent liquidation) be worth £100,000. More typically it might be worth as little as £25,000.

So, how should one value the charitable legacy? Paragraph 3.3 of the Consultation dwells on the value of the asset left to charity. But is it clear that one looks at the value of the minority shareholding in this situation or of 10% of the value of the 100% shareholding?

Furthermore, suppose the testator left 10% of his shares to each of his nine children as well as the 10% to charity. We think - but stand to be corrected - that each child's acquisition cost for CGT purposes of his or her 10% holding would be £100,000.

14 Q5: 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?

14.1 Automatic with right to disclaim the benefit of the 36% rate; however disclaimer should be revocable until finalisation of the IHT position.

15 Q6: 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?

15.1 We believe that there are in fact limited opportunities for avoidance and a targeted anti-avoidance rule (using the words 'tax avoidance' rather than 'tax advantage') should sort out any extreme cases.

16 Q7: 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?

16.1 Issue substantially dealt with at Q6. It is not thought that manipulation is very likely. Restricting the class of assets available for relief (for reasons of simplicity or to prevent avoidance) is simply not justified.

17 Q8: 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?

17.1 Variations do not routinely have to be produced now, so why (for an extra 4%) should the practice be changed?

17.2 The tenor of the consultation implies that the IoV (or the appointment from a discretionary trust established by the Will) would identify one or more specific charities. It might not. It need not. In such circumstances the only confirmation available to HMRC should (as currently) be a copy of the relevant document.

18 Q9: 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?

18.1 Provided the law is clear there should not be any difficulties in drafting Wills. It is inevitable that standard 'formula' clauses will appear. In time, HMRC's views (if there are a number of variants) might be useful.

19 Q10: 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?

19.1 It depends whether the amount of the charitable legacy is enough to 'frank' the deferred gifts too. The rule should be the same as for joint property, settled property and GROBS, namely that if the 10% test is passed (even including the deferred tax) then when the deferred tax eventually becomes payable it should be at 36% (or 10% less than the then prevailing rates). If the 10% test is not passed initially, on the deferred tax becoming chargeable the payer should have the option at that point to make the amount up to sufficient to meet the 10% test.

19.2 However, basing the 10% test and confining the 36% rate to the non-deferred part of the estate would be a simpler option.

20 Q11: 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?

20.1 As mentioned earlier, the absolute nature of the 10% test makes valuation issues of crucial importance. The statutory provisions that can result in a reduction in probate value for securities and land could result in failing the 10% test if the property whose value is reduced was to pass to charity. Unless marginal relief is introduced, for which paragraph 1.18 of the Consultation says there are no plans, the outcome of this and other variations must be accepted, regrettably.

20.2 Date of death would be simpler, but consistency with the entire IHT code must be maintained. The problems only highlight the anomalies and distortions which the 10% test creates.

21 Q12: 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?

21.1 It makes sense to limit the test to the (UK) property potentially chargeable to IHT.

21.2 We assume that charities benefiting would not be confined to those based in the UK but would follow the recent extension to charities established elsewhere in the EU.

22 Q13: 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?

22.1 The executors ought to be able to choose which grossing-up method is to be adopted. Both methods might fulfil the 10% test and the other beneficiaries might prefer the lesser amount to go to charity.

23 Q14: Where interaction applies, would basing the 10% test on the actual value of the legacy before the application of [the APR and BPR] rules present any difficulties?

23.1 The 10% test should be applied to the actual legacy, not that amount reduced by a share of agricultural property relief or business property relief.

23.2 The fact that this question has to be asked shows how flawed the '10%' concept is.

24 Q15: 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.

24.1 It is ludicrous to present a policy without having a clear and substantiated method of assessing its likely effectiveness.

25 Q16: 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.

25.1 Given the complexities, it is thought that advisers will advise on the proposals only where the testator has already committed to substantial charitable giving.

and there is a possibility that the new relief may be relevant. Anecdotal evidence suggests that potential testators are far less keen on the relief when they fully appreciate the implications.

25.2 The Tables above and below Q16, and the paragraph two above Q16 seem to assume (which is pure conjecture) that the full benefit of the proposal will take effect within some 5 years. This presupposes that all testators who might re-write their Wills to take advantage of the proposal will do so within a 5-year period. Experience suggests that very few Testators (and that number could be expanded to include those who currently have no Will) review their Wills with such frequency.

26 Q17: The Government would welcome information from charities about how likely they are to promote this measure and what they expect take up to be.

26.1 Not relevant to the CIOT.

27 The Chartered Institute of Taxation

27.1 The Chartered Institute of Taxation (CIOT) is a charity and the leading professional body in the United Kingdom concerned solely with taxation. The CIOT's primary purpose is to promote education and study of the administration and practice of taxation. One of the key aims is to achieve a better, more efficient, tax system for all affected by it – taxpayers, advisers and the authorities.

The CIOT's comments and recommendations on tax issues are made solely in order to achieve its primary purpose: it is politically neutral in its work. The CIOT will seek to draw on its members' experience in private practice, Government, commerce and industry and academia to argue and explain how public policy objectives (to the extent that these are clearly stated or can be discerned) can most effectively be achieved.

The CIOT's 15,600 members have the practising title of 'Chartered Tax Adviser' and the designatory letters 'CTA'.