

IHT rate reduction through charitable legacies

Synopsis: The rules for securing a 10% reduction in the IHT rate, from 40% to 36%, provided a charitable legacy of at least 10% of the estate is made on death.

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To encourage people to leave part of their estate on death to charity, rules introduced by Finance Bill 2012/Sch32 (and now contained in Schedule 1A IHT Act 1984) apply for deaths after 5 April 2012. The rate of inheritance tax (IHT) payable on death will be reduced to 36% if the deceased leaves 10% or more of their net estate to charity.

In summary...

- Gifts to charity are already exempt from IHT regardless of the size of the gift,
- Where a legacy equates to 10% or more of the net estate, the rate of IHT on the rest of the estate is reduced from 40% to 36%.
- Result: the charity will receive the same amount, while the non-charitable heirs will be marginally better off because less IHT is paid on what they receive.

Note that in the March 2023 Spring Budget it was announced that the definition of a charity would be restricted to UK charities. EU and EEA charities and Community Amateur Sports Clubs that HMRC had not previously accepted as qualifying for charitable relief have been prevented from claiming UK tax reliefs from 15 March 2023.

A transitional period applied until 1 April 2024 for EU and EEA charities that HMRC had previously accepted as qualifying for relief.

So, for the purposes of IHT, this applies in relation to transfers of value made on or after 1 April 2024. However, if the charity had not asserted its status as a charity before 15 March 2023, this applies for the purposes of IHT, in relation to transfers of value made on or after 15 March 2023.

A body of persons or trust has “asserted its status as a charity” if— (a) immediately before 15 March 2023 it falls within the definition of “charity” in Part 1 of Schedule 6 to FA 2010, and (b) at any time before that date, it has (under any enactment) made a valid claim to HMRC in reliance on its status as a charity.

The rules in detail

The rules are relatively complex.

On death, an estate will be divided into three different components for IHT purposes - each of which needs to be looked at separately...

Component	Description
Survivorship	Property held jointly as joint tenants.
Settled property	Property held in a trust that is treated as part of the estate for IHT purposes.
General	Essentially everything else.

Within each of these components, any reliefs or exemptions - such as the available proportion of the nil rate band - will be deducted first to ascertain the chargeable element. The charitable gift is then added back in to give the "baseline amount". If more than 10% of the baseline amount within one component passes to charity, then the reduced rate of 36% will apply to the rest of the assets within that component.

Property subject to reservation of benefit

Property in which a reservation of benefit subsists is not included as a component of the estate as such property cannot by itself qualify for the reduced rate. This is because the reservation of benefit rules do not apply to gifts to charity. However, such property may be eligible for the reduced rate if an election to merge it with, say, the general component, is made.

Basic calculation – the baseline amount

The legislation sets out three steps in arriving at the baseline amount. The baseline amount is determined for each component separately unless an election to merge components has been made...

Step 1

Establish the value transferred by the chargeable transfer (i.e. excluding the charitable legacy) that is attributable to each component.

Step 2

Deduct from this, the appropriate proportion of the available nil-rate band. The available nil-rate band is the nil-rate band that applies at the death, increased as appropriate by any transferable nil-rate band (TNRB) and reduced by the amount used up by any previous lifetime chargeable transfers.

The appropriate proportion is the amount of the nil-rate band apportioned to the component concerned in relation to the whole chargeable transfer on death.

The residence nil rate band (RNRB) is not taken into account in calculating the baseline amount for the reduced rate of IHT for charitable giving.

Step 3

Add the amount of the charitable legacy that was deducted at Step 1 to the amount determined by Step 2, to arrive at the baseline amount.

Example 1: Simple estate - one component

Let's take a case where Jane, a widow, dies after 5 April 2012. All of her husband's estate passed to her on his death three years ago. She has an estate of £1 million, and her Will leaves £50,000 to charity and the rest of the estate to the children.

After the combined nil rate bands of £650,000 are taken into consideration, the baseline amount here would be £350,000.

As the £50,000 charitable gift exceeds 10% of the baseline amount, the reduced 36% rate of IHT will apply to the estate passing to the children.

As a result...

- the IHT liability is reduced to £108,000 (36% of £300,000) instead of being £120,000 (40% of £300,000);
- the charity receives £50,000; and
- the children receive £842,000 - which is £12,000 more than they would have received under the previous rules.

Example 2: Two components in the estate

The calculation is more complex where there is more than one component of the aggregate estate. This is because the 10% test will be applied to each component separately. The value of the assets passing to charity from a particular component will be compared to the baseline amount for that component. If the 10% test for a component is passed, IHT will be charged on that particular component at 36%.

Taking the facts of Example 1, but, rather than being owned by Jane outright, some of the assets of her estate for IHT purposes, say £500,000, were held in an immediate post-death interest trust (created by her husband when he died three years ago) her estate would be made up of two components.

The available (increased) nil rate band of £650,000 would then be split equally across the two components with £325,000 being allocated to each. This means each component would be £500,000 and (after the deduction of the allocated £325,000 nil rate band) the baseline amount for the general component, out of which the charitable gift is made, would be £175,000.

In addition, in this example Jane's charitable gift is not £50,000 but £22,000. However, even this reduced amount of £22,000 exceeds 10% of £175,000, so the reduced rate would apply to the assets passing under her Will. However, the full 40% rate will apply to the assets passing under the trust because none of this is subject to a charitable gift.

You will note that even though £22,000 is less than 10% of the aggregate baseline amount of £350,000, a reduction in IHT has still been achieved as the estate is divided into two components.

If the assets passing to charity from one component are 10% or more of the baseline amount, other components may be merged with it to give an aggregate baseline amount. For example, if Jane did not reduce her gift to £22,000 (above) but kept it at £50,000 this would be more than 10% of the baseline amount of both components added together ($2 \times £175,000 = £350,000$).

In such a case an election should be made to “merge” the two components. By doing this the reduced IHT rate would apply to both her free estate and the trust assets. Without such an election, only her free estate would enjoy the reduced rate, the 40% rate then applying to the trust.

Charitable legacy worded to meet the 10% test

To avoid the need to continually revise charitable legacies in Wills, a clause may be worded so that a specific legacy to charity will always meet the 10% test.

The Society of Trust and Estate Practitioners (STEP) have published a draft model clause for use in Wills. The clause has been approved by HMRC and is referred to on their website - [here](#). Where such wording is used, a specific legacy to charity will always meet the 10% test.

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