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Estate Planner

How a charitable gift can reduce inheritance tax

When planning your will, your family and loved ones will naturally be at the forefront of your mind. But by donating some of your money to charity you can support causes that are important to you while also receiving some tax advantages. Across the UK, people donate roughly £3.9bn a year in their wills. Legacy giving has been particularly important for charities in recent years, as the pandemic and the cost-of-living crisis make fundraising more difficult while simultaneously increasing the demand for their services. One of the biggest charities in the UK, Cancer Research UK, made more than a third of its £719mn income from legacies in the year to March 2023 – with one person leaving a staggering £44mn to the organisation. Gifts left to charity in your will are exempt from inheritance tax (IHT). So are charitable donations made during your lifetime; if you gift money to somebody and then die within seven years, the money still counts towards your estate for inheritance tax purposes, but this is not the case with charities. And if you leave at least 10% of your net estate to a charity, the IHT rate chargeable on the rest decreases from 40% to 36%. It is, though, important to keep the 10% threshold in mind, especially if you were going to make a donation anyway. Otherwise, you could end up giving, say, 8% of your estate to charity and missing out on the tax benefit. You should also express charitable donations as percentages rather than as fixed sums, because you don’t know exactly how much your estate will be worth in future. By donating to charity during your lifetime, you can receive income tax relief. If you agree to Gift Aid, HMRC will return the basic rate of 20 per cent to the charity, boosting your donation for free; but higher and additional rate taxpayers can claim back the rest in their tax returns. So depending on your circumstances, it can be a trade-off between donating more during your lifetime and reducing your income tax, or donating more in your will and lowering your IHT rate. If you don’t want to donate as much as 10% of your estate, a common choice is to leave a 'residual' legacy, leaving to the charity whatever funds are left in your estate after any specific gifts, debts, funeral expenses, and inheritance tax are paid.

Estate Planner

Easy, legal ways to reduce your inheritance tax bill

The best way to reduce your IHT bill for your loved ones is to start planning now. The sooner you put things in place the easier it will be to put the right things in place for your family when you are gone.

Here are some ways to reduce your IHT bill.

1. Write a will

The first thing to do is to make a will. If you don't state how you want your assets to be divided, the law decides for you. That means that even more than necessary could end up going to the taxman. You might also want to appoint a lawyer to help you draft your will, especially if your financial or family situation is complex. If you leave at least 10% of your estate to charity, your family will pay a reduced rate of inheritance tax.

2. Spend your money

The simplest way to reduce or avoid inheritance tax altogether is to try to get your taxable estate under the threshold. This means you could spend money on yourself while you're still alive, so why not go on that holiday of a lifetime? Or you could gift some cash or assets to family and friends, though there are rules around this.

3. Gifts and inheritance tax

We can all give away up to £3,000 each tax year without it being added to the value of your estate. You can choose to give the full £3000 to one person or split it between a number of people. You can also roll the £3,000 annual allowance over, so if you didn't use it last year, you can give away cash or assets worth £6,000 this tax year. But it only lasts for one year. There are other gifts you can give too, such as £5,000 towards a child's marriage or £2,500 for a grandchild's. You can give away more than that but be aware that gifts could be subject to the seven-year tax rule, which we explain below. Beware: the taxman has always got an eye on who might be giving away their money just before they die.

4. Remember the seven-year rule

If you go over the inheritance tax-free threshold, gifts will only be completely free from IHT if you live for seven years afterwards. If you die in less than seven years and have given away more than your tax-free allowance, the gift will be taxed on a sliding scale.

5. Grow your pension pot

Pension savings can be passed on to family when you die without being subject to inheritance tax. This is because pensions don't usually form part of your taxable estate. But bear in mind that if you die before the age of 75 one or more people can inherit the pot as a tax-free lump sum up to the lifetime allowance of £1,073,100. If you die after 75 those inheriting the pension pot have to pay their highest rate of income tax on any withdrawals. So if possible, keep your pensions intact, and focus on spending or gifting money from ISAs or other savings.

6. Draw up a trust

You may want to consider putting some of your assets into a trust for a loved one. A trust is a legal agreement. You decide who manages the money (the trustees) and who the money is used for (the beneficiaries). There are lots of different types of trust and some will allow you to ringfence the money or property so that it sits outside of your estate when you die. Trusts are a complicated area and can be expensive to set up. Some are subject to other tax regimes, so you should get authorised and regulated, specialist advice.

7. Unusual methods

There are other more unusual methods to reduce your IHT bill, including:

- Giving cash to political parties.
- Investing in shares on the Alternative Investment Market (AIM).
- Buying agricultural land.

Investor / Saver

UK investors retreat from fixed income and bond funds

Risk-averse UK investors have retreated from fixed income and bond funds as the turmoil in the bond markets on both sides of the Atlantic dented confidence. Thirty-year gilt yields have risen to their highest levels since the ill-fated "mini" Budget of September 2022, while the yield on 30-year US Treasuries reached a 16-year high as markets digested the possibility of higher interest rates for longer and more government borrowing. Figures from the Investment Association show that retail investors pulled a net £356mn from fixed income funds in August. Funds network Calastone separately recorded a similar outflow of £330mn from bond funds in August, followed by a further £128mn of outflows in September. Experts noted that the bond markets are in the driving seat at the moment. One moment, inflation coming in better than expected or central banks hitting pause on interest rates causes a bond market rally, the next moment, policymakers warn that rates will stay high for the foreseeable future, bond yields surge and equity markets sag. The trend was compounded by investors continuing to seek refuge in ultra-safe money market funds, which had net inflows of £862mn across August and September, according to Calastone. Calastone's figures are not comprehensive but are widely seen as offering a useful snapshot of investment fund flows. They suggest that the selling pressure from UK funds continues, with £448mn of outflows in September alone, while global funds had inflows of close to £1bn. Elsewhere, retail investors continued to swing away from actively managed funds to passive index funds, particularly global equity index funds, according to Calastone figures. Active funds recorded £7bn of retail outflows since the start of the year, while passive funds gained some £5.4bn. Global equity, particularly passive funds, have proved popular as an easy, instant cross-market exposure in a market where making a tactical call is tough. Many are cautioning that a correction in the bond markets is possible in the short term, which will inevitably have an impact on equity markets. A renewed decline in real bond yields by itself would likely boost equities but the full impact would depend on the macroeconomic conditions behind declining bond yields. Commentators believe that the likelihood is that over the course of the next 12 months, equity markets will rebalance, yields will fall, and bond prices will rise.

All

The inheritance tax debate

Scrapping inheritance tax would cost the government almost £15bn a year in lost revenue by 2032, according to analysis by the Institute for Fiscal Studies that follows calls from Tory MPs for the main tax on inherited wealth to be abolished. The thinktank said the latest figures from HMRC showed fewer than 4% of estates paid inheritance tax (IHT) in 2020–21, but the rapid growth in wealth among older individuals meant this number was set to rise to more than 7% over the next decade. While London has the most estates liable to pay the tax, hotspots across Sussex, the Cotswolds and around Birmingham will have the greatest number per 100,000 residences. The IFS report, Reforming Inheritance Tax, found that in 2024, the wealthiest fifth of donors will bequeath an average of £380,000 per child, and pay inheritance tax of about 10% of this amount. By contrast, the least wealthy fifth of parents will leave less than £2,000 per child. The authors estimate that if the amount of money bequeathed through inheritances next year were to be equally shared between all 25-year-olds, each would receive about £120,000. Rishi Sunak is understood to be considering an inheritance tax cut as he attempts to woo voters and create clear dividing lines with Labour. Though Downing Street has sought to play down speculation that the prime minister was drawing up plans to abolish the tax, calls for reforms that allow households to pass on more of their assets are mounting in the Conservative party. Inheritance tax is charged at 40% on wealth over £325,000. Individuals then have an extra £175,000 allowance towards their main residence if it is passed to children or grandchildren, and spouses can share their allowances. This takes the allowance to £1m between a married couple, allowing them to distribute a seven-figure sum tax-free. It is understood that among the proposals under consideration by Sunak is for the 40% rate to be reduced, paving the way to abolish it in future years. The IFS said the cost of abolishing IHT would be £7bn if implemented this year with about half (47%) of the benefit going to those with estates of £2.1m or more at death. These 1% of estates would benefit from an average tax cut of an estimated £1.1m in their bill. "The 90% or so of estates not paying inheritance tax would not be directly affected by such a reform," it said. In the report, the authors Arun Advani, a University of Warwick tax specialist, and IFS researcher David Sturrock, said inheritance tax should be reformed initially to prevent the super-wealthy using loopholes to benefit their descendants. They called for an end to exemptions worth £4.5bn year for those who inherit businesses and farms, saying that the abolition of business relief alone would allow the government to raise the threshold to £500,000 and £525,000 if farm relief was also cut. As an alternative, the reforms would allow the tax rate to be cut from 40% to 25% while being revenue neutral.

Property Owner

UK house prices fall for the sixth consecutive month

UK house prices fell by 5.3% in the year to September, with drops in price in every region of the country as rising interest rates squeeze the market. The house price index by Nationwide, the biggest British building society, showed that seasonally adjusted prices stalled over the month in September, after a 0.8% drop in August. The price of an average home was £257,808 in September, nearly £14,500 lower than a year earlier. The housing market in Britain has slowed in recent months as the Bank of England has raised interest rates sharply to combat a surge in inflation triggered by coronavirus pandemic disruption after Russia’s invasion of Ukraine, which sent energy prices soaring. The Bank responded with a series of interest rate rises that remained unbroken until last month. The September meeting of the Bank’s monetary policy committee was the first time in almost two years that it left rates unchanged, giving hope for an end to further rises in borrowing costs. However, the effects of the rate rises remain clear in the housing market. Only 45,400 mortgages were approved for house purchase in August, according to the latest data available from the Bank of England. Nationwide said that figure was about 30% below the monthly average in 2019 before the start of the pandemic and the consequent volatile period in the housing market. Commentators believe that this relatively subdued picture is not surprising given the more challenging picture for housing affordability. For example, someone earning an average income and purchasing the typical first-time buyer home with a 20% deposit would spend 38% of their take home pay on their monthly mortgage payment – well above the long-run average of 29%. We also have to take into consideration the severe blow to affordability from higher mortgage rates, though recent increases in consumer confidence could buoy up demand after a few more months of downturn. Most experts expect the housing market to remain fairly subdued in the next few months, after declines in price in every region of the country during the July to September quarter of 2023. The biggest decline was evident in the south-west of England, where prices dropped by 6.3% in the quarter, and six out of 13 regions experienced drops of more than 5%. The smallest drop was in Northern Ireland, down by 1.8%.

Past performance is not a guarantee to future performance. You may get back less than invested.

Thresholds percentage rates and tax legislation may change in subsequent Finance Acts and reliefs from taxation are subject to change. The FCA does not regulate tax advice.

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