

CHAPTER 19

GROSSING-UP OF LEGACIES

19.1 The burden of inheritance tax

We know that having calculated IHT on the death estate, this tax is **payable by the Executors** who were appointed by the deceased in his will. In this session, we are interested in who ultimately **bears** the Inheritance Tax - i.e. who is the person or persons **who will eventually suffer the IHT** on the estate?

When an individual dies, his or her assets will pass to the Executors appointed within the will or the administrators under the rules of Intestacy. After obtaining probate, the Executors' responsibilities will include paying the inheritance tax and filing the appropriate Returns etc. Once that has been done, the Executors will **distribute the estate in accordance with the will or the rules of intestacy**. The IHT is due either 6 months from the end of the month of death, or on delivery of the IHT Return if earlier.

Having discharged the inheritance tax, the Executors will distribute the remaining assets of the estate to the nominated beneficiaries ("legatees"). Even though the Executors physically pay the Inheritance Tax, **the tax is actually suffered by the beneficiaries of the estate**. This is because the IHT is deducted from their appropriate entitlements before the balance is distributed. In this session we shall explore the burden of inheritance tax and examine how estates are actually distributed.

19.2 Tax free and tax bearing legacies

[IHTA 1984, s.211](#)

A will is typically drafted so as to leave legacies in two different ways. There are often **specific gifts** or legacies within the will. For example the deceased could leave £10,000 in cash to his daughter, or his shares in ICI Plc to his son etc., and these would be specific legacies. You may also see specific cash gifts referred to as "general" or "pecuniary" legacies.

Alternatively, the will could include "residuary" gifts. The residue of an estate is **what is left after the payment of specific legacies and after all costs and expenses** have been met. The person (or persons) entitled to the residue or remainder of the estate is called a "residuary legatee".

Certain wills leave the whole of the estate on residue. For example, a will could say "I leave the whole of my estate to my beloved son" - in this instance the son will receive the entire estate as a residuary gift.

If a will leaves assets by one or more specific gifts, those gifts will either be "tax bearing" or they will be "tax free". We looked at the distinction between "tax bearing" and "tax free" legacies in the session on Quick Succession Relief.

If a beneficiary receives a tax bearing specific gift, any inheritance tax payable on that gift is **borne by the recipient**. Under general law, gifts of **non UK assets will bear their own tax**, unless otherwise stated in the will. For example, if an individual receives a gift of an overseas property or some non UK shares, under the will the beneficiary who receives the property or the shares will have to pay the IHT due on that asset.

The first thing to remember about "tax free" legacies, is that they are **not exempt from inheritance tax**. A gift to a spouse or a charity on death is an exempt legacy. A tax free legacy simply means that the IHT on the gift is not paid by the recipient, but is **instead paid out of the residue of the estate**.

Unless otherwise stated in the will, **specific gifts of UK assets are tax free**. For example, if a beneficiary receives a specific gift of cash or UK shares under a will, he or she will receive the full amount of the gift and the inheritance tax will be paid by somebody else. That "somebody else" is typically the **residuary legatee**. "Tax free" in this instance therefore means **after tax has already been deducted** - in essence it means "net of tax".

The residuary legatee receives the balance of the estate, after specific gifts have been discharged. Out of his or her residuary share, any **tax on tax free legacies must be settled**. Also, if the residue of the estate is left to a chargeable beneficiary (i.e., someone other than a spouse or charity) **any tax on the residue itself is suffered by the residuary legatee**. Typically therefore there will be two lots of inheritance tax paid out of the residue of the estate - one on tax free legacies, the other on the chargeable residue itself.

Illustration 1

Richard died in August 2010. He made no lifetime gifts. Richard's estate at the date of death was valued at £810,000.

In his will, Richard left a house in the UK worth £200,000 to his son. As this is a **specific gift of UK property, the gift is tax free**. This means that the son will receive £200,000, and any tax on the house will be paid from the residue of the estate.

The will left a house in France worth £250,000 to Richard's daughter. As this is a specific gift of **non-UK property, the gift is tax bearing**. Any inheritance tax on the gift will have to be paid by the daughter.

The residue of £360,000 is left to Richard's brother. The residue is chargeable to IHT as the brother is not an exempt person. **Gifts of chargeable residue will also bear their own tax.** Therefore, the tax on the residue itself is suffered by the brother.

As there are no exempt transfers, the whole of the estate of £810,000 is chargeable to IHT.

	£
Total chargeable estate	810,000
Less nil band	<u>(325,000)</u>
Taxable	<u>485,000</u>
 IHT @ 40%	 <u>194,000</u>
 Estate rate = $\frac{194000}{810000} \times 100$	 <u>23.951%</u>

If we express the IHT as a percentage of the total chargeable estate, we have an "estate rate" of 23.951%. This estate rate enables us to work out how the estate will be distributed between the various beneficiaries.

Richard's son receives a house worth £200,000, free of tax. Richard's daughter receives a house worth £250,000, but out of that legacy she will have to pay her own share of the IHT.

The tax on the house is:

$$£250,000 \times 23.951\% = £59,877.$$

Richard's daughter will have to pay this tax, leaving her with a net legacy of £188,518.

Distribution:	£
Son	200,000
Daughter (250,000 - 59,877)	190,123
HMRC	194,000
Balance to brother	<u>225,877</u>
Total	<u>£810,000</u>

Tax of £194,000 is paid to HMRC. The balance of the estate (£225,877) is distributed to the brother. The brother (the residuary legatee) has suffered two lots of tax - i.e., tax on the tax-free gift and the tax on the residue itself.

19.3 Residue wholly or partly exempt

A residue will be wholly or partly exempt if all or part of it is left to an exempt person such as a spouse or charity.

If a will is drafted such that the **whole** of the estate is left to a spouse or charity, **as there are no chargeable transfers, no inheritance tax is payable.**

If part of the residue is chargeable and part is exempt, (for example, half to daughter and half to spouse), IHT is charged on the chargeable estate but not on the exempt transfer.

In this instance, we must **divide the residue into its component parts, before deducting inheritance tax from the chargeable residue.**

The principle that **a chargeable residue should bear its own tax**, was confirmed by the Courts in the *Ratcliffe* case from 1999. This means that, if an estate is left to be split equally between (say) the deceased's spouse and daughter, having calculated the IHT on the daughter's share of the residue, the tax will be deducted from the daughter's share and **no part of it will be taken from the spouse's share.**

Illustration 2

Helen died in January 2011. Helen made no lifetime gifts and her estate at death totalled £700,000. The will directs that her estate should be divided equally between her son and her husband. Each will therefore receive £350,000, before the deduction of any IHT.

Helen's chargeable estate is £350,000. Tax is as follows:

	£
Son's share	350,000
Less nil band	<u>(325,000)</u>
Taxable	<u>25,000</u>
 IHT @ 40%	 <u>£10,000</u>

Following the *Ratcliffe* decision, as a chargeable residue should bear its own tax, the **£10,000 should be deducted from the son's share.** The son will therefore receive:

$$£(350,000 - 10,000) = \underline{£340,000}.$$

The exempt residue suffers no tax, so the husband's share remains at £350,000.

19.4 "Grossing-up"

If a will directs that the whole of the estate is left on residue to an exempt beneficiary, no inheritance tax is due.

If however a will leaves a legacy to a chargeable beneficiary, such as a son or daughter, and the remainder of the estate is left on residue to an exempt beneficiary, (spouse or charity), **IHT is due in respect of the specific gift but no tax is due on the residue itself.**

If the specific legacy is tax free (i.e. it is a gift of cash or a gift of other UK property), any **tax on the tax free legacy will be paid from the residue** of the estate. Therefore even though the residue is itself exempt, the residuary legatee (the spouse or charity) will still suffer some IHT.

Therefore the amount which will ultimately be distributed to the spouse or charity, will be the **residue of the estate minus the IHT on the tax free gift.**

The other issue to consider here is the concept of "single grossing".

If a will leaves a **tax free legacy** (or a combination of tax free legacies), and a **wholly exempt residue**, we must calculate the inheritance tax on a "grossed-up" basis. A "tax free" gift can also be thought of as a "net gift" - i.e.. the beneficiary receives the net amount, after somebody else has paid the IHT.

In this scenario, the only transfer liable to inheritance tax is the net gift. The rate of IHT applicable on death is 40%. **However to get from the net legacy to the IHT due, we must gross up this rate and use a rate of $\frac{40}{60}$ ths.**

For example if a beneficiary has received a **net gift of £60** after the deduction of 40% tax at source, to arrive at the tax we must **multiply the £60 by the grossed-up rate of $\frac{40}{60}$ ths** to arrive at the tax.

You have come across this concept of "grossing-up" a rate when dealing with lifetime tax. For example, if a donor sets up a discretionary trust and agrees to pay the tax himself, the **trustees receive a net amount**, after tax has been paid by the donor. In this instance when calculating the lifetime tax we do not use a rate of 20%. Instead we use the grossed-up rate of $\frac{20}{80}$ ths.

The difference here is that the death rate is 40%, so this grosses up to $\frac{40}{60}$ ths.

Remember we **only need to use the grossed-up rate where the will leaves one or more tax free legacies and a wholly exempt residue.**

Illustration 3

Stuart died in 2010/11 having made lifetime transfers (after exemptions) of £128,000. His death estate is valued at £900,000.

In his will, Stuart leaves a tax-free legacy of £500,000 to his son. The residue of Stuart's estate is left wholly to his spouse.

The only chargeable part of the estate is the tax free gift of £500,000.

	£
Chargeable estate	500,000
Less nil band (325,000 - 128,000)	<u>(197,000)</u>
Taxable	<u>303,000</u>
 IHT @ $\frac{40}{60}$	 <u>£202,000</u>

The taxable estate is £303,000. As we have a **tax free specific gift** and a **wholly exempt residue**, to calculate the IHT we use the grossed-up rate. This is to reflect the fact that the gift to the son is a net gift - i.e. the son receives £500,000 after tax has been withheld. This tax of £202,000 will be paid out of the residue of the estate and will therefore be effectively suffered by the spouse.

To complete this example, let us consider the distribution of Stuart's estate.

Distribution ;	£
Son	500,000
HMRC	202,000
Spouse	<u>198,000</u>
Total	<u>£900,000</u>

Stuart's son receives a tax-free legacy of £500,000.

HMRC receives inheritance tax of £202,000.

Therefore the spouse will receive the balance of the estate being £198,000. This is made up of the residue of the estate of £400,000, minus the IHT paid on the tax free gift.

Example 1

Cordelia died in December 2010. She made no lifetime transfers. Her estate consisted of:

	£
House in Italy	425,000
Cottage in Devon	95,000
Cash and quoted shares	295,000

She left the house in Italy to her grandson Paul, and the rest of the estate to her daughter and husband in equal shares.

Calculate Paul's net legacy, after IHT.

Example 2

Gerald died in February 2011 leaving an estate of £2 million. He left £900,000 to his son and the rest to a charity. His lifetime transfers (after exemptions) totalled £330,000.

Show the final amount to be distributed to the charity, after IHT.

Answer 1

Chargeable estate;	£
House in Italy	425,000
50% x residue;	
= $\frac{1}{2}(95,000 + 295,000)$	<u>195,000</u>
	620,000
Less nil band	<u>(325,000)</u>
Taxable	<u>295,000</u>
IHT @ 40%	<u>£118,000</u>
Estate rate = $\frac{118000}{620000} \times 100$	<u>19.0323%</u>
Tax on gift to Grandson:	£
£425,000 x 19.0323%	80,887
Tax on chargeable estate	
£195,000 x 19.0323%	<u>37,113</u>
Total	<u>118,000</u>
Grandson:	
House in Italy	425,000
Less IHT thereon	<u>(80,887)</u>
Net legacy	<u>£344,113</u>

Answer 2

Tax free specific legacy + exempt residue = "single grossing".

	£
Chargeable estate	900,000
Less nil band remaining	
£(325,000 - 330,000)	<u>Nil</u>
Taxable	<u>900,000</u>
IHT @ $\frac{40}{60}$	<u>600,000</u>
Total estate	2,000,000
Less gift to son	(900,000)
Less tax to HMRC	<u>(600,000)</u>
Balance to charity	<u>£500,000</u>