

Inheritance Tax

The Normal Expenditure out of Income Exemption

Making regular gifts from your excess income can be an excellent means to immediately reduce the anticipated Inheritance Tax liability of your estate. However, it is crucial that certain steps are taken to ensure that the relevant exemption can be claimed.

The basics

Clients often ask whether gifts they make out of their income are exempt from Inheritance Tax. The answer is that such gifts are exempt if, or to the extent that, the following requirements are satisfied:

- they were made as part of the normal expenditure of the donor (i.e. the person who makes the gift);
- taking one year with another, they were made out of the donor's income; and
- after allowing for all gifts forming part of his or her normal expenditure, the donor was left with sufficient income to maintain his or her usual standard of living.

This exemption can be very useful for a person who has a large income and rarely spends all of it, as it can remove significant amounts of wealth from the Inheritance Tax net immediately.

Unlike gifts made from capital, there is no need for the donor to survive the gifts by seven years, or any other period. It can be used in addition to the £3,000 inheritance tax annual exemption and any other inheritance tax exemptions and reliefs.

Normal expenditure

"Normal" is not defined, but for the purposes of this exemption it is taken to mean "typical" or "habitual". H M Revenue & Customs (HMRC) have made it clear that there is no rule of thumb and that they judge each case on its merits. The test of normality requires a pattern of giving to be established, but a single gift made by a person who dies before making a further gift can qualify as "normal" provided there is evidence that there was a clear intention to make further gifts.

The amount of the expenditure need not be fixed, nor the recipient of the gifts be the same. It is sufficient that a formula or standard has been adopted (or committed

to) by which the payment, which may be of a fluctuating amount, can be quantified, for example the cost of a sick dependant's residence at a nursing home or a commitment to pay all, or part, of grandchildren's school fees.

Alternatively, the standard could be simply that all income over a certain amount is paid to children / grandchildren or into a trust for the family.

When assessing expenditure, HMRC look specifically at the donor's expenditure, not what an "ordinary" person might have spent in similar circumstances. However, they will request evidence to support the submissions made. It is therefore vital to keep records of income and expenditure for this purpose, including bank statements showing the relevant income and payments, for up to seven years.

Made out of income

Income is not defined for the purposes of the exemption, but it is essential that the gifts are made from income as opposed to capital. The exemption cannot in any circumstances, therefore, apply to gifts of personal belongings, such as a car or jewellery, or stocks or shares, unless the donor bought them out of income

specifically for the purposes of the gift. Donors who have invested in certain types of bonds, from which regular periodic withdrawals can be taken, should also take care. Such withdrawals are treated as capital receipts, not income, and thus should neither be included in the assessment of the donor's total income, nor gifted away in the false belief that this exemption will apply.

Sufficient income to maintain his or her usual standard of living

This will depend upon the particular circumstances of the donor and it is his or her standard of living at the time of the gift that is relevant. It is vital that the gift must not force him or her to resort to capital to meet his or her ordinary living expenses. What constitutes ordinary living expenses can also be very subjective, for example the cost of holidays and replacing a car every three years may be treated as ordinary living expenses, if that is something the donor would typically do.

The practicalities

In all but the most straightforward cases, HMRC will require a full statement of the facts before they will accept that the exemption is available. It is therefore crucial that you keep records for the executors of your estate as it will be they who will make the claim when you die. In particular, they need to be able to establish your income, your ordinary living expenses and the pattern of your gifts during the period in question. There

is a specific HMRC form which your executors have to complete when claiming this exemption, so it is helpful for you to complete this form on an annual basis and keep it somewhere safe.

Gifts made more than seven years prior to your death are normally exempt in any event, so you do not need to keep records indefinitely.

In some cases it will not be difficult to establish that the expenditure was "normal", for example where you pay monthly premiums on a life assurance policy which is held in trust for children or grandchildren. In other cases we suggest that you record in writing your commitment to make the payments in question. We recommend that you ask us to advise you if the pattern of your expenditure out of income is likely to be complicated.

There are some simple things you can do to assist your executors in proving the regular nature of the gifts:

- establish bank standing orders;
- document with your advisors your desire to make regular payments out of your surplus income;
- if someone else manages your investments, you may direct them to make regular payments to others out of your income; and
- agree to pay someone else's regular expenditure e.g. school fees (and document this in writing).

Finally

The law is complex and the advice you require will depend on your personal circumstances. These notes, correct at the time of printing, are issued for general guidance only and we cannot therefore accept any responsibility for actions taken on the basis of these notes alone.

For more information call 0345 415 0000 and ask to speak with a member of the Private Capital Team