Quilter

Excess Income Trust

Inheritance tax planning using normal expenditure out of income estate planning – bonds, trusts and top-ups

As people get older and their wealth accumulates, it's natural for them to start thinking about how they can best provide financially for their family and dependents on death.

Whilst it's important to make a will, this may still result in 40% UK inheritance tax (IHT) being payable on a large part of the deceased's estate.

Estate planning involves the transfer of wealth to future generations in a controlled and tax-efficient manner, in order to minimise the effect of inheritance tax.

Planning options such as making lifetime gifts to loved ones and creating trusts to hold assets on their behalf, can be very effective in reducing the impact of IHT.

For financial advisers only.

Tax-efficient trust fund top-ups using 'normal expenditure out of income'

Excess Income Trust

One frequently used solution is to make a lump sum investment, for example into a life assurance bond, which is then held in a discretionary trust for the future benefit of family and loved ones.

Such investments may be liable for IHT under chargeable lifetime transfer (CLT) rules, but as this document explains, settlors can make regular top-ups to the trust without the CLT rules applying if they use the exemption known as 'normal expenditure out of income'.

How a discretionary trust works

Assets held in a discretionary trust that excludes the settlor from benefiting, remain outside the settlor's estate and are not subject to IHT at 40%.

The trustees manage the trust on behalf of a range of different beneficiaries including spouses, children and grandchildren.

The taxes that apply

Typically, the lump sum bond payment used to set up the trust constitutes a chargeable lifetime transfer (CLT) and if the settlor has made CLTs in the previous seven years, or has plans to make further CLTs, a 20% IHT charge may become payable on any excess over their available nil rate band (NRB) at the time.

For example, if a CLT of £200,000 was made three years ago, followed by another of £200,000 today, IHT of £15,000 (Assuming the full NRB of £325,000 was available) would be payable on the second CLT. Additional IHT may become payable if the settlor dies within seven years of a CLT.

Making further payments tax-efficiently

If the settlor wants to make periodic further investments into the trust after setting it up with the initial lump sum, there is a way to do so that will avoid liability for the 20% IHT charge described above.

This is to fund those investments using the 'normal expenditure out of income' exemption detailed in Section 21 of the Inheritance Tax Act 1984.

The 'normal expenditure out of income' exemption rules

To be treated as 'normal expenditure out of income' the transfers to the trust must meet certain conditions:

1. Payments must be normal expenditure
2. Payments must come from income not capital
3. There must be no negative impact on the settlor's standard of living after making the payment.

Continued overleaf

Defining normal expenditure

There isn't a statutory definition of 'normal' so HM Revenue & Customs (HMRC) adopts the dictionary definition and considers it to mean: regular, typical, habitual or usual. Normal expenditure can include making regular contributions to a trust to fund the grandchildren's school fees or assist more generally with their upbringing. Normal expenditure does not necessarily mean making the same payment amount on a fixed periodic basis over a certain time.

The actual amount can vary and will be affected by the client's available income after income tax each year. HMRC will look for a pattern over a reasonable period of time, generally considered to be three to four years, or evidence of an intention to make payments over this time-frame should unforeseen circumstances curtail the planning.

Reporting transfers and keeping clear records

Your clients may be required to report to HMRC the transfer of their bond to the Excess Income Trust and the subsequent payments. They may need to complete HMRC IHT 100 and 100(a) forms each time a payment or transfer is made. This may be a requirement even though they intend to claim that the additional payments are exempt from IHT as normal expenditure out of income. It is very important that the settlor documents their intention to make payments to the trust to benefit their family, and records the payment history. This can then be used by their personal representatives to claim the exemption when administering the estate and completing the relevant IHT form (IHT403).

Expenditure tool

We have created a useful expenditure tool which your clients can use to record each payment. This information can then be copied onto form IHT403 for passing to HMRC.

Download it

- ***https://platform.quilter.com/support-and-help/tools/expenditure-tool/***

Defining 'income'

Income includes; earned income, dividends, deposit account interest, rental income and pension income.

It does not include capital. For example; withdrawals from a policy, or the proceeds from the sale of stocks and shares.

The gifts should be made from current income as there are limitations on how accumulated income from previous years can be used without it becoming capital, and therefore ineligible.

What is considered a reduction in standard of living?

The gift is considered eligible if, having made the gift, the remaining net income allows the donor to meet their normal living expenses without having to resort to capital savings.

For example, if they're forced into paying the mortgage or utilities bills out of other accumulated savings then HMRC will consider their standard of living to have reduced and the gift will not qualify as normal expenditure out of income.

Keep reading to see an example of this in practice

Case study

Name: **Greg Tyler**

Age: **50**

Salary: **£60,000**

Receives an annual performance bonus.

Greg is 50, he earns a salary of £60,000 and in addition, he receives an annual performance bonus. The bonus is surplus to his immediate income requirements and is available for investment.

He is concerned that when he dies, 40% IHT will be payable and wishes to minimise the impact that this will have on his family. As well as ensuring that his wife, children and any future grandchildren are looked after financially after his death, he also wants to keep the arrangement flexible to allow for changing personal circumstances.

Greg's adviser recommends making an initial investment followed by regular payments into a bond and discretionary trust using some of his surplus annual income and recording in writing his planning intentions and objectives using the 'normal expenditure out of income' exemption.

The trust excludes Greg from being a beneficiary, making it an IHT efficient solution, and provides the flexibility he requires over how his family is looked after in the future.

Over the next three years, Greg makes the following payments:

- January 2018, he pays £20,000 into a bond which is then transferred into the discretionary trust.
- Shortly after the trust is created, Greg invests a further £30,000 which is recorded as expenditure from normal income in the tax year 2017/18.
- January 2019, he pays £25,000 into the trust, once again recording it as expenditure from normal income.
- In January 2020, he pays £35,000 into the trust.

The initial investment of £20,000 is a chargeable lifetime transfer but provided Greg has sufficient unused Nil Rate Band after making any other such transfers in the past seven years, this will not be taxed at 20%.

Over the three years, Greg is able to pay a total of £110,000 into the trust which is invested into a bond. As the trust fund is outside his estate, it won't be subject to 40% IHT on his death.

Greg dies after 20 years, aged 70, with no distributions being made from the trust during this time. The original investments, assuming a net growth rate after charges of 3% per annum, have grown to approximately £192,000. If the rate of IHT has been unchanged at 40%, the decision to create a trust may have saved Greg's family a total of £76,800 in IHT.

The key points

- Once a discretionary trust is set up, additional payments into it can qualify as normal expenditure out of income and are therefore exempt from IHT.
- The trustees will hold the bond and any growth will accumulate outside the settlor's estate, helping to avoid 40% IHT on death.
- The flexible nature of the trust means that beneficiaries can be looked after financially, based on their needs and circumstances at the time, leaving the trustees in control over how funds are distributed.
- Clients should record all payments and create a written plan explaining their intentions and objectives. This can be used by personal representatives when administering their estate.

The case study is fictional and used purely to illustrate a possible real life scenario.

This document is based on our interpretation of the law and HM Revenue & Customs practice as at January 2022. We believe this interpretation is correct, but cannot guarantee it. Tax relief and the tax treatment of investment funds may change and the value of any tax relief will depend on the investor's individual circumstances.

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platform.quilter.com

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