Quilter

Technical Insights - Quick reference guide

Inheritance Tax - gifts from excess income

This guide will provide you with the information you require to advise your clients on the normal expenditure out of income Inheritance Tax (IHT) exemption. This is a useful exemption which can avoid having to wait for seven years for a gift to fall outside of the estate for IHT purposes.

3 conditions must be met for gifts to qualify

The exemption under section 21 of the Inheritance Act 1984 allows for an individual to make exempt gifts, reducing their taxable estate, as long as it can be demonstrated that the gift meets 3 conditions:

1. It forms part of the individual's (settlor's) **normal** expenditure
2. It was made **out of their income**
3. It doesn't **cause a reduction in their standard of living**

If all these conditions are met then there is no limit on the amount which can be gifted and immediately exempt from IHT.

More details on each of the conditions are provided below.

Normal

There is no statutory definition of 'normal' for these purposes. HMRC adopt the dictionary definition of normal as including standard, regular, typical, habitual or usual. There is no guidance on what evidence is considered to be acceptable for this purpose but, for example, a written declaration to make normal gifts out of income may be helpful, and keeping good audit trail is critical.

HMRC will usually consider a payment (in this case, a gift) to be regular or habitual if it has been made across three or four years, with the intention of continuing to make further, similar payments. However, even if the individual should die after only one such gift, it's possible to establish that it meets this requirement, if it can be shown that it was your client's intention to make the gift regularly on a habitual basis.

Documentary evidence of intention is therefore important. The facts of each case will be considered by HMRC on its individual merits. Gifts do not have to be of a fixed amount and can vary from year to year, but generally the individual should evidence an established pattern over a number of years to be considered habitual or regular.

Out of income

Income can include	Income doesn't include
Dividends from investments	Capital from existing savings and investments
Income from UK pensions, including payments from capped or flexi-access drawdown	Regular withdrawals taken from 'non-income producing' investments e.g. (5% withdrawals from bonds)
Earned income	
Interest from bank accounts	

Reduction in standard of living

The individual's normal standard of living is assessed at the time of the gift(s). If we refer to the previous dictionary definition used by HMRC, standard, regular, typical, habitual or usual, it would need to be demonstrated the pre and post standard of living was not impacted by the gift claiming the exemption for.

Gifts will not qualify for the exemption if the individual has to resort to capital to meet their normal living expenses e.g. mortgage payments, bills, other loan repayments etc.

For financial advisers only

Example of using the exemption

Mr Blake, aged 55

Salary of £150,000 each year (fluctuates depending upon bonus received).

His bonus is due in May each year.

His salary provides him with sufficient income to cover his standard of living.

Mr Blake has helped fund his three children through university and they have now all found employment. He and his wife are currently enjoying their re-found wealth. Whilst Mr Blake enjoys a large salary, over the last few years he has tended to spend this on material items. As a result, whilst still having a large estate, he does not have a substantial sum of freely available assets with which to carry out any IHT planning. Mr Blake has discussed the IHT planning options available to him with his financial adviser.

Mr Blake's financial adviser recommends an investment using a trust, which allows additional premiums to be made at any time.

To make the investment IHT efficient, Mr Blake must not have access to it so it is to be held by the trustees of a trust. As none of his children have any family yet, Mr Blake wishes to have some control over the future beneficiaries. Therefore, a discretionary trust with the settlor excluded (meaning Mr Blake, as the settlor, cannot benefit) is used. Mr Blake's performance bonus this year is £26,565. He therefore invests the amount of £25,000 into the trust. The trustees subsequently invest the money.

A year later...
Mr Blake receives a bonus of £52,455. He decides to use £50,000 of this sum to top up the trust. He completes the supporting paperwork to show that this money has come from earned income and is not affecting his standard of living for the tax year.

A year later...
Bonuses this year have been low and Mr Blake only has an amount of £5,050 to invest in the trust and reflect as a gift out of natural income for the tax year. Whilst a relatively small amount Mr Blake adds a further £5,000 to his trust so that it continues to be a regular and habitual payment made to it.

Over the three tax years Mr Blake has been able to gift a total of £80,000 to the trustees. This amount, together with any growth, is immediately outside his estate and therefore saving a potential 40% tax liability upon his death.

Record keeping

As the exemption is claimed after death it would be prudent for your clients to keep a full record of any payments for which they intend to claim the 'normal expenditure out of income' exemption. This will allow their LPRs, upon their death, to complete HMRC's form IHT403 (Page 6). This form asks for a breakdown of expenses in order to justify the claim that their standard of living had not been affected by the gifts made.

We have produced a handy tool which can exist with this record-keeping process. You can access the tool here: ***https://platform.quilter.com/support-and-help/tools/expenditure-tool/***

Important note – even where gifts are considered exempt there may still be a requirement to report them to HMRC using forms IHT100 and 100(a) at the time each gift is made. This will depend on the size of the gift being made and the gifting history of the individual.

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