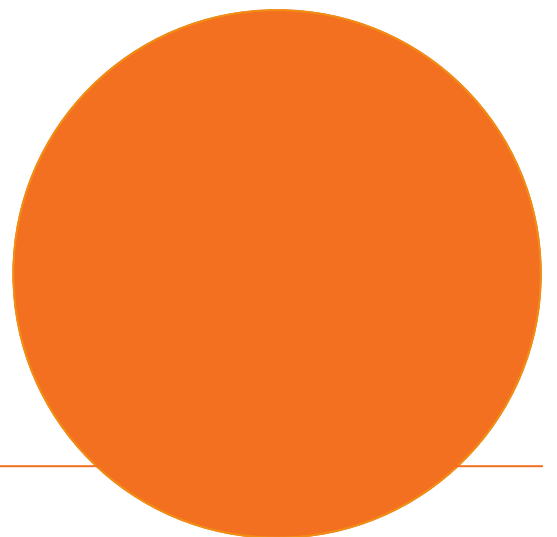


Normal expenditure out of income

A valuable inheritance tax exemption



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The Finance Act 2006 made the use of trusts to reduce Inheritance Tax (IHT) liability less attractive, so it is now sensible to think of other reliefs available under the IHT legislation.

If you are thinking of making lifetime gifts, there are a number of exemptions from IHT. The best known is an outright gift, after which you have to survive for seven years from the date the gift is made. If you survive for that period the gift will fall outside your estate for IHT purposes. There is a sliding scale relief under which the tax payable is reduced if you survive for more than three years, see below.

However, some people are put off making outright gifts for a number of reasons, namely:

- to make an outright gift which is going to have a significant impact on your estate, you need to give a fairly big amount
- you need to survive for seven years
- the sliding scale relief in years 4-7 is a reduction of the tax payable, not a reduction of the value of the gift. If the gift falls within your nil rate band (currently £325,000) there is no tax to pay, and even if you survive into years 4-7 the relief does not apply. So if you give, say, £250,000 and live for six years eleven months, you have used up part of your nil rate band, but as there was no tax payable on the gift (because it fell within the nil rate band) the taper relief does not apply. The IHT bill on your death will not be reduced even though you nearly outlived the seven year period.
- there is no room for second thoughts with an outright gift – if you find yourself short of resources in later years you cannot reclaim it.

Another approach to gifting, to reduce your IHT liability, is to use the "normal expenditure out of income" exemption. This is one of the more generous exemptions and can suit a donor better than an outright gift.

In brief, to use this exemption you make (or start to make) a series of regular gifts out of your after-tax income. If you can satisfy the conditions for the exemption the gifts are exempt from IHT as soon as they are made and you do not have to survive for seven years. The exempt gifts do not cut into your nil rate band. If your circumstances change, you can stop making the gifts without losing the exempt status of those you

have made already. The gifts can be used to fund an insurance policy, written in trust for the family, and the policy proceeds will themselves be exempt from IHT. The exemption can be combined with the annual exemption of £3,000 a year which everyone is entitled to.

Example 1

John is a widower who has a fairly high income, and he is not spending all of it. He is able to save £7,000 a year, which just adds to his IHT problem. He tells his daughter, Daphne that he is going to give her £10,000 a year, starting with a cheque now. (He intends £7,000 of that to come from his excess income and £3,000 to come from his capital using the annual exemption).

John dies in just over five years, by which time he has made six gifts to Daphne, totalling £60,000. This will all be exempt from IHT. His nil rate band of £325,000 is available in full.

The IHT bill is reduced by $£60,000 \times 40\% = £24,000$. If he had made a one-off gift of £60,000 at the start there would have been no saving at all, as he would not have survived it by seven years.

The Inheritance Tax Act 1984 lays down a number of conditions for the exemption to apply. These are outlined below with suggested guidance notes to help you.

1. The gifts must be part of your "normal expenditure"

- "Normal" is not defined but there must be a prior commitment to make the gifts, or it must be shown (after the event) that the gifts were part of a settled pattern of giving.
- The Courts have talked about the donor having "assumed a commitment or adopted a firm resolution regarding their future expenditure" and then having complied with that. The commitment may be "legal, religious or moral."
- There should be evidence of an intention to make regular gifts over a period of time. For example, this can be shown, for example, by a letter stating the intention to make the gifts, or a pattern such as the payment of annual premiums on a life policy for the benefit of someone else.

- The first in a series of gifts can qualify as "normal" expenditure if there is clear evidence that further gifts are intended. This could be shown by a letter or from the circumstances. For example, this was the first payment of the premium on an insurance policy written in trust for the beneficiary of the gift.
- There is no timespan over which the taxpayer must show a habit of giving, HMRC guidance suggests that "a reasonable time span would normally be three to four years."
- It is not enough to set money aside (say, in a bank account) with the intention of using it later to pay regular gifts to your chosen beneficiaries. It is essential to start the regular payments. If you do set aside a sum of money for the purpose of making the regular gifts, it is the payments you actually make which will qualify as normal expenditure, not the money you still retain.
- The gifts do not have to be made to the same person or always be of the same amount but a pattern must be established by proving a prior intention to make regular gifts, or showing that there was a pattern.

Example 2

Henry writes a letter to his children to say that he intends to make gifts out of his surplus income.

His income fluctuates from year to year so he cannot say in advance how much he will give. His base net income is £80,000 a year but in some years he receives more from special dividends.

In each year after the letter, he gives all his net income over £80,000 to one or other of his children, or to his grandchildren. The gifts will qualify for the exemption.

2. The gifts must be made out of income

- "Income" means net income after tax. So, this would exclude (for example) gifts from the capital content of a purchased life annuity or capital sums from the sales of investments. But it would include salary, commissions or rent received, dividend income from shares, and interest paid on a bank or building society account.
- The gifts must be made out of income "taking one year with another." This is intended to meet the situation where income fluctuates. In some years the gifts are more than the surplus income after tax, in other years less.

Overall the donor has enough income to make normal gifts and meet their standard of living on an ongoing basis. This means that income can be carried over to satisfy the test that the gifts are made out of the donor's income but HMRC are likely to look closely at situations where the donor carries forward more than two year's income.

- Gifts will not normally satisfy this condition if they are made from a source which was originally income, but has acquired the nature of capital because it has been retained or accumulated over a period of time. HMRC has recently amended its guidance to suggest that it will regard accumulated income as becoming capital after two years but admits that in some cases there is room for dispute, so care needs to be taken if gifts are to be made out of accumulated income.

Example 3

In his forties, Jim was a high earner and saved a lot of his income. Now in his sixties he has high savings but very little income. His saved earnings from ten or twenty years ago cannot be used to show that "taking one year with another" his regular gifts now are made out of income.

3. After allowing for all gifts forming part of your normal expenditure, you are left with sufficient income to maintain your normal standard of living

- This is tested according to your own standard of living and not the standard of living of some other 'average' person.
- Gifts will not normally qualify for the exemption if you have to resort to capital to pay your living expenses.

Example 4

Sally has an income of £150,000. She maintains serviced flats in Belgravia and in the South of France, and runs a sports car in each place. She enjoys lovely holidays and her credit card bills show that she is spending all her income, and more, on clothes, restaurants and opera outings. She makes regular gifts to her family.

She cannot say that her gifts qualify for the exemption just because a more frugal person would have had surplus income.

4. Some other points

As well as satisfying the requirements of the legislation, there are some other practical points to bear in mind.

- If you start making gifts as part of your "normal expenditure" and your circumstances change, you can discontinue or reduce the gifts, or increase them if your circumstances allow. Past gifts which satisfied the conditions for this exemption will still be within the exemption. So there is a lot of flexibility in this exemption.
- Generally "normal expenditure" gifts are not made under a legal obligation. So if you start making these gifts to your nephew and then change your mind, you can stop making the payments, and you will not prejudice the exemption for the "normal expenditure" gifts you have made already.
- The exemption is not given automatically and is claimed retrospectively by your Executors after your death.
- The Executors have to demonstrate to HMRC Trusts and Estates that your gifts satisfied the conditions set out above.
- The Executors need to complete a special form (Form IHT403) to demonstrate that the deceased person had satisfied the conditions for the exemption to apply. This form breaks down your income, living expenses and gifts year by year to show that you were indeed paying the gifts out of your income, and you had enough to maintain your usual standard of living.
- HMRC looks at each person separately. There is no rule about pooling the incomes and gifts of a husband and wife or other couples. So if one of the couple has all the income, and the other makes all the gifts, the exemption may not apply to either, and you need to do some planning to suit the particular situation.

5. The normal expenditure exemption can be combined with other exemptions

- Even if gifts run over the limitations set out above, if they were made more than seven years before death they will not be charged IHT because they will be outside your estate for that reason.
- If you are not using up your annual £3,000 exemption, that can be set against the excess portion of gifts which do not fully comply with the conditions for "normal expenditure" gifts.

Example 5

For 15 years Jane made regular but heavy payments of £12,000 a year to fund premiums on an insurance policy for £250,000 written in trust for her daughter.

When the figures were examined it seems that the result of her gifts was that she ate into her capital by about £5,000 a year. Only the payments made in the last seven years fell back into her estate. Her annual exemption of £3,000 was set against these, as she was not making any other gifts.

Taxable value of the gifts: $(£5,000 - £3,000) \times 7 = £14,000$

The £250,000 proceeds of the policy itself were not liable to IHT.

Conclusion

So this is a rather useful but slightly uncertain exemption. To improve your chances of the relief applying, we suggest:

- You write a letter to the recipient of gifts, which we would normally prepare for you, to demonstrate your intention to make regular gifts out of your net surplus income.
- Be aware of Form IHT403 (this is the form your Executors would need to complete to claim the relief) as a way to keeping a running record of your approximate income and expenditure each year.
- Know the HMRC guidance. They say:

"There is no rule of thumb. We basically judge each case on its merits. We do look closely at the standard of living of the transferor. The test of normality requires patterns of giving to be established. That is why it is not always possible to say that, at the time it is made, a particular gift is or is not exempt or normal".

Important

We have prepared this note as general guidance for clients. It summarises and simplifies some complicated law and tax practice, mainly under section 21 of the Inheritance Tax Act 1984. Please refer to your usual adviser in the Private Client Department at FSI to find out how this will apply in your particular case. Alternatively, contact John Annetts at john.annetts@fsilaw.com or 020 7344 5558.

Finers Stephens Innocent LLP

179 Great Portland St, London, W1W 5LS, T: +44 (0)20 7323 4000, www.fsilaw.com