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Inheritance Tax

Case study: Gifts of income out of normal expenditure

John

- is a widower
- pension income of £70,000 a year
- is not fully spending
- Inheritance Tax (IHT) problem

John estimates he has surplus pension income of around £10,000, each year. He doesn't spend this, so it currently accumulates in his bank account, immediately adding to his IHT problem.

Normal expenditure out of income

John speaks to his financial adviser about IHT mitigation and is interested to learn that there is an IHT exemption which allows him to make gifts out of his surplus income.

His adviser explains that the exemption is available if John meets the criteria to qualify. He could start to make regular gifts from his surplus income and provided that after making each gift, he has sufficient income to maintain his usual standard of living, the gifts will be covered by the exemption.

John's adviser explains that as the claim for the normal expenditure out of income exemption is made on death, it is important that John keeps clear records and evidence of the gifts he's made. Keeping records will support John's legal personal representatives when claiming the exemption from HMRC and also allow John and his adviser to review his surplus income situation regularly to make sure he still has enough to use the exemption.

John really likes this idea but is also keen for the first gift to include some of his accumulated savings. His adviser warns him that income which has been retained or accumulated over several years becomes capital in nature and gifts made from this source will not qualify for this exemption. So John decides to keep the two gifts separate.

Using an investment bond

John would like to help his family but doesn't want to make outright gifts, preferring to keep control during his lifetime. So he sets up an investment bond, with a £100,000 gift from his accumulated savings. He places it into a discretionary trust so that the trustees can decide how and when his family will benefit. This gift is a chargeable lifetime transfer (CLT) because it is made from capital. As John hasn't made any other CLTs in the last seven years and this gift doesn't exceed the nil rate band (NRB), currently £325,000, there is no lifetime IHT charge.

John's investment bond and discretionary gift trust both allow additional investments to be made, so he tops up by £10,000 each year, using his surplus income. These gifts are considered immediately exempt from IHT because:

- John has an established pattern of gifting so they form part of John's normal expenditure,
- They were made out of income,
- John is left with sufficient income to maintain his normal standard of living.

This means that these gifts do not use John's NRB and he doesn't need to survive for seven years for them to drop out of his estate.

To help support a claim for this exemption, John's adviser organises records to be kept of John's income and expenditure using the 'Gifts made as part of normal expenditure out of income' schedule in HMRC form IHT403. This means that old bank account records won't need to be reviewed to piece together a clear history of gifting. This would be a very challenging task after John's death.

Once the total of John's lifetime gifts, including the £100,000 CLT and the £10,000 gifts from surplus income, exceed the £325,000 NRB, he needs to report this to HMRC using form IHT100.

Five years later John decides he needs more income to maintain his standard of living and speaks to his adviser about reducing the regular annual top up from £10,000 to £5,000. He is pleased to learn that the investment bond allows this, meaning John can still benefit from the normal expenditure out of income exemption.

The exemption provides flexibility so that the gifted amount does not have to be fixed and can adapt to the change in John's circumstances. John could even stop the regular gifting out of income altogether without losing the exempt status of the gifts he has already made.

Reduces John's potential IHT bill

Six years after setting up the investment bond in discretionary gift trust, John dies leaving an estate of £550,000.

- John was a widower, so let's assume he has two NRBs (£650,000), his own and transferable NRB from his deceased spouse but no residence nil rate band
- John died within seven years of making the £100,000 CLT into the discretionary trust
- Chargeable and potentially exempt gifts made in the seven years before death are applied to the NRB in date order, so the CLT uses the first part of John's available NRB
- This leaves £550,000 (£650,000 - £100,000) to be used against the estate resulting in no IHT liability
- The £55,000 additional premiums, paid into the investment bond, are deemed to be fully exempt as the qualifying conditions were met when the contributions were made and HMRC approved this when the IHT403 was submitted following John's death
- The positive outcome of using the normal expenditure out of income exemption means that an IHT saving of £22,000 (£55,000 x 40%) has been secured
- Additionally any investment growth on the exempt premiums will have fallen out of John's estate immediately
- It's worth mentioning that as the trust is discretionary in nature, it is within the Relevant Property Regime for IHT purposes, potentially subject to ten year and exit charges, where the value of the bond exceeds the available nil rate bands at each relevant point. This exemption is only available for gifts into the trust and doesn't reduce the value of the discretionary trust fund when it comes to assessing for these charges.

This is one of the more generous exemptions but one which may result in challenges by HMRC, if the exemption's criteria are not properly met, so we suggest:

- Records should be kept of John's income and expenditure each year, preferably using HMRC form IHT403
- The gifted premiums must always have been derived from proper income and not capital
- John should consider writing a letter to the trustees of the discretionary trust to demonstrate his intention to make regular gifts out of his surplus income
- A financial adviser is always approached to discuss this type of estate planning

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