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Gifting as part of normal expenditure out of income

Briefing Note

Normal expenditure out of income is a valuable exemption which is often overlooked when undertaking tax planning. There is no seven year clock and it does not disturb any other exemptions, nor does it constitute a chargeable transfer. It can be used to prevent an inheritance tax (IHT) problem arising or getting worse.

What must be considered when dealing with normal expenditure out of income?

The legislation, in section 21 of the Inheritance Tax Act 1984, exempts transfers if, taking one year with another, it can be shown that the gifts:

- formed part of the donor's usual expenditure
- were made out of income, and
- left the donor with sufficient income to maintain their normal standard of living

The exemption is only available for gifts made out of surplus net income. It should be emphasised that this does not apply to gifts made out of capital. For example, 5% investment bond withdrawals (even if held under a discounted gift trust) and the capital element of a purchased life annuity payment. Also, the donor could not give away income and then rely on capital to meet their normal expenditure.

Bennett and others v IRC (1995)

In this case, the court identified several points to consider:

- 'normal expenditure' means when it took place it was part of the settled pattern of expenditure adopted by the donor;
- a 'settled pattern' can be shown from the expenditure of the donor over a period of time or by showing that the donor assumed a commitment or adopted a firm resolution, in relation to future expenditure and has then made gifts in accordance with that commitment;
- there is no fixed minimum period to establish the relief, however, it needs to be more than one payment;
- where there is no formal commitment or resolution, it may be necessary to show a series of payments (three will usually suffice, two possibly);
- there can be some variation in the pattern, but to claim the relief it must be shown that the donor intended a pattern to exist and to remain for a period of time, barring unforeseen circumstances;
- the amount of the transfer does not have to be fixed; the amount does not need to be to the same person each time; the amount may be fixed by a formula such as a percentage of earnings or a figure such as 'what is left over after paying nursing home fees';
- HM Revenue & Customs (HMRC) interpret net income as meaning income after tax and normal outgoings.

Record Keeping

As the claim for the normal expenditure out of income exemption is made on death it is important to keep clear records and evidence of the gifts made.

HMRC form IHT403 includes a schedule which may be used to log these gifts as they are made and can be used to support a claim to use this exemption. Form IHT403 can be accessed from this page along with many other useful inheritance tax form **www.gov.uk/government/collections/inheritance-tax-forms**

Reporting rules

To determine whether a report is required, the donor needs to add together any gifts made under this exemption in the preceding seven years with any chargeable lifetime transfers made in the same seven year period. If the total exceeds the donor's nil rate band, they will need to report all the gifts to HMRC using form IHT100.

HMRC will review the exemption at this time to confirm it meets the requirements and confirm their conclusion in writing.

Where the total is within the donor's nil rate band, HMRC will only consider the exemption after the death of the donor. The executors of the deceased's estate will need to include a claim that the regular gifts should be treated as exempt as 'gifts out of income' using form IHT400 as well as form IHT403.

Typical planning objectives

These could include:

- Can be used to regularly save into a policy written in trust
- As the test is based on the donor there is the potential to move large sums out of their estate
- Can be used to prevent an IHT problem arising or preventing one from getting worse
- Can be used to fund pension contributions for family members

This document is based on Canada Life's understandings of applicable legislation, law and current HM Revenue & Customs practice as at October 2023. It is provided solely for general consideration. The information regarding taxation is based on our understanding of current legislation, which may be altered and depends upon the individual financial circumstances of the investor. We recommend that investors take their own professional tax advice.

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