



Gifts made as part of normal expenditure out of income

An introduction

Gifts made out of your income after tax may be exempt from inheritance tax.

When does the exemption apply?

To qualify, you must show that the gifts fulfil the following conditions:

- They were made as part of your normal “usual” expenditure;
- They were from your income, taking one year with another;
- After all transfers were made, you were left with sufficient income to maintain your usual standard of living.

What is normal expenditure?

- There is no set time span over which you must show the habit of giving. However, H M Revenue & Customs (HMRC) (previously known as the Inland Revenue) state in their guidelines that a reasonable span would normally be three to four years.
- It is a subjective test; normal is considered to be typical of your circumstances, and not those of the average or reasonable person.
- In establishing normal expenditure, it is important to maintain evidence that any payments fell within an established pattern of expenditure created by you. This can be established by proof of a commitment to someone to make the payment, or by a resolution, or by reference to a sequence of payments. For example, the payment of one premium on a life policy can be sufficient to establish a pattern of future payments. However, if there is some clear indication from the outset that the gifts were never intended to continue, they cannot be regarded as habitual.

- This does not mean “regular” or “annual”. HMRC do not apply an arithmetical formula, but in most cases a pragmatic approach is taken by averaging the yearly amount of your gifts of a particular type to form a fair opinion.
- It is important to ensure that any gifts you make are comparable in size. You do not need to worry about small discrepancies unless the difference is such that it would be treated as falling in a different category from those gifts which can be established to be “normal”.

Income

Income means net income after income tax and determined in accordance with accountancy (not income tax) rules. For example, share options which may be taxed as income will not qualify as income for this inheritance tax exemption.

Can I make a gift from capital?

The requirement that the gift is made out of income means that, where there is a gift of property other than cash, it must be shown that the property was purchased from your income. Generally income refers to current income and the exemption will not normally apply if the gift is made from a source which, although originally income, has been retained for some time and has acquired a capital nature. If the retained income has been invested to yield income it is generally deemed to have become capital. This can be disapplied if the sums were invested temporarily to accumulate funds for a specific expense.

Examples

5% withdrawals from Investment Bonds / Single Premium Bonds

Income and capital are retained within the bond. Withdrawals of up to 5% of the premiums paid can be taken free from income tax for the first 20 years of the bond. However, any withdrawals are not classed as income for the purpose of the normal expenditure rules, and are instead classed as capital.

Annuities

The capital element of a purchased life annuity is not regarded as income.

Payments to life time care plans

These plans are normally described as life time care plans or immediate care plans. Although all plans differ, it is usual that a single capital payment is made. The plan provider in consideration of this pays your care fees direct to the care provider on a periodical basis.

HMRC have tended to take the view that payments made on your behalf by the plan provider do not satisfy the income test.

Who can benefit from the gift?

You may well have different relatives or organisations whom you would wish to benefit. This is fine so long as you can prove a pattern of giving to each class.

My income fluctuates, does this matter?

- It is possible that your income may fluctuate between one year and the next. HMRC guidelines permit income to be carried over from year to year. However, it is likely that they would raise an enquiry if you sought to carry forward more than one year's income.
- It is extremely important that you keep good records to show that any gifts were made from your current income. HMRC tend to disqualify gifts from assets which were originally derived from income, but which have, by retention over a period of time, acquired the nature of capital. For instance, if you were to save your surplus current income over a period of years and then make a gift, HMRC may assert that this was a gift of capital and not income. The fact that the retained income has been invested or saved in a form that itself yields income will normally indicate that it has become capital. It is possible to get around this, by investing the income for a specific purpose, provided you can prove that the income was invested temporarily in order to accumulate an amount sufficient for the expenditure which you had specifically contemplated. This is, however, a contentious area and before considering gifts of this nature you should speak to us.
- Where the gift is made from a current account which

includes capital receipts HMRC will normally enquire further to determine whether the gift was made from income. It is sufficient that it could have been made from income. However, even if the gift is made out of income it will not qualify for the exemption if you have to resort to capital for your living expenses.

How do I establish my usual standard of living?

- After allowing for all gifts forming part of your normal expenditure, you must be left with enough income to maintain your usual standard of living.
- In order to establish this, you will need to document evidence indicating that you did not need to resort to capital to maintain your standard of living for your own living expenses. In particular, you should record expenditure in some detail, specifying for example household expenses, car expenses, council and other taxes, birthday and seasonal gifts, holidays and so on. You will need to prove that you could still live on your income after depleting it by the gifts in question. If necessary, one year can be compared with another. In these circumstances, HMRC would consider individual cases on their merits.
- Although slightly tedious, it is important to keep a record of all gifts which have been made, and the surplus income you have been left with. HMRC form D3a is attached and this is a useful starting point.

What if circumstances beyond my control alter my standard of living?

HMRC will generally apply the standard prevailing at the time of the transfer. So if you were required to lower your standard of living because of circumstances beyond your control, for example a drop in income on retirement, it will be your usual standard of living at the date of the gift that will be taken into account.

What should I do now to take advantage of this allowance?

- Keep detailed records of your annual income and outgoings. It may well be that you or your accountant already keep records of this nature.
- Keep a record of when any gifts are made, and to whom they are made, so that a pattern can be established.

For further information, or to discuss your estate planning needs, please contact Barry Glazier, Richard Fairbairn, David Parkhouse, Jeremy Mills, Ann Corke, Michael Norton, Emily Copping, Natalie Gamble, Paula Shea or Mahendree Naidoo of our Tax Trust and Wills Team who will be pleased to help you.

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Name

Date of death IR CT reference

You should read form D3 (Notes) before filling in this form

Give details of the deceased's income and expenditure

	Tax Year in which gifts made (6 April to 5 April) eg 2001/2002				
	/	/	/	/	/
Income					
Salary					
Investments					
Other					
Gross Income					
Less Tax Paid					
Net Income					
Expenditure					
Gifts					
Bills					
Expenses					
Nursing Home Fees					
Other					
Total Expenditure					

Surplus income for the year