

Briefing Note

Inheritance Tax: Normal Expenditure
out of Income Relief

When a person gifts assets during their lifetime, subject to certain exemptions, the gift is either:-

- A potentially exempt transfer - if the donor survives for seven years after the gift then the gift is not included in their estate for inheritance tax (IHT) purposes when they die (provided that the donor has not reserved a benefit in the gift); or
- A chargeable transfer i.e. a gift into trust. To the extent that the transfer exceeds the settlor's available Nil Rate Band an IHT charge at 20% will be payable when the gift is made. A further charge may arise if the person dies within seven years of making the gift.

One of the exemptions available is the "gift out of excess income relief". If a gift is made out of excess income then it is exempt from IHT. The statutory basis for this relief is Section 21 Inheritance Tax Act 1984 ("s.21").

Section 21

In order for a gift to qualify for relief:-

- (a) The gift must be made as part of the normal expenditure of the donor; and
- (b) The gift must be made from income; and
- (c) The donor must be left with sufficient income to maintain their normal standard of living.

Part of a gift may qualify for relief, the balance being chargeable or exempt under another provision.

(a) The gift must be made as part of the normal expenditure of the donor

Normal expenditure is considered to mean typical of the transferor, not of the average or reasonable man.

The gifts must be made as part of a pattern of expenditure. The pattern can be established in two ways:-

1. by reference to a sequence of gifts; or
2. by demonstrating a commitment or a firm resolution to make gifts.

The amount gifted each time the relief is claimed does not have to be the same as for previous gifts, nor do the gifts have to be made to the same person.

(b) The gift must be from income

HMRC will require evidence that the gift is being made out of income. They will require details of the donor's annual income after tax and full details of the donor's usual living expenses to show that the net income was sufficient to make the gifts. Furthermore they will require the donor to show that the particular gift made is being made out of that income. This may be a case of producing bank statements to show the income being received and then the payments being made from the account. For example, if a large dividend is received in one account with a payment being made from another account, HMRC will require to see the "paper trail" showing funds transferred between the accounts so that it is clear income is being used to make the payments.

Relief is available where income is used to purchase an asset specifically for the purposes of gifting the asset.

(c) The donor must be left with sufficient income to maintain their normal standard of living

The gifts must be out of excess income so that the donor's standard of living is not affected. To claim the relief, HMRC will require a list of all current normal annual expenditure including that spent on entertaining, holidays, medical expenses etc.

In order to provide evidence that the series of gifts are being made under s.21, the donor should, before the first gift is made, give the recipient a letter which:-

- Confirms the amount being transferred;
- States that the gift is made out of income which is excess to the donor's needs and that the donor can demonstrate this; and
- States that it is the donor's intention to make similar gifts on a regular basis.

Generally, HMRC will only consider whether exemption is available under s.21 on the donor's death. Exceptionally, HMRC may provisionally allow the exemption, though this will always be subject to review and may be disallowed at a later date. HMRC may review whether the exemption is available during a donor's lifetime where, for example, a lifetime transfer is made into trust which exceeds the donor's available nil rate band.

Please note that this briefing note is intended as a short summary of Inheritance Tax – Normal Expenditure out of Income relief. No responsibility can be accepted for any action taken in reliance on this note and specialist advice should be taken in every case. Turcan Connell would be happy to provide such advice.

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