Briefing Notes

Mercer & Hole

GIFTS OUT OF INCOME

It is surprising that one of the most valuable exemptions from Inheritance Tax (IHT) is also one of the most underused. The normal expenditure out of income exemption applies to certain gifts. The most usual example is cash but in some circumstances the exemption can apply to chattels bought from income for the specific purpose of making the gift. The exemption is limited in amount only to the extent of a donor's (net) surplus income. When used alongside the IHT £3,000 annual exemption, it can be very useful in moving assets out of a donor's estate.

Most gifts stay in an estate for seven years after the date of gift. However, provided that a donor satisfies three conditions, gifts out of income can be treated as immediately exempt from IHT.

The qualifying conditions are:

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

HMRC's interpretation is that the gifts should form part of a regular pattern of payments.

The exemption may be available where it can be shown that the donor had made a firm commitment regarding future expenditure. You should document this intention, possibly by letter.

Examples of regular gifts could include Christmas and birthday gifts, annual family holiday, insurance policy premiums, education costs, private healthcare arrangements, etc.

The donor must retain sufficient income to maintain his (or her) standard of living

Whether or not a gift is made out of income is a subjective test. The amount of income needed, and any available surplus will vary depending upon the particular circumstances of the donor at different times. It may be helpful to prepare an income and expenditure analysis each year to clarify the position.

Gifts must be made out of income

The exemption only applies where expenditure is from surplus net taxable income. Examples of income include salary, dividends, interest, pensions, rental income, business profits, etc. Ideally, income should be identified in the year in which gifts are made to demonstrate that there is sufficient income available, before considering earlier years. Income from earlier years does not retain its character as income indefinitely.

There are no set rules about when accumulated income becomes capital but HMRC normally considers this to happen after two years. This may be a problem where income has been accumulated.

An example of a qualifying gift Mrs Mercer had total net income (after tax) of:				Total
	Year 1	**Year 2**	**Year 3**	
Net income (after tax)	£120,000	£130,000	£95,000	£345,000
Regular expenditure	£75,000	£75,000	£75,000	£225,000
Surplus income	£45,000	£55,000	£20,000	£120,000

Mrs Mercer wishes to gift her surplus income to her children; Bill, Ben and Alice. This would immediately remove £120,000 from Mrs Mercer's estate for IHT saving approximately £48,000, provided she can demonstrate the income has not been capitalised by Year 3.

Mrs Mercer's surplus net income fluctuates year on year, but this is not a problem. The value of regular gifts does not have to be fixed, or even need to be made to the same donee each time. Mrs Mercer could gift up to £40,000 per annum and still qualify for the exemption because 'taking one year with another' she has sufficient income to meet the criteria.

As with most IHT-related gifts, a donor must not retain any future benefit, either directly or indirectly, or the exemption will not be available.

Record keeping

We would recommend that Mrs Mercer writes a letter to her chosen donee(s) to record the gift. An example of suitable wording might be: "I have surplus income to and it is my intention to let you have a cheque for this every Christmas". By keeping a copy of the letter this will represent contemporaneous evidence of Mrs Mercer's intentions.

It will be the responsibility of the executors to prove that the gifts meet the conditions for exemption, and submit details on schedule IHT403 to the Inheritance Tax return form IHT400. It is useful therefore if records are kept in this format during the donor's lifetime.

Summary

As long as a donor has excess income available and can maintain appropriate records, the regular gifts out of income exemption can help to reduce IHT. .