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IHT Exemption for Lifetime Gifts

- Normal Expenditure out of Income

If you make lifetime gifts, then in the event of your death, they may be added back when it comes to working out any inheritance tax (“IHT”) payable on your estate. But some gifts are “exempt” from IHT so they are not added back and would not increase the amount of tax payable on your estate on death.

An important exemption which can sometimes be overlooked is the “normal expenditure out of income” exemption. So, if you are thinking of making any lifetime gifts but want to try to make sure they will not be added back to your estate for IHT, this is an exemption well worth considering.

In essence, there are three conditions each of which must be satisfied for the exemption to apply:

a) the gifts must be part of your “normal expenditure”;
b) the gifts must be made out of income, and
c) taking the gifts into account, you must be able to maintain your usual standard of living.

It is worth expanding a little on each of the requirements.

a) **Normal expenditure**

What counts as normal expenditure can be established in two ways.

(i) You need to demonstrate a pattern of gifts over a period of time, most likely a few years.

To demonstrate the required “normal pattern”, we recommend you set up a monthly standing order for the same amount each month (an annual standing order payment may suffice in some exceptional cases).

(ii) You need to assume a commitment to future expenditure and then comply with it. Thus, we recommend such income gifts are made for at least a period spanning two to three years.

Once you’ve been able to establish a pattern over a few years, the amounts gifted in all those years should count for the exemption, even if you have to stop making normal gifts out of income, if say your income later substantially reduces.

b) **Gift must be made out of income**

"Income" is not defined in the legislation but it certainly means net income after income tax. Also, "income" refers to **current** income, not income earned in the past which has been saved over a period. From April 2012, HMRC's view changed from often allowing accumulated past income to be treated as a gift out of income to the following:

"...If there is no evidence to the contrary, we consider that income becomes capital after a period of two years...each case will depend on its own facts but, in general, the longer the period of accumulation, the more likely it is that the income has become capital..."

c) **Maintaining your usual standard of living**

Your income will need to exceed your expenditure by a reasonable margin. Whilst reasonable is not defined, we consider it means more than just say £200 - £500. Your income needs to exceed your expenditure by a "comfortable" margin.

Moreover, the standard of living is your own individual standard - not that of the proverbial man on the Clapham omnibus.

It is possible to increase or decrease the amount to adapt to your changing circumstances.

Because HMRC is taking a stricter line in allowing gifts to be exempted, to rely on this important "normal expenditure out of income" IHT exemption, it is increasingly important to **keep detailed records,** including your intentions with regard to retained income.

Thus, we strongly recommend that you regularly complete the final page 8 of "Form IHT403" http://www.hmrc.gov.uk/inheritancetax/iht403.pdf .

Please call us if you have any queries.