Inheritance Tax - Guide to Making Gifts from Surplus Income

Do you have excess income and want to make Inheritance Tax free gifts? If so, you need to make use of the normal expenditure out of income exemption.

If you want to make inheritance tax free gifts from surplus or excess income, there is a useful and much under utilised exemption that allows gifts over and above the value of £3,000 per annum to be paid without these gifts forming part of your estate if you die within seven years of making them.

This Inheritance Tax exemption comes under the heading of "Normal expenditure out of surplus income". It is a particularly valuable way of gifting part of your estate to future generations on a regular basis.

If you want to make inheritance gifts from surplus or excess income, you need to show that you intend to make regular gifts that will not affect your normal standard of living and that will come out of income rather than capital. This form of giving is most effective for those with higher incomes relative to their cost of living.

What are the requirements?

1. The gift must form part of your normal expenditure – this can mean either a pattern of regular gifts or the intention to make regular gifts. You will therefore need to record when you are making a gift out of income, by writing a letter for instance.

2. The gift is made out of income.

3. If you are left with enough income to maintain your normal standard of living.

How do you assess whether you have sufficient income?

In order to assess whether you have sufficient income to satisfy conditions 2. and 3. above, you will need to:

(a) Consider how much net income you receive (for example from employment, pensions, dividends, interest, rent) after tax. Withdrawals from Investment Bonds are not, however, treated as income for these purposes.

(b) Review what your normal expenditure amounts to – there is no actual legal definition of what "normal expenditure" amounts to but it is based on an individual's particular circumstances. This may of course fluctuate from year to year.

Carrying forward your income

If appropriate you could complete this process every tax year to review how much surplus income you have for that year. You can then increase or decrease the amount you gift accordingly. There are no hard and fast rules as to when income no longer retains its status as income. However, HMRC tend to take the approach of being able to carry forward income for a period of two years.

It is important to keep financial records that allow you to calculate and offset expenditure against income. This will determine the amount available for gifting. We can provide you with a form to assist for ease.

Continuing to make regular payments

It is also helpful to record a Memorandum of Intent declaring your future intention to make regular gifts of your excess income which can be used to anticipate a challenge to their nature. The normal expenditure out of surplus income exemption will need to be claimed by your Executors on your death and it is therefore important to maintain thorough record keeping.

In certain situations it may be possible that a single gift could qualify so long as it can be proved that there is an intention to continue with the payments. Such intention could be proved by the Donor providing a signed letter to the recipient confirming their intention to continue to make regular payments.

Retaining control of your capital

The normal expenditure out of surplus income exemption is a particularly effective means of tax planning if an individual is not dependent upon such income to maintain their current standard of living and wishes to retain control of their capital. It also ensures that the gifts made are not subject to the normal seven year rule. An example of where the exemption can be used would be a parent paying the premiums on a life policy for their child, making payment into Trust for the benefit of their children, paying their children's school or university fees. The income can be made out of general income or it could be made out of a nominated source such as a property rental or specific investment income.

Further information

For further information regarding this useful exemption, please contact either Christopher Hamlyn (e-mail c.hamlyn@wjclaw.co.uk) Susannah Griffiths (e-mail s.griffiths@wjclaw.co.uk) or James Rousell (e-mail – j.rousell@wjclaw.co.uk) Tel No 01384 371622
