GIFTS MADE AS NORMAL EXPENDITURE OUT OF INCOME

Gifts can be made by individuals throughout their life which will be exempt by statute from Inheritance Tax (IHT). These include gifts of any amount to spouses or to charities, gifts out of capital which do not exceed £3,000 per annum (to 5 April each year), and any outright gifts to any individual which do not exceed £250 per annum (to 5 April each year). It is also possible however to make unlimited gifts, which are exempt from IHT so long as they qualify as 'normal expenditure' out of an individual's income.

There are four conditions which the transferor must be able to show that he has satisfied for the normal expenditure out of income exemption to apply. These are:

- Gifts have to be made out of the 'normal expenditure' of the donor;
- Gifts to be made out of the donor's income, taking one year with another; and
- The donor must subsequently be left with sufficient income to continue his/her normal standard of living.
- Gifts have to be of money unless an asset is purchased out of income specifically for the purposes of making a gift of that asset.

Gifts that satisfy these conditions are immediately exempt from IHT and will not fall into charge. However, they must be reported to HMRC after the donor's death. If the donor does not survive seven years after the gifts were made, they are still exempt.

It is instructive to consider the first three conditions in further detail.

NORMAL EXPENDITURE

'Normal' is taken to mean 'typical' or 'habitual'. There is no specific financial limit to what is 'normal' and it is judged in the context of the habits of the particular individual.

A pattern of gifts through a sequence of payments out of past expenditure will make it 'normal' by demonstrating that they are habitual and part of a settled pattern. There is no fixed minimum period over which gifts must actually have been made but there must be evidence of an intention to make regular payments over a period of time, although the gifts do not have to be made on the same specified dates every year.

Evidence of a specific commitment or resolution can demonstrate the intention to make the gifts habitually without an actual pattern of payments being established at the start. Where there is a commitment to make these gifts it need not necessarily be a legally binding commitment in order to qualify.

The amounts of the gifts do not have to be fixed nor do they have to be to the same person each year, as long as a pattern can be shown as existing or intended.

Payments to a life policy or payments under deeds of covenant are examples of continuing payments. A single payment can also qualify as long as a prior commitment or resolution to make future payments has been made.

MADE OUT OF INCOME

Income is not easily defined. However, a gift can not qualify if it is made out of capital unless the capital item was acquired out of income specifically in order to make a gift of it.

Income is calculated on an annual basis and it is the net after tax income that should generally be considered. Income can fluctuate from one year to the next and therefore it is permissible for income to be carried over but it must remain current income. Gifts made out of savings may not qualify where the income has accumulated over a number of years and so is not current.

The evidence of the donor's intention to make gifts in this way should include an approximate total annual amount, or proportion of his 'surplus' income, that he intends to give.

SUFFICIENT INCOME TO MAINTAIN THE TRANSFEROR'S NORMAL STANDARD OF LIVING

The donor must be left with sufficient income to be able to continue his or her normal standard of living without realising capital assets to meet day to day expenditure. The level of income to achieve this will vary from one person to another and is determined by his or her standards of living prevailing at the time of the gift.

Gifts which are made outside the donor's normal expenditure are ignored when deciding whether he or she has sufficient income to live on.

Other lifetime gift exemptions can be used alongside gifts made out of income. For example, the donor can make a gift out of income and then make a further gift of £3,000 out of capital in the same year which will be covered by the annual exemption.

To ensure that there is evidence to support a claim for exemption for gifts made out of income, the donor should put in place, perhaps in a letter, evidence of the commitment to make regular gifts.

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