PEMBERTON GREENISH

Inheritance tax on income. How to avoid it.

Most people grudgingly pay tax on their income, but smart at the prospect of a further 40% on what is unspent at death. Lifetime gifts of lump sums are a sound way of avoiding tax on accumulated wealth, or capital, but what about income as it arises?

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 gifts you make during your lifetime and it is limited in amount only to the extent of your own (net) surplus income. When used alongside the annual exemption (at present £3,000) it provides a valuable tool to place assets immediately outside of your estate.

If you find that your income exceeds your spending needs then rather than accumulating the excess and increasing your anxiety about the eventual IHT liability of your estate, you have the option of giving away all or some of the excess in the form of regular lifetime gifts. These gifts will not be subject to IHT on your death and nor will they be subject to the seven year rule.

How does it work?

The Inheritance Tax Act 1984 sets out three conditions for the exemption to apply. It must be shown that the gift:

1. was made as part of the normal expenditure of the person making the gift;
2. was made out of his income; and
3. that the donor was left with sufficient income to maintain their usual standard of living.

What is normal expenditure?

This means expenditure which is typical of you, the actual person making the gift, not simply an average or reasonable person.

This expenditure must correspond with a settled pattern when it was made and such a pattern can be established either through a series of payments made by you in the past or by evidence that you have a prior commitment to future payments. There is no requirement for a fixed minimum period and the amount of your gifts need not be fixed or the recipient be the same.

In theory, a single gift which shows a regular commitment such as the first of a series of premiums on a life policy can be accepted as normal if there is a clear indication from the outset that the gifts were intended to continue. Without this clear intention however, your gift cannot be regarded as typical.

Arrangements such as a regular payment life assurance savings policy under trust, or a parent funding a stakeholder pension on behalf of their child can therefore take advantage of the exemption: they demonstrate a commitment to habitual payments and, when held under a trust for the benefit of another they satisfy the gifting criteria.

Income

Any gift has to have been made out of your income. This requirement means that when you make a gift of something other than cash it must be shown that you bought it from your income in order to make the gift. Giving away jewellery unless specifically purchased from your income would not apply.

Generally income refers to current income and the exemption will not normally apply if you have made the gift from a source which although originally income, has been retained for some time and acquired a capital nature. If the retained income has been invested in a form which yields income, it is generally deemed to have become capital.

In situations where your income might fluctuate, income can be carried over from year to year in order that the exemption can be afforded to what is otherwise a normal gift. This opens up the exemption to those who do not always have a consistent income stream.

Usual standard of living

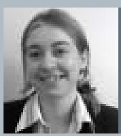
After making a gift out of your excess income, you have to be left with enough income to maintain your usual standard of living. If a gift resulted in you having to resort to capital for your general living expenses, the gift would not qualify for the exemption.

The standard to be met is usually the standard prevailing at the time of the gift, but where a regular commitment is made the exemption will not be lost if you have had to lower your standard of living due to changed circumstances such as the loss of employment or the payment of retirement or nursing home fees.

Summary

If you regularly have more income than you need then the normal expenditure out of income exemption is a worthwhile consideration that can maximise the benefit of advance IHT planning. It is flexible in that you do not have to give away all of your excess income every month, but as long as what you do give displays a regular and settled pattern the exemption will apply.

The normal expenditure out of income exemption is claimed retrospectively by your personal representatives so it is important to note that sufficient records must be maintained during your lifetime to enable a claim to be successful. We would be happy to discuss how the exemption could work for you and how you could go about keeping a record of gifts made when a financial assessment is undertaken as part of an estate planning exercise.



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