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Making inheritance gifts from surplus income

Are you making use of this useful and much under-utilised exemption?

If you want to make inheritance 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 made without these gifts forming part of your estate if you die within seven years of making them.

The 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 from income rather than capital.

This form of giving is most effective for those with higher incomes relative to their cost of living, who are either looking to clear their estate or just make gifts to loved ones – especially in order to distinguish these gifts from lifetime gifts of capital that have already been made or are being contemplated.

SO, 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 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. You are left with enough income to maintain your normal standard of living.

In order to assess whether you have sufficient income to utilise this exemption and to satisfy conditions 2 and 3, you will need to:

Consider how much net income you receive (for example, from employment, pensions, dividends, interest, rent) after tax.

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.

CONDITIONS THAT MUST BE MET

It is important to consider the conditions that must be met for gifts to qualify. The conditions of 'surplus' and 'normality' are qualitative and, without methodical planning, can leave room for doubt about the tax effects.

It's therefore important to seek professional financial advice in advance to identify any ambiguity. Inadvertently making a gift of capital could be very costly and later give rise to a 40% Inheritance Tax charge on those funds should you die within seven years.

CARRYING FORWARD YOUR INCOME

If appropriate, you could complete this process each 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, HM Revenue & Customs tends to take the approach of being able to carry forward income for a period of two years.

It's important to keep financial records that allow you to calculate and offset expenditure against income. This will determine the amount available for gifting. Tracking the opening and closing balances on monthly bank statements is the usual starting point.

CONTINUING TO MAKE REGULAR PAYMENTS

It's 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 Inheritance Tax Form 403 provides a useful record-keeping tool. Your executors will need to claim the exemption on your death, and therefore it is 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 upon death that there was 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.

WISHING TO RETAIN CONTROL OF YOUR CAPITAL

This is a particularly effective means of tax planning if an individual is not dependent upon such income to maintain their current standard of living but wishes to retain control of their capital. For example, a parent could pay the premiums on a life policy for their child, make payments into trust for the benefit of their children, or pay their children's school or university fees.

The gift can be made out of general income or it could be made out of a nominated source such as property rental or specific investment income. ■

IS YOUR WEALTH PROTECTED FOR YOU AND YOUR FAMILY?

Estate planning is essential to make sure your wealth is protected for you and your family. By structuring your assets in a tax-efficient way, you can make sure everyone is provided for in the future. To discuss your options or any estate planning concerns you may have, please contact us.

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