

ADVISER GUIDE

IHT planning – gifts out of income

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IMPORTANT

This information is based on current understanding of tax rules. This is provided for information only; we do not provide advice.

Tax rules may change in the future and tax treatment depends on personal circumstances. This guide is provided for professional advisers' use only.

Background

For deaths occurring on or after 6 April 2027 the value of unused pensions will be included in the deceased's estate for the purposes of calculating inheritance tax (IHT) due. This has led to increased interest in making gifts in life to reduce the size of the estate remaining on death.

If certain conditions are met, lifetime transfers that are part of normal expenditure out of income will be exempt from IHT, regardless of how long before death the gifts are made.

The exemption applies where the gift:

- forms part of normal expenditure;
- is made from income; and
- doesn't impact normal standard of living.

Normal expenditure

In the context of the exemption "normal" means normal for that individual, not necessarily normal for the average person.

When deciding if the expenditure is usual, HMRC are likely to consider the pattern of gifts including frequency and amounts, nature of the gifts, who the gift is made to and the reason for the gift.

There is no set period over which gifts must have been made. It is possible for a single gift to meet the requirement, but evidence would need to be provided to demonstrate that this was genuinely intended to be the first in a pattern of gifts.

For example, if a standing order was set up, or the first of a series of premiums on a life policy was paid, this could demonstrate the intention to start a regular pattern (but if the life policy is linked to an annuity and considered a back-to-back arrangement it will not qualify).

Setting up a regular payment by standing order to a child or grandchild is likely to be classed as normal expenditure, as is making similar size gifts every year for birthdays and Christmas. It is worth noting that gifts are usually made by transfer of money, although it is possible for an asset to be purchased from income specifically for the recipient. This could still meet the exemption if the nature of the gift is comparable with other gifts that have been made.

HMRC's guidance on normal expenditure can be found [here](#).

Income definition

For the exemption to apply, gifts must normally be made from net income received in the tax year. However, there is some flexibility where income fluctuates from year to year but overall there is enough income to meet needs on an ongoing basis. This is the "taking one year with another" principal. In practice if more than two years' income is carried forward for this purpose then this may be more closely examined by HMRC.

Income will be net income after income tax has been deducted. However, income for these purposes is not defined in the Inheritance Tax Act 1984 (IHTA84) but should be determined "in accordance with normal accountancy rules". It is not necessarily the same as income for income tax purposes.

The key point is that gifts must be made from income, and not from capital. The individual must have sufficient income to live on themselves, before they can make any gifts. It is not possible to live on capital and take income in order to gift it.

Usual sources of income include employment income, pension income, rental income, interest and dividends. Natural income from ISAs would be classed as income, provided it is paid out and not accumulated within the ISA. Generally, HMRC considers that income becomes capital after two years, but there can be exceptions to this rule.

Withdrawals from an investment bond, even if received regularly so they look like income, is a return of capital so would not qualify. This is the case even if the withdrawals result in chargeable events and are subject to income tax.

If a purchased lifetime annuity was being paid, only the interest element would be included as income for the purposes of the exemption. The capital part of each payment would not qualify.

HMRC's guidance on how income is defined can be found [here](#).

Standard of living

The final condition for the exemption to apply is that the person making the gift must be able to maintain their usual standard of living from their remaining income. They cannot be drawing on capital to support themselves so they can leave more income to gift.

What "usual standard of living" is will be different for different people. Generally, the standard of living the individual enjoys when starting regular gifts should be maintained.

Normal living expenses are taken to include things like mortgage, rent, utility bills, council tax and insurances, plus anything "usual" for the individual – which may include regular holidays, eating out, leisure memberships, subscriptions etc. One-off expenses such as home improvements, or a new car every 10 years wouldn't necessarily be included. However, if regular monthly car payments were made this is likely to be included as a usual expense.

Record keeping

If regular gifts out of income are to be made, it is essential that records are kept to evidence that the exemption has been met. These records should include total income received each year, net of tax, normal expenditure with a breakdown of what it covers, and the amount of gifts made, to whom and how much. When a new gift pattern is started evidence should be recorded that the intention is for it to be made on a regular basis. This could be done by putting a standing order in place, or by written agreement.

If records aren't kept it does not mean the exemption cannot be met but may make it a lot harder for the personal representatives dealing with the estate to provide evidence to satisfy HMRC to allow the claim.

It is important that the individual making the gifts has a will appointing executors, and that those executors know where the appropriate records are kept.

How to claim the exemption

When the individual dies their personal representatives (PR) will be responsible for dealing with their estate and paying any IHT due. Where there is a valid will, the PR will be the executor(s) named. If there is no will then someone else, usually the next of kin, will apply to court to be appointed as administrator for the estate.

The PR must value the estate for IHT purposes. Excepted estates include those with a value below the IHT threshold. This may include unused threshold transferred from a spouse or civil partner that pre-deceased the individual, or estates worth less than £3 million where everything is going to their spouse / civil partner or charity. For estates other than excepted estates the PR must complete the IHT400 form.

Gifts made as part of normal expenditure out of income

Only fill in this page if you've ticked 'Yes' to box 6 on page 1. This is a guide to the type of income and expenditure the deceased may have had so that you can show that gifts made were part of the deceased's normal expenditure out of their income. Give details of the deceased's income and expenditure for each of the years in which the gifts were made.

20 Income									
Tax year in which gifts made (for example, 6 Apr 2005 to 5 Apr 2006)									
Salary									
Pensions									
Interest (including PEPs and ISAs)									
Investments									
Rents									
Annuities (income element)									
Other									
Minus Income Tax paid									
Net income									
21 Expenditure									
Mortgages									
Insurance									
Household bills									
Council Tax									
Travelling costs									
Entertainment									
Holidays									
Nursing home fees									
Other									
Total expenditure									
22 Surplus (deficit) income for the year (Net income minus total expenditure)									
Gifts made									

IHT403

Page 8

Where gifts were made in the seven years prior to death form IHT403 must also be completed. Page 8 is shown above. This details the deceased's income, expenditure, surplus and gifts made in each relevant tax year. The PRs will need the appropriate records from the deceased so they can complete this information and claim the exemption.

It is not possible to know whether the claim will be successful prior to the individual's death and any subsequent assessment by HMRC. If the claim was not allowed (or partially disallowed), then the gifts made in the last seven years would be treated as failed potentially exempt transfers (PETs). This means they would use up nil rate band and potentially have IHT applied which would be payable by the recipient of the gift. Depending on how long has passed between the gift and date of death, taper relief may apply.