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TECHNICAL BULLETIN

INHERITANCE TAX - GIFTING FROM SURPLUS INCOME

What is it?

For those in suitable circumstances, making gifts from income can be an effective way to reduce their estate's exposure to Inheritance Tax (IHT). Unlike potentially exempt transfers (PETs), regular gifts made from surplus income are immediately exempt from IHT, provided certain conditions are met.

This relief is particularly appealing for individuals with consistent excess income who wish to prevent their IHT liability from increasing, without reducing their capital.

How does it work?

For the exemption to apply, it must be shown that a transfer of value meets all three conditions below.

1. It formed part of the transferor's normal expenditure (normal for the transferor specifically rather than normal for an individual).
2. It was made out of income (which is not classified as capital).
3. It left the transferor with enough income to maintain their normal standard of living (i.e. Gifts, even if made out of income, will not qualify for exemption if the transferor had to resort to capital to meet their normal living expenses).

Where the exemption is used over a number of years, it doesn't matter if in one of those years there was a deficit, so long as 'taking one year with another' there was a surplus and gifts were made out of that surplus.

What isn't allowed?

Income is not defined in IHT legislation and is not necessarily the same as income for income tax purposes.

For example, the 5% annual withdrawals from an investment bond do not count as income for this purpose, as they're considered return of capital.

Similarly, the capital element of a purchased life annuity does not count as income, but the interest element does count towards it.

It's also worth bearing in mind that although it's possible to gift income from previous years, over time, income is considered capital and therefore does not satisfy condition two above. HMRC view this as being about two years, although there have been cases where this period has been extended.

What do you need to watch out for?

Whilst it's exempt if the conditions are met, HMRC may well investigate gifts at death. It's therefore important to ensure sufficient records are retained as evidence, such as:

- the amount and frequency of gifts
- all sources of income, and
- a letter of intent to the recipient of your financial gifts, outlining that they are being made out of surplus income, prior to the first payment.



The IHT return contains a schedule for this purpose where income and expenditure is broken down and viewed against gifts made under this exemption.

The legislation hasn't been updated since 1984 but there have been a number of court cases since then that have clarified some aspects of the rules. This highlights that HMRC do investigate gifting of this nature and will challenge estates where they feel the conditions have not been met.



FOR MORE INFORMATION

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