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wills & probate

Inheritance Tax Gift Exemptions
Key Information

Use Inheritance Tax gift exemptions now to reduce a potential 40% tax liability

Under current legislation, your estate will be subject to Inheritance Tax (IHT) at 40% if, on your death, it exceeds the nil rate band (presently £325,000). One way to reduce a potential IHT liability is to reduce the size of your estate by making gifts during your lifetime.

Some gifts rely on you surviving seven years (or more) from the time you make them in order to be fully effective in reducing IHT but it's also possible to make gifts using exemptions, meaning the value is immediately outside of your estate for IHT purposes.

These exemptions include:

- Normal expenditure out of income.
- The annual £3,000 exemption.
- Small gifts of up to £250 to any person in any one tax year – to as many people as you wish.

Normal expenditure out of income exemption

The normal expenditure out of income exemption is potentially the most generous exemption since, unlike the latter two exemptions above, it has no defined monetary limit. The maximum that you can give under this exemption is instead determined by the amount of surplus (or spare) income that you have. Gifts of surplus income do not have to be for the same amount each year, nor made every year nor made to the same person. The exemption provides a large degree of flexibility.

What do you need to use the exemption?

You do not need to claim the exemption during your lifetime – it has to be claimed retrospectively by your personal representatives following your death. As they will need to satisfy HM Revenue & Customs (HMRC) that you have met certain requirements, you can help them by ensuring adequate records are available regarding any gifts you have made.

Your personal representatives will need to demonstrate:

- That the gifts made were part of a regular pattern of payments or that you had made a firm commitment regarding future expenditure.
- That the gifts were made from surplus net taxable income such as salary or pensions, dividend income from unit trusts or shares, interest from your bank or building society accounts or rental income. Amounts such as withdrawals from investment bonds, capital sums from the sale of investments or the capital content of a purchased life annuity are not classed as income.
- That you retained sufficient income to maintain your standard of living. In simple terms, you cannot give away your pension if you then need to take withdrawals from your investment bond to cover your own personal expenditure.

When making gifts as normal expenditure out of income, you can assist your personal representatives by recording details on HMRC form IHT 403.

It is important to give the income on a regular basis rather than accumulate it. Although HMRC will normally allow amounts that have been saved temporarily to be treated as income, they are unlikely to allow the same treatment for gifts made out of several years' worth of accumulated income.

Making the most of the exemption

Whilst you could simply make outright gifts of income to members of your family or friends, there are other methods of using the exemption which might be more appropriate as part of your overall estate planning strategy.

For instance, making the gifts to a discretionary trust offers greater flexibility and, whilst not allowing you access to the money for your own personal use, does give you continued control. If you make a gift to an individual, you might not agree with how the money is used.

Example: Normal expenditure out of income exemption

Laurence is a successful company director age 55, he intends to continue working for several years, and then expects to retire on a generous pension. Although he and his wife live comfortably, they manage to save £80,000 from Laurence's income each year.

They decide that Laurence should give £10,000 of this surplus income to a family trust every three months. Over a period of ten years he gives a total of £400,000 of surplus income to several family trusts.

He dies, unexpectedly, at age 67. Although he failed to survive most of his gifts by seven years, all the gifts are wholly exempt from IHT because they were regular gifts of surplus income. The gifts have saved a minimum of £160,000 in inheritance tax.

It is also worth remembering that the trustees have a duty to ensure that any trust funds are invested in a suitable manner. All growth achieved on any investments the trustees have made would be exempt from IHT, although may be subject to income tax or Capital Gains Tax depending on the investments made.

Make the income work harder – use it to create a tax free lump sum via life cover in trust

A straightforward way of using surplus income is to use it to pay for life cover. Life assurance premiums are payable for the remainder of your life and so, in setting up the life cover, you will demonstrate your firm commitment regarding future expenditure. Of course, it is important to consider whether you will have surplus income not just this year but in every year for the remainder of your life in order to keep the life cover in place.

Writing the life cover in trust ensures that the lump sum payable in the event of your death is exempt from IHT and that the normal delays associated with probate are avoided.

On your death, the sum assured will be paid to your trustees and this lump sum can then either be used to settle any IHT on your estate or used over the longer term for the benefit of your heirs.

Under current legislation, assets can remain in trust for up to 125 years. Discretionary trusts are often used as part of an overall estate planning strategy for several generations of a family due to the various forms of asset protection that they provide.

Example: Creating a tax free lump sum via life cover in trust

At age 65, Kenneth retires from his position as a headmaster. From his pension, he finds that he can afford to give away some surplus income. He takes out a life plan in trust with monthly premiums of for example £318.40. This provides life cover of £100,000 on a guaranteed basis.

Kenneth dies 15 years later, aged 80. Over the years, he has given away £57,312 of his pension which has saved £22,924 in IHT. Additionally, his trustees receive £100,000 tax free from the life plan proceeds.

What if you don't expect to have surplus income every year for the rest of your life?*

Whilst it wouldn't be appropriate to set up life cover if you don't expect to have surplus income to pay for it later in life, it is still possible to consider giving your surplus income to a discretionary trust rather than directly to an individual.

Further advantages of using a discretionary trust are that:

- You can delay making decisions over who you actually want to benefit from the gift.
- You can control when money is given to individuals.
- The monies can be invested for longer term growth rather than spent immediately by individuals.
- The gift may be protected in the event of divorce or bankruptcy of any of the individuals you might otherwise have chosen to make outright gifts to.
- Similarly, it may be ignored in the event of any of those individuals undergoing local authority financial assessment for long term care purposes.
- The funds don't form part of anyone else's taxable estate for IHT purposes.

Of course, it is important to remember that when making a gift to a discretionary trust, you give up all future rights to the capital, in much the same way as you do when making an outright gift to an individual.

To ensure that any trust meets all of your needs and objectives, it may be necessary to pay for legal advice when including surplus income trusts in your financial planning. The cost of this work will vary depending on your precise needs.

*If you would like to consider paying for life cover out of capital, there are tax efficient means of doing so. Please ask your financial adviser for more information.

Appointing trustees

It's possible to appoint friends or family as trustees (often called lay trustees). However, if your reason for giving your surplus income to a trust is to avoid giving initial control of it to a friend or family member then you will need to appoint independent trustees.

Even if this wasn't your reason for using a trust, perhaps you don't wish to ask a friend or family member to take on the role of a trustee with the perceived burden that it brings. Again, an independent trustee could be the solution.

They will take control of the day-to-day administration of the trust and ensure that your objectives and wishes are considered in the context of their legal responsibilities. They will also aim to meet the individual needs of the beneficiaries, however diverse those needs may be, and will ensure they consider the relevant tax and legal implications.

Designated unit trust

If you don't require the flexibility afforded by a discretionary trust, a designated unit trust may offer a straight forward alternative for your surplus income gifts. Here, you make regular gifts of income which are invested in a unit trust which is 'designated' for somebody else – the beneficiary.

The designated status means that, although the investment is made in your name, you are simply holding it on behalf of the beneficiary. You effectively create a bare trust in the eyes of HMRC. The investment is immediately outside of your estate but does form part of the estate of the beneficiary from day one. The beneficiary can request access to the investment at any time from age 18 onwards and, from that point onwards, you have no further control as a trustee.

Through a designated unit trust, you can control how your gifts are managed whilst invested. Your financial adviser can provide more information regarding this.

Boosting your gift by 20% at no extra cost to you!

If you invest your surplus income into a pension fund for another individual, it may be eligible for income tax relief at 20%. All UK resident individuals are eligible for minimum income tax relief of £720 on pension contributions so, if you give away surplus income of £2,880, the total value of the gift including income tax relief will be £3,600.

This may provide an ideal solution if you would prefer your gifts to be used for longer term benefit. Perhaps you would like your own income to help provide a grandchild with income, or even a 25% tax-free lump sum, in retirement rather than allowing him or her access to the funds earlier in life. By contributing to a pension in this way, you can also decide on an annual basis whether you would like, or can afford, to make a further contribution.

If you would like to discuss any of the methods of giving away surplus income covered in this information sheet, please contact your financial adviser.

Important

The value of an investment will be directly linked to the performance of the funds selected and may fall as well as rise. You may get back less than the amount invested.

Please note that trusts are not regulated either by the Financial Conduct Authority or the Prudential Regulation Authority.

The levels and bases of taxation and reliefs from taxation can change at any time and are dependent on individual circumstances.

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