

## Normal gifts out of income – using trusts (Lecture P1314 – 19.34 minutes)

### *The statutory provision*

By virtue of S21 IHTA 1984, a transfer of value is an exempt transfer if, or to the extent that, it is shown that:

- it represented part of the transferor's normal expenditure;
- taking one year with another, it was made out of income; and
- the transferor was left with sufficient income to maintain his usual standard of living.

It is up to the transferor to demonstrate that he has satisfied all three conditions in connection with any given transfer.

### *Normal expenditure*

'Normal' is taken to mean habitual and thus requires a pattern of giving to be demonstrated. In relation to this, it can reasonably be argued that the first in a series of life assurance premium payments qualifies. Where there is initially no evidence of any regular commitment, HMRC Inheritance Tax are prepared to accept that expenditure is normal once it has occurred three times – in such circumstances, the first two payments are also retrospectively eligible for relief. However, this view has been modified following the decision of Lightman J in the case of *Bennett v CIR* (1995), where it was accepted that an elderly lady, whose trust income suddenly enjoyed a considerable increase following the sale by her trustees of some private company shares to a plc, could make a resolution to give the resulting additional trust income to her sons such that this resolution was a qualifying S21 IHTA 1984 gift (even though the elderly lady died just one year after executing the authority). During this 12-month period, the sons received only two payments.

In his judgment, Lightman J said:

'In my view, in the context of S21 IHTA 1984, the term "normal expenditure" connotes expenditure which at the time it took place accorded with the settled pattern of expenditure adopted by the transferor.

The existence of the settled pattern may be established in two ways.

1. An examination of the expenditure by the transferor over a period of time may throw into relief a pattern, e.g. a payment each year of 10% of all income to charity or members of the individual's family or a payment of a fixed sum or a sum rising with inflation as a pension to a former employee.
2. The individual may be shown to have assumed a commitment, or adopted a firm resolution, regarding his future expenditure and thereafter complied with it. The commitment may be legal (e.g. a deed of covenant), religious (e.g. a vow to give all earnings beyond the sum needed for subsistence to those in need) or moral (e.g. to support aged parents or invalid relatives). The commitment or resolution need have none of these characteristics, but nonetheless be likewise effective as establishing a pattern, e.g. to pay the annual premiums on a life assurance qualifying policy gifted to a third party or to give a predetermined part of his income to his children.

For expenditure to be “normal”, there is no fixed minimum period during which the expenditure shall have occurred. All that is necessary is that on the totality of evidence the pattern of actual or intended regular payments shall have been established and that the item in question conforms with that pattern. If the prior commitment or resolution can be shown, a single payment implementing the commitment or resolution may be sufficient. On the other hand, if no such commitment or resolution can be shown, a series of payments may be required before the existence of the necessary pattern will emerge. The pattern need not be immutable; it must, however, be established that the pattern was intended to remain in place for more than a nominal period and indeed for a sufficient period (barring unforeseen circumstances) in order for any payment fairly to be regarded as a regular feature of the transferor’s annual expenditure. Thus a “death bed” resolution to make periodic payments “for life” and a payment made in accordance with such a determination will not suffice.

The amount of the expenditure need not be fixed in amount nor need the individual recipient be the same. As regards quantum, it is sufficient that a formula or standard has been adopted by application of which the payment (which may be of a fluctuating amount) can be quantified, e.g. 10% of any earnings whatever they may be or the costs of a sick or elderly dependant’s residence at a nursing home. As regards the payees, it is sufficient that their general character or the qualification for benefit is established, e.g. members of the family or needy friends.

There is no need . . . for the expenditure to be reasonable or that the expenditure is such that an ordinary person might have incurred in similar circumstances, though the existence or otherwise of this characteristic may be relevant in deciding whether the evidence establishes the necessary pattern. The fact that the objective behind the expenditure is tax planning, e.g. to prevent an accumulation of income in the hands of the transferor liable to IHT on his death, is no impediment.

What is necessary and sufficient is that the evidence should manifest the substantial conformity of each payment with an established pattern of expenditure by the individual concerned – a pattern established by proof of the existence of a prior commitment or resolution or by reference only to a sequence of payments.’

#### *Other matters*

The word ‘income’ is not defined in IHTA 1984, although it does specifically exclude the capital element of a purchased life annuity. Nor would it include receipts of a capital nature. It is generally taken to mean the transferor’s disposable income after tax and after all living expenses. In the view of HMRC Inheritance Tax, an individual’s income must be determined in accordance with accountancy rather than income tax rules.

One example which can commonly arise of an item taking advantage of the normal expenditure exemption is, as Lightman J points out, where a husband takes out a policy which assures his life for the benefit of his wife or children – with such a policy, the proceeds on maturity do not pass through the estate of the deceased husband whose life was assured and thus do not attract IHT (rather they go directly to the wife or children who are set out in the policy as the beneficiaries).

Although the capital sum in such circumstances cannot be taxed, the husband is deemed, if he pays the premiums, to have made a transfer of value to his wife or children every time that he makes a payment.

However, he will usually be able to establish that the payment does not represent a chargeable transfer because it can be exempted under the normal expenditure out of income provisions. This is obviously of particular importance where the children are the beneficiaries.

There are two further points which should be made in connection with this exemption:

1. The exemption can be used in conjunction with the annual exemption (and not simply instead of it). Thus a transfer of £10,000 to a discretionary trust could be covered as to £4,000 by the normal expenditure exemption and as to £6,000 by the annual exemption for the present tax year and the previous one.
2. The Inheritance Tax Manual makes it clear that, where there is a gift of an asset other than cash, the donor must have bought the property out of his income in order to make the gift. Note that the word 'income' refers to current income and so the S21 IHTA 1984 exemption will not normally apply if the gift is made from a source which, although originally income, has been retained for some time and which has therefore 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. However, the sums may remain income if they were temporarily invested in order to accumulate sufficient funds for a specific future event. Where the gift is made from a current account which includes capital receipts (from the sale of shares, for example), HMRC Inheritance Tax say that they will not normally make further enquiries in order to determine whether the gift was made from income. It is sufficient that it could have been made from income.

In the context of 2. above, it should be noted that the decision in *McDowall v CIR* (2004) is relevant. A number of gifts to the taxpayer's children were made out of a deposit account which contained substantial surplus income. HMRC Inheritance Tax challenged their right to relief under S21 IHTA 1984 following the death of the donor by arguing that, where the money is transferred from a current account to the taxpayer's deposit account, it lost its character as income. This argument was rejected. The Special Commissioners concluded that the payments were made out of retained income which had remained income in character rather than capital. Their judgment contained the following sentence:

'It was identifiably money which was essentially unspent income and which had been placed on deposit but not invested in any more formal sense.'

Do not overlook the important fact that clients who have surplus disposable income can make lifetime gifts of cash to settlements without incurring an entry charge.

#### *Example*

Alan has surplus disposable income of at least £500,000 each year after his bonuses are taken into account. He therefore creates a series of discretionary trusts and pays this income into the trusts. Because Alan's transfers are exempt by virtue of S21 IHTA 1984, these gifts do not affect his cumulative lifetime total so that each settlement should have a full IHT nil rate band. It is assumed that they are not related settlements under S62 IHTA 1984.

It will be sensible to transfer no more than the current nil rate band into each trust so that no exit or 10-year anniversary charges are payable – any interest income can always be stripped out in advance of a 10-year anniversary.

Alan must not be a beneficiary of the trust, given that the gift with reservation (GWR) rules would apply even though the initial transfer was exempt – see Para IHTM14231 of the Inheritance Tax Manual.

*Contributed by Robert Jamieson*