

‘Normal expenditure out of income’ (Lecture P1284 – 8.53 minutes)

Background

The ‘normal expenditure out of income’ exemption (IHTA 1984, s 21) is very generous since it is only limited broadly by an individual’s personal circumstances and the amount of surplus income available to be given away.

An individual can benefit from the exemption to the extent that the following conditions are all satisfied:

- ‘(1) A transfer of value is an exempt transfer if, or to the extent that, it is shown—
 - (a) that it was made as part of the normal expenditure of the transferor, and
 - (b) that (taking one year with another) it was made out of his income, and
 - (c) that, after allowing for all transfers of value forming part of his normal expenditure, the transferor was left with sufficient income to maintain his usual standard of living.’

A useful exemption

As indicated, there is no fixed upper monetary limit to the normal expenditure out of income exemption - a transfer of value (e.g., a cash gift) is exempt to the extent that it satisfies the exemption conditions.

An important feature of the exemption is that if a gift satisfies the conditions, it is immediately free of IHT. This is a big advantage compared to potentially exempt transfers, which require the person making the gift to survive at least seven years before the gift becomes exempt.

Satisfying the conditions

Whilst the exemption conditions may seem straightforward enough on paper, in practice everyone’s personal circumstances are different, so it can be difficult to determine whether the exemption is due from one case to the next.

For example, there is no statutory definition of ‘normal’ for these purposes. HMRC adopts the dictionary definition of normal as including standard, regular, typical, habitual or usual. The test of normality is a qualitative test, rather than a quantitative one (A-G for Northern Ireland v Heron [1959] TR 1). Indeed, HMRC confirms that it is possible for a single gift to qualify for the exemption, if it is (or is intended to be) the first of a pattern, and there is evidence to that effect (IHTM14241). HMRC’s general approach is to require a pattern of giving to be demonstrated, normally over a period of three to four years.

‘Income’ for these purposes is considered (by HMRC) to mean net income after tax and calculated using normal accounting rules. With regard to income from earlier years, HMRC’s view is that income does not retain its identity as income indefinitely: “At some point it becomes capital but there are no hard and fast rules about when this point is. If there is no evidence to the contrary, we consider that income becomes capital after a period of two years” (IHTM14250).

Transferors should be capable of maintaining their usual standard of living from their remaining income after making gifts, for the exemption to apply. This test is applied at the time of making the gift, so a change in usual living standards due to reasons outside a donor's control (e.g., redundancy) will not necessarily be fatal for exemption purposes, if an earlier commitment had been made when the surplus income was available.

Record keeping

Keeping and maintaining a record of net income and usual living expenses is important.

Donors may find HMRC form IHT403 useful on an ongoing basis for lifetime gifts. The form includes a spreadsheet, which allows various types of income and expenditure to be listed in arriving at a surplus (or deficit) income figure for the tax year, as well as a record of gifts made.

Case law - Was it 'normal'?

Bennett & Others v CIR [1995] STC 54 - Mrs Bennett executed a form of authority in 1989 addressed to the trustees of her late husband's will trust, authorising them to distribute equally between her three sons 'all or any of the income arising in each accounting year as is surplus to my financial requirements of which you are already aware'. Payments were made to each of the sons of £9,300 on 14 February 1989 and £60,000 on 5 February 1990, prior to Mrs Bennett's sudden death on 20 February 1990. In allowing the taxpayers' appeal against Revenue determinations that the payments did not qualify for the normal expenditure exemption, the court held that Mrs Bennett's considered determination for the rest of her life to give to her sons all her surplus income from the trust beyond what she reasonably required for maintenance had been implemented by the execution of the authority and the trustees' actions. Mrs Bennett had therefore adopted a pattern of expenditure in respect of the surplus income.

Nadin v Inland Revenue Commissioners [1987] STC (SCD) 107 - The deceased gave away over £271,000 during the tax year 1993-94. Her gross income for that year was £18,625, and her expenditure included nursing home fees of £13,440. The normal expenditure exemption was claimed (inter alia) on gifts of over £58,000 during 1993/94. Perhaps unsurprisingly, the denial of the exemption did not turn upon the nursing home fees.

Case law - Made out of income?

McDowall and others (Executors of McDowall, deceased) v IRC and related appeal [2004] STC (SCD) 22 - The deceased (WCM) had formed a habit of making small cash gifts to his children, and had executed a Trust Disposition and Settlement. His habit of making gifts to his children continued until 1991, when he began to suffer from dementia. WCM gave a power of attorney to his son-in-law (M) in 1993. M as attorney made a commitment to distribute a substantial part of WCM's excess income over the amount required for his maintenance. In early 1997, a payment of £12,000 was made to each of WCM's five children. The Special Commissioners held that, on a proper construction of the Power of Attorney, M had no power to make gifts. The gifts had therefore not been validly made. However, the Commissioners went on to decide (albeit that their comments were obiter) that had the five gifts of £12,000 been valid, they would have constituted part of WCM's normal expenditure (acting through his attorney). The payments were substantial because of the build-up of excess income in previous years. There had been an intention to make regular payments, and a settled pattern had been established by M's prior commitment.

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