Give from income to save inheritance tax

Within a family scenario, there are many situations in which one family member may make a gift to other family members. However, the way in which gifts are funded and made can make a significant difference to the way in which they are treated for inheritance tax purposes.

Not all gifts are equal

There is no inheritance tax to pay on gifts between spouses and civil partners. A person can make as many lifetime gifts to their spouse or civil partner as they wish (as long as they live in the UK permanently). There is no cap on the value of the gifts either.

Other gifts may escape inheritance tax if they are covered by an exemption. This may be the annual exemption (set at £3,000 per tax year), or a specific exemption such as that for gifts on the occasion of a marriage or civil partnership or the exemption for 'gifts out of income'.

Gifts that are not covered by an exemption will counts towards the estate for inheritance tax purposes and, if the donor fails to survive for at least seven years from the date on which the gift was made, may suffer an inheritance tax bill if the nil rate band (currently £325,000) has been used up.

Gifts from income

The exemption for 'normal expenditure out of income' is a useful exemption. The exemption applies where the gift:

- formed part of the taxpayer's normal expenditure;
- was made out of income; and
- left the transferor with enough income for them to maintain their normal standard of living.

All of the conditions must be met for the exemption to apply. Where it does, there is no requirement for the donor to survive seven years to take the gift out the IHT net.

What counts as 'normal' expenditure?

For the purposes of the exemption, HMRC interpret 'normal' as being normal for the transferor, rather than normal for the 'average person'.

To meet this condition it is sensible to establish a regular pattern of giving –for example, by setting up a standing order to give a regular monthly sum to the recipient. It is also possible that a single gift may qualify for the exemption if the intention is for it to be the first of a series of gifts, and this can be demonstrated. Likewise, regular gifts may not qualify if they are not made from income.

In deciding whether a gift constitutes normal expenditure from income, HMRC will consider a number of factors, including:

- the frequency of the gift;
- the amount;
- the identity of the recipient; and
- the reason for the gift.

The amount of the gift is an important factor – to meet the test the gifts must be similar in amount, although they do not have to be identical. Where the gift is made by reference to a source of income that is variable, such as dividends from shares, the amount of the gift may vary without jeopardising the exemption.

Gifts will normally be in the form of money to the recipient, or a payment on the recipient's behalf, such as school fees or a mortgage. The reason for making a gift may indicate whether it is made habitually – for example, a grandparent may makes a gift to a grandchild at the start of each university term to help with living costs. It is also important that having made the gift, the donor has sufficient income left to maintain his or her lifestyle.

When making gifts from income, check that they may meet the conditions to ensure that the exemption is available.