Friends Provident International

Flexible Future Benefit Trust

The ‘normal expenditure out of income’ exemption

For advisers only. Not for use with customers.

A guide to the 'normal expenditure out of income' exemption

It may be the case that the settlor of a Flexible Future Benefit Trust wishes to make regular gifts to the trust, which will be applied as top-ups to the Friends Provident International single premium bond.

In such cases, those regular payments may qualify for Inheritance Tax (IHT) exemption under the 'normal expenditure out of income' exemption. This will be preferable to the gifts being treated as Chargeable Lifetime Transfers (CLTs) and so potentially avoids using some of the settlor's available Nil Rate Band (NRB).

This guide explains the conditions that need to be satisfied for the 'normal expenditure out of income' exemption to apply.

What is the 'normal expenditure out of income' exemption?

The 'normal expenditure out of income' exemption applies where the taxpayer can show that a lifetime gift (which is a transfer of value) meets **all three** of the following conditions:

01 It forms part of the donor's (settlor's) normal expenditure.

02 It was (taking one year with another) made out of the donor's income.

03 It leaves the donor with enough income to maintain their usual standard of living.

The three conditions are explained in more detail in the following sections:

Normal expenditure (see page 3)

Is the expenditure out of income? (see page 5)

Does the donor maintain his or her normal standard of living? (see page 6)

The exemption is given under section 21 of IHT Act 1984. It is not an all or nothing exemption. Part of a single gift may qualify for the exemption and the other part of the gift might be a CLT or Potentially Exempt Transfer (PET) or might even be exempt under another provision, for example the £3,000 annual exemption.

It does not generally apply to transfers of capital assets unless, exceptionally, these were purchased from income for the specific purpose of making the gift and they meet the other conditions.

How is it claimed?

The donor will need to provide sufficient evidence to show that on the balance of probabilities the three conditions are satisfied. As this question is likely to arise after the donor's death, this requirement will fall to the donor's executors. It is therefore important that the donor keeps adequate records while they are alive that their executors can refer to when making the claim.

In general, HM Revenue & Customs (HMRC) will need the following information before it can agree that a gift is exempt within the normal expenditure exemption:

- Details of all gifts made over a representative period of years.
- Details of the deceased's net income in the relevant years.
- Details of the deceased's usual living expenses for the relevant years.

In this respect it would make sense for the donor to complete the Schedule in Box 20 of HMRC Form 403 'Gifts and other transfers of value' while alive. This is the form that the executors must complete when making a return on death. This can be obtained via the following HMRC link: http://www.hmrc.gov.uk/inheritancetax/iht403.pdf

In borderline cases, HMRC must give the donor the benefit of any reasonable doubt.

1 Normal expenditure

'Normal' would usually mean something that is standard, regular, typical, habitual or usual for the donor. In most cases, it will be clear whether or not the donor has a pattern of giving.

A single gift may qualify if it is, or is intended to be, the first of a pattern and there is evidence of this.

Is the gift normal?

Whether a gift is 'normal' or not requires a consideration of factors such as the frequency and amount, the nature of the gifts, the identity of those who received them and the reasons for the gifts.

It is important that there is a pattern of regular gifts.

Whilst there is no set time span, a reasonable time frame would normally be three to four years. However, a longer period can be used if this helps the taxpayer to illustrate that the gifts were 'normal'.

HMRC will look at cases that involve gifts to trusts more carefully – especially those that cause the donor to exceed his or her NRB.

Is there a pattern of gifts?

We now look at these factors in more detail	
Frequency	Whilst normal does not necessarily mean regular or annual, gifts made on a regular basis are more likely to meet the normality test.
Amount	The amount of the gift is an important factor. Each gift should be comparable in size. However, gifts may on occasion be made by reference to a source of income that is by its nature variable in amount – for example annual dividends from company shares, or bonuses paid from an employment. Similarly, gifts may relate to specific costs, such as grandchildren's school fees, which also vary in amount.
Nature of the gifts	Gifts of or from capital are not covered by the exemption. However, if a capital asset is purchased from income for the specific purposes of making the gift, it may be covered. Therefore, the purchase of a Friends Provident International bond out of income that is gifted to the Flexible Future Benefit Trust, along with further gifts that will be applied to enhance the bond, is capable of falling within the 'normal expenditure out of income' exemption. If the settlor intends to claim the 'normal expenditure out of income' exemption, it is recommended that they keep evidence to demonstrate that the money used to invest in the bond has been made out of surplus income. Particular care needs to be exercised on this where the settlor is near the NRB threshold and the gift could take them above that threshold, which could trigger an IHT charge at the 20% lifetime rate.
Identity of donees	Gifts made to donees in the same category can usually, but not always, be considered together. So, for example, a series of gifts to the Flexible Future Benefit Trust out of the settlor's income would be looked at together.
Reasons for the gifts	The circumstances surrounding the gifts made and the reasons for them may indicate whether the donor has habitually made gifts in such circumstances. HMRC states that 'a regular gift to the same trust holding assets for the same beneficiaries may well assist in enabling a claim to be made.' This would clearly be useful in the case of a series of gifts to the Flexible Future Benefit Trust.

Relevant case law

The judgment in the case of Bennett and others v Inland Revenue Commissioners [1995] STC 54 considered the meaning of 'normal' in this context.

In this case an elderly life tenant directed her trustees to give all the income in excess of a specified amount to her family. The trustees made two payments before her death: £27,900 and £180,000. The Court held that the payments were exempt within the 'normal expenditure out of income' exemption because they were clearly made out of income and her instruction meant that the payments were 'normal' despite the differing amounts.

'Normal' connotes expenditure which at the time it took place accorded with the settled pattern of expenditure adopted by the donor.

The settled pattern could be established in two ways:

If a pattern of expenditure by the donor actually exists.

If the donor has assumed a legal, religious or moral commitment, or adopted a firm resolution, regarding future expenditure and has then complied with it.

In short, for expenditure to be normal, it is necessary to show an established pattern of expenditure by the individual concerned – a pattern established by either:

- proof of the existence of a prior commitment or resolution;
- reference only to a sequence of payments.

In either case it makes sense for the donor to make a written declaration of intent that he or she intends to give away surplus income.

2 Is the expenditure out of income?

The second condition to satisfy in order to benefit from the exemption is that the donor should have made the gift out of their income.

The meaning of income

With regard to the meaning of 'income' for the purposes of qualifying for this exemption, HMRC makes the following statement in IHTM 14250 of the IHT Manual:

- 'It is not necessarily the same as income for income tax purposes. Income is the net income after payment of income tax'.
- 'It is usually clear whether payments received are income in nature. Common sources of income are employment and self employment, rents from property, pensions, interest and dividends. But, it is possible that payments received on a regular basis may appear to be income but are in fact capital in nature. An example would be withdrawals from a discounted gift scheme.'

Available income

Normally one would look at the income of the year in which gifts were made to see if there was enough income available for the donor to make the gifts. If there is not, it may be possible to look at income from earlier years. Income from earlier years does not retain its character 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, HMRC considers that income becomes capital after a period of two years.

If a gift is made out of a current account it is only necessary to specify that the gift could have been made out of income. The gift does not need to be matched to specific money in the account.

Fluctuating income

The words 'taking one year with another', referred to in the second condition on page 2, are in section 21(1)(b) of the IHT Act 1984. The section provides for the case where a person's income fluctuates from year to year but overall they have enough income to make normal gifts and maintain their standard of living on an ongoing basis. Although income can be 'carried over' from year to year in these circumstances, HMRC may enquire in cases where the taxpayer wishes to carry forward more than two years' income.

Case law

The question of whether payments were made out of unspent accumulated income for the purposes of the 'normal expenditure out of income' exemption was examined in McDowall and others (executors of McDowall, deceased) v Commissioners of Inland Revenue and related appeal [2004] STC(SCD). In this case an attorney announced that he was going to make gifts of surplus income on behalf of his incapacitated father-in-law. The first gifts were large as they used up accumulated income. The gifts would have been exempt within the 'normal expenditure out of income' exemption had they not been invalid because they were outside the powers of the attorney.

3 Does the donor maintain his or her normal standard of living?

After allowing for all gifts forming part of their normal expenditure, the donor must have been left with enough income to maintain their usual standard of living. Gifts, even if made out of income, will not qualify for exemption if the donor has to resort to capital to meet their normal living expenses.

For the exemption to apply it is necessary to establish:

Whether the donor could meet their normal living expenses from their income after reducing it by the gifts in question, in that year; and

If not, if they could do so by taking one year with another.

Income and expenditure should normally be considered over the tax year to 5 April.

Gifts that are not part of the donor's normal expenditure will not be exempt.

Sufficient income

Although the normal expenditure gifts must have left the donor with 'sufficient income' to maintain their usual standard of living, they do not need to have actually used this for living expenses. The donor may in fact choose to use capital to meet their living expenses and use the income remaining, after making the gifts, for some other purpose. For the exemption to apply it is enough that the income was sufficient to meet both the normal expenditure gifts and the usual living expenses.

If the income that is left after making the gifts is not enough to meet the usual living expenses, the exemption is not available in full, but part of the gifts may still qualify for the exemption.

Usual standard of living

A donor's usual standard of living will generally be what was usual for that donor at the time the transfer was made.

If the donor has had to lower their standard of living for some other reason, such as a drop in income on retirement, the exemption may not be completely lost if they had made a regular commitment at an earlier date when surplus income was available.

For example, the donor may have taken on a commitment to pay regular insurance premiums, initially affordable out of income, but later on has to pay nursing home fees, that were unforeseen when the policy was first taken out. But, a commitment made at a time when the fall in income could be foreseen would not qualify.

Get in touch

To find out more about how the Flexible Future Benefit Trust could benefit your clients, please call us on **+44 1624 821153**, or email us at: **alt@fpiom.com**.

About Friends Provident International

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Friends Provident International has over 35 years of international experience in offshore savings and investments.

Important notes

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