TAXATION

Readers’ forum: Gifts out of income

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Issue: 4808 / Categories: Forum & Feedback

Relief for making gifts out of income to next generation

I have been discussing with my wealthy client using the ‘normal expenditure out of income rules’ gradually to pass wealth to his children without creating a potentially exempt transfer (PET).

His income is greatly more than his outgoings and at the levels he proposes I do not think that there will be any difficult in demonstrating that the gifts were indeed made from income.

My question concerns when the relief will be first available. Suppose in year 1 he makes a gift out of income of £50,000. If he has not done that before can this be ‘normal’ expenditure or does he have to wait until a pattern has formed? Suppose that he continues to make annual gifts of £50,000. If we assume that by year 3 a pattern has been established then that £50,000 will qualify. But what about the two previous gifts: do they qualify retrospectively because they can now be shown to be part of a pattern?

If my client survives seven years from the first gift there would no problem, but if he did not and it was necessary to review whether PETS had become chargeable, this point could make a difference.

Have any readers considered this matter before?

Query 19,810 – Generous.

Useful to consider the decision in Bennett and others

How does a donor prove that a gift is part of their normal expenditure (IHTA 1984, s 21(1))?

In *Bennett and others v CIR* [1995] STC 54 the High Court held that ‘normal expenditure’ means expenditure which, when it takes place, accords with the settled pattern of expenditure adopted by the donor. This test is easy enough to satisfy after a couple of gifts have been made and a pattern becomes discernible; in *Bennett* the judge said that a settled pattern can be established by examining a donor’s expenditure over a period of time.

The test is less easy to apply without the benefit of hindsight, but it is still possible for the exemption to apply to the initial gift(s) that subsequently become part of a settled pattern of giving.

In *Bennett* it was said that a settled pattern can also be established by showing that the donor has assumed a commitment (such as their executing a deed of covenant or setting up a standing order on their bank account), or has adopted a firm resolution, regarding future expenditure and has thereafter complied with it. There is no fixed minimum period during which expenditure has to be incurred, although HMRC’s view is that a period of three or four years is reasonable. Indeed, a single payment

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implementing the commitment or firm resolution may be sufficient to establish the requisite settled pattern, although the donor will be on more certain ground where the gifts continue over time in accordance with the initial commitment or resolution.

So, as long as the requisite evidence exists, the exemption applies to the client's initial gift(s) at the time they are made – rather than the exemption applying retrospectively – or the initial gift(s) being treated as PETs which become exempt only if the donor has survived seven years of making them. However, where no commitment or resolution can be proved, a series of payments will be required to establish the requisite pattern.

HMRC's *Inheritance Tax Manual* para IHTM14242 addresses the matter of a single gift made close to a person's death. It does not rule out the application of the exemption but says that strong evidence must be provided that the gift was genuinely intended to be the first in a pattern and that there was a realistic expectation that further payments would be made.

Applying this observation to the case where a payment made pursuant to an initial commitment is indeed followed by a series of payments to establish a pattern, it becomes more certain that the exemption is available to the initial gift(s).

In *Bennett* it was also stated that while a pattern of giving was required for the expenditure to be regarded as normal, the pattern need not be immutable, but it must be intended to remain for a sufficient period (barring unforeseen circumstances). The expenditure need not be fixed, nor need the recipient be the same on each occasion. The amount of the gift may be fixed by a formula, eg a percentage of earnings, or by reference to an ascertainable liability, eg the cost of nursing home fees, and the donees may be a general class, eg family members or needy friends.

In IHTM14243 HMRC states that whether a gift is 'normal' is tested by considering all the relevant factors. It says that these will include the frequency and amount of the gifts, their nature, the identity of those who received them and the reasons for the gifts. It goes on to discuss these factors in more detail in that paragraph. – *KS.*

The risk should diminish over time

Generous is concerned at what point a gift out of normal expenditure actually becomes a gift out of normal expenditure. The starting point for this is IHTA 1984, s 21.

To paraphrase s 21(1), a gift falls into this exemption if it was made as part of normal expenditure and, taking one year with another, it was made out of income and made without reducing the transferor's standard of living.

The reference under s 21(1)(b) to 'taking one year with another' seems to imply it is necessary to consider at least more than one year before a pattern can be established. HMRC advocate that a reasonable timespan for a pattern would normally be three to four years.

That HMRC places importance on there being a pattern, can be seen from *Inheritance Tax Manual* at para IHTM14241. For example, 'it will be clear whether or not there is a pattern of giving' and also 'you will need to analyse all the facts in cases of doubt to see in a pattern can be found'.

However, that latter reference is prefaced by an acknowledgement that a single gift can still qualify for the relief as much as a number of gifts, if 'it is or is intended to be the first of a pattern and there is evidence of this'. Indeed HMRC subsequently refers to a single qualifying gift being made close to the date of death. This point was even illustrated in *Bennett and others v CIR* [1995] STC 54 where Mrs Bennett died around a year after making the first gift but the courts found sufficient intent and evidence were present to establish a pattern within the relief.

There is thus clearly an element of subjectivity and given HMRC's emphasis on intent, as indeed the *IHT Manual* sets out, it is not necessarily a case of waiting a number of years, but rather ensuring there is sufficient supporting evidence from the start to demonstrate the gift being made is truly normal expenditure from surplus income.

The risk attached to any gift should diminish with time. HMRC will consider factors such as frequency, amounts and the nature of the gifts. So repeated similar gifts over a period of time should then help quickly establish a defendable position, as is the case with Generous' client. However that doesn't mean the first gift in the series cannot be claimed as falling under the exemption at the point it is made. If there is intent and supporting evidence, determination can be made at that point rather than in year 3 coming back to add support to the year 1 gift. *– Elman Wall, a Xeinadin company .*

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Pattern of gifts should be clear over time

The relief can be available from the point at which the first gift is made. It is important to be able to demonstrate the donor's *intention* of establishing a pattern of gifting. It would be prudent for the client to write a letter to the children setting out his intention to make regular gifts of, say, £50,000 or a percentage of his income, or whatever his plan is, to his children each year.

As the years pass, the pattern should become evident from the gifts alone, but this will help protect the client in the intervening period.

I have had clients make gifts out of income into trust which would, but for the exemption, be immediately chargeable. With these we have at the outset submitted a letter of intention to HMRC which it has accepted and not sought to levy an immediate inheritance tax charge. – *Harriet Betteridge*.

Evidence of strong commitment is essential

Generous' s question concerns when the relief will be first available, as the provisions are quite clear that it is 'normal' or regular expenditure and not 'one off' expenditure out of income that is exempted.

The accepted meaning of 'normal' in this context, is a gift that has happened more than once; the gift will have needed to have been habitual, regular or have had a predictable pattern established. As Lightman J, explained in *Bennett and others v CIR* [1995] STC 54 a gift out of income is 'expenditure which at the time it took place accorded with the settled pattern of expenditure adopted by the transferor'.

However the settled pattern could be assessed from the past behaviour of the donor (as is usually the case) or the future behaviour of the donor. It will depend on the donor's actions and intentions at the time of the first gift though, whether the future gifting can be relied on.

Compare the following situations; first a mother gives her adult daughter a gift of £5,000 for her birthday. This is a one-off gift and as such, the gift cannot rely on the 'normal gifts out of income' exemption even if it later transpires that it has become normal or regular for the mother to gift. In the second situation, the mother gifts the same £5,000 but associated with the gift is a card that reads 'Please find £5,000 for your birthday. From now on I am going to give you a comparable amount every year on your birthday'. In this situation, if the gift was indeed then repeated every year, the 'normal gifts out income' exemption can be relied on from the first gift.

To obtain this exemption from gift one, it is essential to have evidence of a strong commitment or resolution for the gifts in the future that exists from the first gift. What was crucial according to Lightman J, was that the evidence given at the time of the first gift, should prove either the pattern had been established either by past payments or the commitment or resolution of future ones.

HMRC also considers this exemption and lists five conditions that should be taken in account when considering whether a payment is indeed out of income. These are the frequency of the gift, the value of the gift, the nature of the gift, to whom the gift is being made, and the reason for the gift. The more predictable the gift in the future - same asset of the same amount to the same person for the same reason - the more likely a first gift with a clear associated intention to continue, will be likely to be considered as exempt. In *Nadin* (SpC 112), the Special Commissioners held that payments to close relatives that were not regular in timing, or amount, did not constitute normal expenditure. – *30metresunder*.

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