Normal expenditure out of income exemption

Synopsis: An outline of normal expenditure out of income exemption in respect of IHT planning.

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The normal expenditure out of income (NEI) exemption is one of the most useful strategies in inheritance tax planning.

This is because people will frequently wish to make regular gifts to their children/grandchildren to meet expenditure such as school fees, contributions to pension plans or payments to ISAs or Junior ISAs.

In such cases, where the NEI exemption applies, those gifts will be exempt when made – there is no need to survive the gift by 7 years.

The forthcoming changes in inheritance tax as in April 2027 will mean that any unused pension pots on a person's death will be aggregated in their taxable estates. It is thought that this will have 2 main impacts…

- Where not all of their pension benefits are required, it will encourage people to make regular withdrawals from their pension plans and make gifts to the next generation.

This would look to be a particularly attractive where the pension scheme member will pay income tax at 20% on the drawdown income yet save 40% inheritance tax on the pension funds which would otherwise be treated as part of their taxable estate on death.

- Given that the pension fund will use part of the deceased's nil rate band on death, the potential inheritance tax liability on the member's estate will increase. This will encourage more people to take out life assurance policies in trust to help beneficiaries meet that liability and more easily obtain probate.

In both of these cases, the NEI exemption will help to provide an exemption on the gifts of income or premiums paid, as appropriate.

Main conditions to qualify for the exemption

Section 21 of the Inheritance Tax Act 1984 impose three main conditions that have to be satisfied for gifts to qualify for the NEI which are…

- The gifts must be part of the donor's normal expenditure,
- Taking one year with another, the gifts were made out of income, and
- After the gifts the donor was left with sufficient income to maintain their usual standard of living.

We now look at these in more detail….

Part of the donor's normal expenditure

Normal means that the gift has to be regular (usually annual or monthly), habitual or expected. In effect, a settled pattern of expenditure has to been adopted by the donor. However this does not mean that a donor has had to have made payments in the past for a subsequent payment to qualify.

Provided the donor **intends** to make further gifts in the future, the first gift will qualify.

So, for example, the exemption could cover the first premium to a life policy in trust on the basis that there is an intention and commitment to pay future premiums.

The amount or value of the gift would normally be expected to be consistent. However if it is linked to a variable amount of expenditure of the recipient, such as school fees, that will be acceptable. The nature of the gift may be a factor but this will not be an issue where cash gifts are made. It will also help if gifts are made to the same group of recipients.

Gift is made out of income

For the purposes of the NEI exemption, "income" means net income, after income tax and normal outgoings and is determined in accordance with normal accountancy provisions. It will include earned income, savings income, rent and dividend income. It will also include tax free income – such as income from ISAs. Income will **not** cover...

- The capital element of purchased life annuity payments,
- Withdrawals/part surrenders from single premium bonds, and
- "Income" from discounted gift trusts.

Income is considered taking one year with another and so, if in one year, income reduces such that there is insufficient to make the gift in that year, this will not necessarily mean that the exemption is lost. Nor will the exemption be lost if the donor has to temporarily resort to capital because, say, of an unexpected or exceptional expense.

If it can be shown that income was previously accumulated in an account, a later payment out of that account should count as a payment out of income.

For example, HMRC will accept that a gift of capital assets such as jewellery or shares may qualify for the NEI exemption if the donor can demonstrate that they were specifically purchased out of income with the intention of making the gift.

The donor maintains their usual standard of living

This can be determined by comparing the donor's lifestyle in one year with that in another year to see if there has been any change as a result of the gifts that are being made**.**

Questions and answers

Is there any limit on the amount that can qualify for the normal expenditure?

No. The amount that will qualify depends on the circumstances of the case. So, for example, a person who has a net (after tax) income of £200,000 with expenditure of £50,000, would have scope to make regular annual gifts of up to £150,000 per year. An individual with net income of £30,000 and annual expenditure of £25,000 would only have scope to make gifts of up to £5,000 and be within the exemption.

Do you have to have been making gifts for some years before you can claim the normal expenditure exemption?

No. It is all about the donor having an intention and commitment to make regular gifts out of income in the future. So the first premium payment into a policy in trust can qualify for the NEI exemption.

Do the gifts need to be used by the recipient to meet regular expenditure?

No. whilst many regular gifts will be used to meet certain elements of regular expenditure, such as school fees, mortgage costs and contributions to ISAs and pensions, there is no requirement for the funds to be used by the recipient in a particular way.

Provided the three conditions are satisfied, the gifts can be invested in capital assets such as protection life policies in trust or as additional premiums to single premium bonds in trust.

Can you include all of a donor's income for the purposes of the exemption?

All income will count including tax free income from ISAs. However, the capital element part of a purchased life annuity does not count nor do withdrawals from single premium bonds or regular payments from discounted gift trusts.

Do you have to claim the normal expenditure out of income exemption?

Where gifts are potentially exempt transfers, there will be no need to claim the exemption when gifts are made. On the donor's death within 7 years of the gift, those gifts will become chargeable transfers and need to be declared on form IHT 400. At that time, completion of form IHT 403 will enable the legal personal representatives to justify the availability of the NEI on those gifts in the last 7 years.

What about payments that are made into trusts such as discretionary trusts?

Such payments will be chargeable lifetime transfers and so if they cause the current nil rate band (£325,000) to be exceeded on a cumulative 7 year period,

they would normally need to be declared to HMRC on form IHT 100a. In determining whether they exceed the nil rate band, the taxpayer can deduct any exemptions, including the NEI exemption. However, in cases where the NEI keeps the cumulative total below the nil rate band, HMRC require a full return to be made so that the availability of the NEI exemption can be agreed with them at that time.

At that time, in order to claim the exemption, it will be necessary for the donor to justify that the payments qualify for the NEI exemption**.** To the extent that the NEI exemption is not confirmed by HMRC as being available on those lifetime chargeable transfers, and they cause the donor to exceed the nil rate band, they will be taxed at 20%.

Example: Jeremy makes annual gifts of £63,000 to a discretionary trust for the benefit of his family. After deduction of the annual exemption of £3,000, this means he is making annual chargeable transfers of £60,000. He takes the view that these payments fall within his NEI exemption and so no IHT return is needed even when the cumulative value over 7 years exceeds £325,000.

However HMRC will require details of these transactions on form IHT100 in year 6 when the cumulative payments are £360,000. They will then agree or disagree that they fully qualify for the NEI exemption.

How does the NEI exemption interact with the annual exemption.

The annual exemption is £3,000.

Where the annual value of gifts is within this amount, the NEI exemption will not be particularly relevant. However where the annual value exceeds £3,000 it may well be that payments in excess of this will be PETs or chargeable lifetime transfers as appropriate and so the availability of the NEI exemption will be relevant (see above).

How does the exemption work in connection with premium payments made to life policies in trust?

If the policy is subject to a bare/absolute trust, premium payments will be PETs to the extent that the value of the policy increases in value. The balance will be a chargeable transfer (IHTM 20332) and so, to the extent this exceeds the annual exemption, the NEI exemption will be immediately relevant.

In the case of a discretionary trust, the whole premium payment will be a chargeable transfer and so to the extent the annual exemption is exceeded or not available, the NEI exemption will be relevant. This will be particularly the case once cumulative CLTs over 7 years exceed the donor's nil rate band [currently £325,000 – see above].

Is it best for the donor to complete the form 403 whilst alive?

Yes. The form IHT403 has a schedule in which the donor can log details of gifts made and record details of income and expenditure.

This could make things much easier for the donor's legal personal representatives when they come to make a claim for the NEI exemption using the completed form IHT 403**.**

What is the position on joint settlor policies?

Frequently a husband and wife will establish a joint lives second death policy in trust for their family as part of an inheritance tax planning exercise.

In such a case if premiums are being paid from a joint bank account, both husband and wife will be treated as paying premiums equally and making equal gifts. So, each will have their own £3,000 annual exemption and each will need to justify the NEI exemption on any balance payment according to their share of the net household income and the regular expenses they incur.

Are there any particular issues that arise with "back-to-back" arrangements?

If a person takes out a purchased life annuity and at the same time effects a life policy in trust for somebody else, the NEI exemption will not be available on premium payments if the taking out of the annuity and the life policy are treated as associated operations under s263 IHT Act 1984**.**

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