Gifts out of surplus income: 15 points to consider

Inheritance tax receipts continue to rise year on year and reached £8.2bn for the year to March 2025. This figure will increase significantly from 2027 when pensions are included in the taxable estate, and this is naturally driving increased interest in ways to mitigate the impact on pension savings earmarked for wealth transfer. Gifts out of surplus income is one option to consider.

Gifts out of surplus income refers to regular transfers of money or assets made from an individual's income (not capital) that do not reduce their standard of living and which meet the following criteria:

- Gifts must form part of normal expenditure
- Gifts must be made from income
- Gifts must leave the donor with sufficient income to maintain their usual standard of living

However, the above can be open to interpretation and we have set out some key aspects to consider.

1. When is a gift regarded as 'normal' expenditure?
Gifts will usually be made in cash and must form part of a regular and demonstrable pattern of gifting. HMRC will usually consider 3 or 4 years to determine a regular pattern.

2. Do gifts have to be made to the same person?
Gifts do not have to be to the same recipient every year but should be paid to the same class of beneficiary, for example children or grandchildren.

3. Do gifts have to be for the same amounts?
The amount of the gifts will generally be of a comparable size for example the same value or the same percentage of surplus income, but in the case of gifting for a specific purpose, eg school fees, then the actual amount may vary accordingly.

4. Do gifts have to be made at the same intervals?
There are no set intervals and gifts could be monthly, quarterly, 6 monthly or annual. In fact the pattern of gifting could start off on a monthly basis and later change to say annually as long as the annual amounts remain proportionate and are made to the same group of beneficiaries.

5. What is included as income?
Gifts must normally be made from net income received in a tax year, for example, from employment or pension income or income arising from investment such as interest, dividends and rental income.

6. Can pension tax-free cash be included in income?
Pension drawdown withdrawals, including tax-free cash, are treated as income for this purpose but must still form a regular pattern of gifting. For example spreading withdrawals over a period of time rather than withdrawing all your tax free cash and gifting it over the course of a couple of years.

7. Can bond withdrawals be included in income?
Bond withdrawals are normally regarded as a return of capital even if they result in a chargeable gain subject to income tax. Payments received from a discounted gift trust, or a loan trust are also not regarded as income.

8. Can accumulated income be included?
Generally, income which is reinvested into other investments will be deemed to have been capitalised which includes income automatically reinvested as in the case of 'accumulation' units.

Although 'income' will usually be income received in a tax year, it is possible to carry income over from a previous year if it has not been capitalised, for example income received and kept in the donor's bank account. However, HMRC will generally deem that it has been capitalised if left in the bank account for more than two years.

9. Can income be transferred between spouses for joint gifts?
Income cannot directly be transferred between spouses for the purpose of joint gifts as income is typically taxed individually. In fact, if the higher earner covers expenses for the lower earner generally, then this is regarded as a regular expense and lowers their surplus income available anyway. It may therefore be better for spouses to make separate gifts.

10. What is surplus income?
This is defined as the amount by which an individual's income exceeds their usual spending each year and should not affect their usual standard of living. If they have to resort to capital to maintain their lifestyle this indicates the surplus is insufficient to cover the gift, and the exemption may be lost or limited.

11. What is included in normal living expenses?
These include costs such as mortgages, utility bills, council tax and insurances plus additional costs relating to standard of living, including travel costs, regular holidays and club memberships.
Large one off costs such as home improvements or a new car would not typically count as 'normal'. There are no guarantees however, and treatment will depend on individual circumstances.

12. Can household expenses be allocated between spouses?
Household expenses such as council tax and heating will normally be regarded as shared equally even though the higher earner may be making the actual payment. Other expenses clearly attributable to one partner do not have to be split, for example the costs of a hobby or a gym/club membership.

13. What is regarded as a 'usual standard of living'?
This will generally be the standard of living at the time of making the gift. However, where unexpected circumstances cause a change to the standard of living, such as unemployment, the exemption may not be lost even if they do have to temporarily resort to capital to continue making future gifts.

14. Do gifts have to be reported?
Gifts do not have to be reported to HMRC at the time they are made. The exemption is claimed on death and acceptance by HMRC is not guaranteed. The exception to this is for regular gifts into a discretionary trust which will need specific treatment and reporting.

15. How is the exemption claimed?
The exemption is usually claimed by the donor’s executors following the donor’s death. They will need to send detailed records of gifts made and income and expenditure for the seven years prior to death.

Although a useful strategy for mitigating IHT, careful consideration and planning is needed together with thorough recording keeping. For further advice please get in touch with us at justask@jjfsltd.com or call 01789 263257.

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