Practical Wisdom

CASE STUDY

Gifts to Grandchildren IHT Planning and Record-Keeping

Normal Expenditure Out of Income Exemption: Simplifying the Framework

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OPENING

The Challenge

A retired professional with a comfortable pension income and modest investment returns had been making regular cash gifts to grandchildren — £500 per month to each — since they were young. It was a straightforward arrangement: the income was there, the gifts mattered to the grandchildren, and it was something that could comfortably be sustained.

But when the arrangement was mentioned to an accountant in the context of estate planning, the response was unexpectedly complex. The accountant had sent a detailed breakdown of expenditure categories and suggested maintaining an annual schedule showing income, all living expenses, and the gifts made. The list was comprehensive: household utilities, food, holidays, insurance, car costs, and more. It looked like a full accounting exercise that would need to be done every year.

Two concerns emerged. First, was all this record-keeping really necessary? Second, the accountant had mentioned taper relief as part of the planning. Taper relief was understood to reduce IHT if something went wrong, but the whole thing felt uncertain. Did the gifts actually fall outside the estate, or was there reliance on something that might fail?

The deeper question was whether the framework itself was understood at all.

PHASE 1

Understanding the Exemption

The research started with a straightforward question: under what circumstances do gifts to grandchildren fall completely outside the estate for IHT purposes?

The answer exists in a single section of UK law: the Income Tax and Inheritance Act 1984, section 21. This section provides for the “normal expenditure out of income” exemption.

What Section 21 Says

If a gift is made as part of a settled pattern of normal expenditure, funded from income rather than capital, and the donor’s standard of living is not affected, the gift is immediately outside the estate. There is no seven-year wait. There is no taper relief calculation. The gift is simply not an inheritance tax event.

This is the most powerful exemption available for this kind of arrangement. All three research sources converged on this point without contradiction: if the conditions are met, section 21 is the right tool, and it works completely.

PHASE 2

The Three Conditions

Section 21 exemption requires all three of the following to be demonstrated:

Condition 1: Normal Expenditure

The gifts must be part of a settled pattern — a regular, habitual arrangement — not a one-off or sporadic gift. “Normal” in tax law has its ordinary meaning: something that happens regularly and predictably. Making £500 monthly gifts to the same grandchildren for several years establishes normality. A sudden single gift of £6,000 does not.

The leading case on this is Bennett v IRC, which established that a settled pattern is sufficient. The arrangement does not need to be a formal legal commitment. The test is whether the

pattern is objective and sustained, not whether the donor made a binding promise to continue forever.

Condition 2: Funded from Income

The gifts must be paid out of income — pension, dividends, rental income, interest — not from accumulated capital, savings, or the sale of assets.

The distinction matters for documentation. If the donor's pension is £48,000 per year and investment income is £10,500 per year, total income is £58,500. Gifts of £12,000 per year are funded from income. Gifts of £60,000 per year are not (they exceed income). The accountant's annual schedule exists to show this calculation clearly.

Condition 3: Standard of Living Maintained

After making the gifts, sufficient income must remain to maintain the donor's usual standard of living. This is not a poverty test — the donor does not need to be wealthy to claim the exemption. It is a continuity test: the donor's life does not change materially because of the gifts.

Someone with £58,500 income spending £46,000 on living expenses can make £12,000 gifts and still have surplus income. They have maintained their standard of living and have demonstrated that the gifts do not come from capital.

The Burden of Proof

All three conditions must be shown. The burden is on the taxpayer (or their executors) to demonstrate them. HMRC will not assume the gifts qualify; they will ask for evidence. The annual schedule is the instrument that provides this evidence.

PHASE 3

The Accountant's Expenses List

At this point in the conversation, the accountant's detailed list of expenditure categories begins to make sense. It is not a trap or a bureaucratic exercise. It is the foundation for demonstrating all three conditions.

The initial review may seem burdensome: bank statement analysis, allocation of spending to categories, confirmation of surplus income. But understanding the actual structure of the work changes the picture considerably.

Year 1: The Setup Exercise

In the first year, HMRC needs to see a credible baseline picture of what a normal year looks like — what income came in, what was spent on living, and what was available for gifting.

The bank statement review is the most reliable way to establish this baseline honestly and completely. It does not need to be forensic or itemised to the pound. Broad category totals are entirely sufficient. A one-off review of twelve months of bank statements, organised into ten or twelve categories (utilities, food, holidays, insurance, car costs, personal care, subscriptions, other family support), is typically a half-day task. The accountant can then confirm that the format is adequate for section 21 purposes.

Years 2 Onwards: Maintenance

Once that baseline is established and the accountant has confirmed the format, the annual maintenance becomes straightforward. In a stable year — where income and spending are broadly similar and gifts are unchanged — a brief confirmation record is all that is needed. A simple one-page statement: "My income exceeded my normal living expenses this year, leaving sufficient surplus. I made regular gifts from this surplus. Nothing material changed."

The full detailed schedule only needs revisiting if something material changes: a significant drop in income, an unusually large expense, or a change to the gifting pattern.

The Three-Phase Model

Think of the record-keeping in three stages:

- Year 1 — Setup: Bank statement review, baseline expenditure summary, accountant sign-off on the format. One-time exercise.
- Years 2+ — Maintenance: Brief annual confirmation that nothing has changed materially, supported by bank statements. Five minutes.
- Any year with material change: Revert to the full schedule for that year only, then resume maintenance mode.

The accountant's list is not a recurring burden. It is the raw material for a system built once and run easily thereafter.

PHASE 4

Taper Relief

At some point in the planning conversation, taper relief had been mentioned. This created confusion. The donor understood that taper relief reduced IHT if something went wrong, but was uncertain whether the gifts actually fell outside the estate.

The relationship between taper relief and section 21 needs to be clear. See the Technical Notes section below for detailed rates.

What Taper Relief Actually Does

Taper relief applies only when a gift fails to qualify for any exemption and the donor dies within seven years of making it. It reduces the IHT rate applied to the gift — not the value of the gift. The reduction depends on how many years passed between the gift and death. The schedule of rates is shown in the appendix.

Why It Does Not Apply Here

If the section 21 exemption applies, the gift is immediately outside the estate. It is not subject to the seven-year rule. Taper relief does not come into play because there is no IHT to taper.

Taper relief is a fallback — a safety net for gifts that fail to qualify for any exemption. It is not a planning tool. A well-structured section 21 gifting programme does not rely on taper relief at all.

PHASE 5

The System — Templates and Implementation

With the framework understood, the practical system becomes clear. Three documents need to exist:

Document 1: Annual Schedule

A single-page document showing: Income (pension, investment income, etc.); Normal expenditure by category (utilities, food, holidays, insurance, car, personal care, subscriptions, other family support); Surplus income; and Gifts made.

Year 1 version is detailed. Subsequent stable years use a short-form confirmation.

Document 2: Statement of Intention

A brief signed statement written at the outset, stating: “I intend to make regular financial gifts to my grandchildren as part of my normal expenditure. These gifts will be funded from my surplus income and will not reduce my standard of living. It is my expectation that these payments will continue on an ongoing basis.”

This document directly strengthens the “normal” and “habitual” element of the section 21 test. Signed and dated once. Does not need to be renewed annually.

Document 3: Letter of Instruction to Executors

A brief letter kept with the will, identifying the gifting programme and stating where the annual schedules are stored. Critical instruction: “Please draw this to the attention of the probate solicitor immediately on my death and claim the exemption on the IHT400.”

This is the most important safeguard. Executors who are unaware the records exist will not raise the exemption. Years of carefully maintained documentation will be lost in the estate administration process unless executors know to look for it.

PHASE 6

Managing Change

The system assumes circumstances remain stable. Two scenarios need consideration:

If Income Drops

If investment income falls in a poor market year, the surplus income calculation changes. The exemption will still apply if surplus income (after the gifts) remains sufficient to maintain the standard of living. The key is to recalculate and document it honestly.

If the margin becomes tight — say, surplus drops to £2,000 with £12,000 gifts — the full-schedule approach should be used for that year to document the position clearly. If the margin becomes negative (gifts exceed surplus), the gifts may not fully qualify under section 21 that year. The annual exemption (£3,000) may shelter part of the gift; the remainder becomes a PET (potentially exempt transfer) subject to the seven-year rule.

This is not a disaster. It is manageable and expected. The key is to document it at the time rather than ignore it.

If a Large One-Off Expense Arises

A significant home repair, major medical expense, or other large outlay can spike expenditure in a single year and reduce the calculated surplus. That year’s gifts may not fully qualify under section 21. Again, the annual exemption and seven-year PET rule provide a safety net.

PHASE 7

How the Exemptions Fit Together

Three exemptions operate in this context:

- Section 21 (normal expenditure out of income): Unlimited if all three conditions are met. Immediate exemption. No seven-year wait.
- Section 19 (annual exemption): £3,000 per year, plus one year carry-forward. Useful backstop if section 21 fails in part for a given year.
- Seven-year PET rule: Any gift qualifying for neither exemption becomes a PET, fully exempt if the donor survives seven years, subject to taper relief if death occurs sooner.

These exemptions work together. A £12,000 annual gift that fails to fully qualify under section 21 can be sheltered: £3,000 under the annual exemption, leaving £9,000 as a PET. The PET is fully exempt after seven years, or subject to taper if death occurs sooner.

The combination provides flexibility. A well-documented section 21 programme is the first line. The annual exemption and seven-year rule provide backstops for years where section 21 does not fully apply.

PHASE 8

The Execution

With the framework and system understood, execution becomes straightforward.

Immediate Actions

1. Simplify the record format. Meet with the accountant. Agree on a single-page annual schedule covering income, broad expenditure categories, and gifts. Have the accountant confirm this format is adequate for section 21 purposes. Once confirmed, the donor can maintain it independently going forward.

2. Write the statement of intention. A brief signed statement: “I intend to make regular financial gifts to my grandchildren from surplus income...” One paragraph, signed, dated. Done once.

3. Write the letter to executors. A brief letter kept with the will identifying the gifting programme and its location, with clear instruction to raise the exemption with the probate solicitor on death. Update only if circumstances change materially.

4. Maintain the annual schedule. Year 1: Full schedule based on bank statements. Years 2+: Brief confirmation for stable years; full schedule only if something changes.

What This Achieves

The system is defensible, friction-free, and requires minimal ongoing effort. Once set up: the donor can maintain the records independently; the executors have clear instruction on what to do; HMRC can see exactly how the conditions are met; the gifts remain outside the estate indefinitely.

OUTCOMES

Outcomes and Lessons

The Documentation Priority

This case demonstrates that the primary risk in section 21 planning is not legal complexity. It is documentation. The law is clear and consistent. The exemption is powerful. The risk is poor record-keeping or, worse, executors being unaware the records exist.

The letter of instruction to executors is the single most important safeguard. It is also the simplest to write.

The Year 1 vs. Ongoing Distinction

The accountant’s guidance was correct but lacked the crucial framing: Year 1 is a setup exercise; ongoing maintenance is minimal. Understanding this distinction transforms the whole picture from “I will need to do detailed accounting every year” to “I set up the system once and maintain it with five minutes of work annually.”

On Taper Relief

Taper relief is not a planning tool for section 21 arrangements. It is a fallback. A well-structured programme does not rely on it. Understanding this removes a significant source of anxiety and clarifies that gifts under section 21 truly do fall outside the estate immediately, without qualification.

The Exemption Interaction

Section 21, the annual exemption, and the seven-year PET rule work together. The combination provides redundancy. Even in years where section 21 fails in part, the other exemptions catch most or all of the gift. Complete failure to shelter a gift from IHT is rare if any structure is in place at all.

APPENDIX

Technical Notes

Taper Relief Rates

Taper relief applies only when a gift fails all exemptions and the donor dies within seven years. The rate of IHT applied to the gift is reduced according to the time elapsed:

Years between gift and death	IHT rate applied
0–3 years	40% (no relief)
3–4 years	32%
4–5 years	24%
5–6 years	16%
6–7 years	8%
7+ years	0% (fully exempt)

Statutory References

- IHTA 1984 s21 (normal expenditure out of income) — the primary exemption
- IHTA 1984 s19 (annual exemption) — £3,000 per year, plus carry-forward
- IHTA 1984 s3A (seven-year PET rule) — gifts exempt after seven years
- Bennett v IRC — leading case on “normal” and “settled pattern”

HMRC Guidance

HMRC’s detailed guidance on section 21 is published in the Inheritance Tax Manual (IHTM14250–14255). The guidance confirms that: broad expenditure categories are adequate; itemised accounts are not required; “normal” is given its ordinary meaning; a settled pattern suffices; income is determined by normal accountancy rules (net of income tax); one year’s accounts can be averaged with the prior year if income fluctuates.

Practical Implementation Sequence

1. Accountant review (one meeting): Agree the annual schedule format; confirm adequacy for section 21
2. Statement of intention: Write once at the outset; does not need renewal
3. Letter to executors: Write once, keep with will; update only on material change
4. Annual maintenance: Five-minute confirmation in stable years; full schedule only if something changes

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