MILESTONE WEALTH MANAGEMENT

A guide to Onshore Bonds

What is an Onshore Investment Bond

An investment bond is technically a single premium life assurance contract although the life cover aspect is only nominal.

Bonds are collective investments and can be invested into a wide choice of managed, general and specialist funds, such as single strategy equity, property and fixed interest funds, available from the insurance company provider chosen. The bond structure allows you to switch between these funds without incurring any capital gains tax, on gains made and switching costs are normally free or very low cost.

An investment bond can be set up with a number of policy segments, i.e., 10 or 100. This has benefits of providing greater flexibility for withdrawals and tax planning.

Contribution Limits

The minimum lump sum is usually £10,000 but this may be higher or lower depending on the provider. The maximum limit will be set by the provider.

Additional Premiums

Although classed as single premium investments, most providers allow you to top up the original investment.

Eligibility

To be eligible to invest in an investment bond, an individual investor must be 18 years of age or over. The investment can also be made on a joint basis, or by a company or trustee(s). The nominated life (lives) assured is usually the applicant/investor but could also include an individual aged under 18.

Internal Taxation

Because the bond is a life assurance fund, the underlying investments are taxed on income and gains (after indexation) at the life assurance company rate of tax, this is around 19/20% and are the liability of the insurer.

Withdrawals

You can withdraw some or all the bond whenever you need to. This be achieved by the total encashment of bond segments or partial encashment of the segments. The best option may depend upon your tax position at the time of withdrawal.

Tax treatment

It is the tax treatment that gives bonds their advantage because as mentioned earlier, investors are not subject to capital gains and the insurer is subject to insurance company tax on any gains or income. This means that providing, after any gains are declared, individuals remain non-taxpayers or basic rate taxpayers, they will have no income tax liability.

Income tax maybe payable at higher or additional marginal rates only. Income Tax maybe liable on what is known as a chargeable event.

Tax is only payable on a chargeable event.

Chargeable Events

- Death of the life assured (or last to die of lives assured) where benefits are payable.
- Assignment (full or in part) for money or money's worth.
- Maturity of the policy.
- Partial or regular withdrawals across a whole bond, which are more than the 5% tax deferred allowance.
- Surrender of the bond, whether in full or surrender of segments.

Under HMRC regulations, Investment Bonds have several tax advantages.

Tax Deferment (the 5% rule)

HMRC regulations allow you to withdraw up to 5% of the **initial premium** in each policy year with no immediate tax liability.

From the start date of the bond, you accrue a 5% tax deferral and if it is not used, it can roll-up, so this means that if you held the bond for 10 years without any withdrawals, you could then withdraw 50% of the original premium on a tax deferred basis without any immediate tax liability. In year 11, you could then withdraw another 5% of the original investment.

If your withdrawal exceeds the 5% entitlement, any such excess would be added to your taxable income in the year and only if income goes into the higher rate tax band would a tax liability arise.

Once you have withdrawn 100% of your original investments, any future withdrawals are taxable in the year of withdrawal.

The 5% withdrawal will not be suitable for everyone. You can withdraw one off lump sums if you wish and create a tax liability in the year of withdrawal, which may be better for some individuals tax planning.

Top Slicing

The Taxation of investment bonds is unique in that they allow investors tax deferral on investment growth until there is a chargeable gain.

Tax is only payable when a chargeable event does occur, and the gain will be taxed in the tax year of that event. As a result, more of the gain could be taxed at higher rates than if it had been taxed on an annual basis. 'Top Slice relief' attempts to correct this by providing a deduction from the amount of tax due.

Firstly, working out the value of the allowances that can be used and taxing them in the right order of unused allowances.

Order of tax

- Non savings income
- Savings income (including interest and offshore bond gains)
- Dividends
- Onshore bond gains

Top slicing only applies when the full gain takes an individual into the higher rate or additional rate bracket. Both the gain and the relevant number of years to calculate the slice will be listed on the Chargeable Event Certificate. Top slicing is calculated as follows:

The total gain

The maturity value is deducted from the original investment to work out the gain made. Any withdrawals under the 5% rule must also be added to provide a true reflection of the overall gain the bond has made.

To work out the average gain the following calculation is used:

The total gain is divided by the number of full policy years the bond has been held. This provides the average gain.

If when added to the individual's income the policyholder remains a basic rate taxpayer, there is no further liability to income tax. If they fall into higher rate tax, the whole gain will be taxed at 20% and if an additional rate taxpayer at 25% of the whole gain.

Example

Jim originally invested £40,000 in May 2010, he withdrew 5% of the original value in 2012 and 2013 (£4,000 in total).

In June 2019, he surrendered the whole bond for a value of £60,000. His annual gross income was £42,000. Ordinarily the total bond gain of £24,000 and his income of £42,000 would make him a higher rate taxpayer.

However, using top slicing relief ensures that he remains as a basic rate taxpayer.

Jim's total gain is £20,000 (£60,000-£40,000) plus £4,000 (partial withdrawals) = £24,000.

His gain of £24,000 is divided by the number of full policy years the bond was held, which is 9. The average gain is therefore £2,666.66.

This is then added to his income of £42,000, which is below the higher rate threshold and therefore there is no income tax liability.

Risk Considerations

There are several risks that need to be considered. It is important that you are aware of these.

- Past performance is no guarantee of future returns.
- If growth is low, charges may eat into the capital invested.
- The value of the investment is not guaranteed and on encashment you may not get back the full amount invested.
- Before making any withdrawals, you should seek advice in respect of the most appropriate and tax efficient method of achieving this.
- The price of units and the income from them can fall as well as rise.
- Any ongoing adviser charges taken from an investment bond count towards the 5% tax deferred income. This means that if the adviser charge was 0.75% per annum, only 4.25% per annum could be taken as tax deferred income.

Notes

*This information is a brief guide on Onshore Investment Bonds and in no way constitutes a recommendation or any form of advice and was correct as at 27th January 2021 and is based on our current understanding of legislation. Please contact us for further details on 01372 371030. The information contained in this booklet is not to be used by any third parties without our express permission.

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