FACT SHEET FACT SHEET

Investment Bonds -

Taxation for Trusts

The Trustee Act 2000 coincided with the bursting of the 'dotcom' bubble and the most vicious decline in stock-market values since the early 1970s. The Act correctly identified the importance of diversification as a means of reducing risk. Not only was the vulnerability of individual equities exposed – as, indeed, it was again exposed in 2010 by the BP oil spillage – but the importance was also recognised of diversifying investments between asset classes other than fixed interest and equities.

If trustees are to satisfy the need for diversification and the other main requirement of the Trustee Act, namely suitability, they should seek to minimise tax by selecting an investment vehicle or 'wrapper', the tax treatment of which is appropriate to that of the trust. There are a number of different products or 'wrappers' available in which Trustees can invest to achieve this aim, each of which have their own unique taxation structure. This fact sheet looks at the taxation of the Insurance or Investment Bond product.

WHAT IS AN INVESTMENT BOND?

An investment bond is essentially a single premium whole of life policy and as such is a non-income producing asset. It is normally created as a series of identical segments (often up to 1,000) which provides significant planning opportunities. The product often provides access to a wide selection of investment funds from many different fund management groups in the same way as an ISA, pension or other investment product or 'wrapper'.

- The funds within an investment bond are taxed at a deemed rate of 20%, being the corporation tax paid by the insurance company, which meets all liabilities for basic rate tax payers. Nil rate tax payers cannot reclaim any over-paid tax.
- No CGT is payable by Trustees or beneficiaries on capital gains arising within the investment bond.
- Investments within the funds enjoy some favourable tax treatment because they are 'owned' by the insurance company, compared to, say, a directly held equity or Collective (OEICs/Unit Trusts):
  - Dividend income is subject to no further taxation as the 10% tax credit satisfies the life fund's liability to corporation tax. For example, a £900 dividend received by the fund suffers no further tax within the fund, whereas it would suffer a further £275 tax if held directly by the Trustees (or in a Collective).
  - Savings income is taxed at 20%
  - Rental income is subject to tax at 20%
- Although 20% tax is charged on capital gains within the funds, this is offset by the fact that switches between investment funds held within the bond are not treated as disposals for CGT purposes, unlike direct equities and collectives. **This is an important issue where an active investment process is employed.**
- Capital gains and income generated by the underlying investments are 'rolled' up within the bond 'wrapper', hence the term non-income producing asset**.** The proceeds, in the form of chargeable gains, from investment bonds are subject to Income Tax, not CGT, because they are technically life assurance policies.

THE ANNUAL 5% ALLOWANCE

Up to 5% of the original investment(s) may be withdrawn from an investment bond each year without any immediate liability to tax to either the trustees or beneficiaries, in effect returning the original capital and deferring the taxation.

Such withdrawals provide a valuable means of creating a consistent regular 'income', which can be paid directly from the insurance company to the beneficiary's bank. Additionally:

- Unused 5% annual withdrawal allowances are rolled up for future use
- The income (withdrawals), within the 5%, does not count towards the beneficiary's Age Allowance
- Investment bonds avoid the penal RAT taxation levied on dividend and other income
- Investment bonds negate the need to declare the withdrawals as income (because they are withdrawals of capital) to HMRC by the trustees and/or beneficiaries, which simplifies tax administration for both
- The tax charge on gains is deferred until a *chargeable event* occurs.

ARE REGULAR DISTRIBUTIONS OF CAPITAL TREATED AS INCOME?

It has been suggested that regular payments of capital to beneficiaries might be regarded as assuming the nature of income and be taxable as such (advancement of capital could also result in an exit charge for inheritance tax purposes, but this might be small and might not arise at all, depending on the circumstances).

However, in the case of *Stevenson v Wishart* [1987] STC 266, the Court of Appeal held that, in topping up income payments with capital to fund the nursing home fees of an elderly beneficiary of a discretionary trust, the trustees were exercising a power over capital, and that the payments retained their nature as capital and should not be taxed as income.

The conclusion may therefore be drawn that no problem should arise from the payment to beneficiaries of withdrawals up to 5% from investment bonds, though cautious trustees might consider it prudent to ensure that their payments are irregular in amount and timing.

CHARGEABLE EVENTS

A chargeable event for Income Tax will occur if:

- The trustees surrender all or some of the segments within an investment bond, or
- Withdraw more than the cumulative 5% annual allowance, or
- If the last of the lives assured dies. Because a bond is technically a life policy it has life/lives assured.

The person(s) on whom tax is assessed on a chargeable event depends on the circumstances at the time, but it is typically the 'owner' of the bond or segment(s) at the time of encashment. If the trustees own the bond at the time of the chargeable event and the settlor is alive and UK resident or in his/her tax year of death the Income Tax on the gain is assessed on the settlor or his/her estate.

MITIGATING TAX – ASSIGNING TO BENEFICARIES

Tax charges on full surrender of all or some of the segments could be avoided if the trustees, instead of surrendering themselves, were to assign segments of the bond *in specie* to a non-higher rate taxpaying beneficiary or beneficiaries for nil consideration. The assignment would not constitute a chargeable event and assuming that, after the top-sliced element of the gain was added to their other taxable income, the beneficiary was still not a higher rate taxpayer, he or she could encash the segments – preferably in the following tax year – without any further liability to tax.

HOW IS A GAIN CALCULATED?

For a **full surrender**, i.e. full surrender of a bond or individual segments, the gain is calculated as follows:

- Current value plus previous withdrawals, LESS
- Initial investment less previous chargeable gains i.e. withdrawals above 5%annual allowance

Any gains arising on these events will reflect the actual investment performance of the bond.

For a **partial surrender** under a bond, i.e. withdrawals evenly across all segments, the gain is calculated as follows:

- Total value of the partial surrender since the last chargeable event, LESS
- Total allowable payments, i.e. the cumulative 5% tax deferred allowance since the last chargeable event.

Gains arising on these events are artificial in nature as they are not linked to the actual investment performance of the bond.

Where a chargeable event does arise, the product provider will issue a Chargeable Event Certificate to confirm details of the amount of the gain and the amount of tax deemed to have been paid within the bond.

IN WHICH TAX YEAR IS THE GAIN ASSESSED?

A gain arising on full surrender will be assessed in the tax year of the actual surrender. For example, a full surrender on 6 October 2013 will be assessed in the 2013/14 tax year.

Chargeable gains as a result of a partial surrender will occur on the 'periodic calculation' (i.e. the bond anniversary) date, and not the actual date cash is withdrawn. It is therefore the bond's anniversary date that determines the tax year of the chargeable event. For example, a bond is effected on 1 March 2005 and a partial surrender is taken on 6 October 2013. If there is a resulting gain on the anniversary date 1st March 2014 this will be assessed in the 2013/14 tax year. Had the bond been effected on the 1 May 2005, instead of March, the next anniversary date after the 6 October 2013 withdrawal will be 1 May 2014, and the resulting gain would be assessed in the 2014/15 tax year.

Bond chargeable gains are subject to Income Tax. The calculated gain will form the top slice of income, i.e. it will sit on top off all other sources of income when calculating the tax liability. Bond chargeable gains carry a basic rate paid Income Tax 'credit', which non tax payers cannot reclaim. However, basic rate tax payers will have no further liability, whilst higher rate tax payers will be subject to the additional tax above the basic rate 'credit'.

Version 1.2 13062013

CLAIRVILLE YORK LIMITED, 22-34 HIGH STREET, CHEAM, SURREY, SM3 8RL
TEL: 020 8642 3899 – Fax: 020 8642 8348 – E-MAIL cyfsl@cyfsl.co.uk