

## UK Taxation of Offshore Single Premium Bonds

### For financial advisers only

#### Non-qualifying policies (ITTOIA 2005, s484(1))

For tax purposes, an offshore single premium investment bond is a non-qualifying life assurance policy. Investment bonds are designed to accumulate income and gains within their funds. Consequently, policyholders do not have an ongoing liability to tax if benefits are not taken. In any event, the normal Capital Gains Tax rules, which apply to most UK investments, do not, in most circumstances, apply to investment bond capital. Special rules were introduced in the form of "chargeable events" which, when they arise, give rise to a potential charge to income tax.

#### Circumstances where a tax liability may arise

For non-qualifying policies, a chargeable event will occur on:

- i) the death of the life assured, or last life assured in the case of last survivor policies
- ii) the maturity of the policy
- iii) the total surrender of the policy
- iv) the assignment of the policy in exchange for money or money's worth
- v) any excesses on partial surrenders arising in any policy year
- vi) a personalised bond, a gain will arise on the final day of the policy year
- vii) a fundamental reconstruction of the policy (ie changing a life assured).

#### Calculation of the gain (TA 1988, s. 541)

When all the benefits are taken from a bond by way of maturity, full surrender, death or assignment for money, the amount chargeable to tax is calculated using the following formula:

**[surrender value *plus* all previous withdrawals] *less* [total premiums paid *plus* all previous chargeable excesses].**

Where the chargeable event is as a result of the death of the life assured (or last life assured) the taxable gain (if any) is calculated following notification of death and will not include any additional life cover.

#### Example 1

$$\text{Gain} = [a + b] - [c + d]$$

Where a = surrender value

b = all previous withdrawals

c = total premiums paid

d = all previous chargeable excesses

(i) Initial Premium £45,000

Surrender Value after 10 years = £89,000

Gain = [£89,000 + £0] - [£45,000 + £0]

**Gain = £44,000**

(ii) Initial Premium £45,000

5% withdrawal each year for 10 years  
i.e. £45,000 x 5% x 10 = £22,500

Surrender Value after 10 years = £66,500

Gain = [£66,500 + £22,500] - [£45,000 + £0]

**Gain = £44,000**

(iii) Initial Premium £45,000

6% withdrawal each year for 10 years  
i.e. £45,000 x 6% x 10 = £27,000

Surrender value after 10 years = £62,000

Chargeable excess = 6% (£2,700) - 5% (£2,250)  
x 10 = £4,500

Gain = [£62,000 + £27,000] - [£45,000 + £4,500]

**Gain = £39,500**

### Partial Surrenders (ITTOIA 2005, s507(5))

For each premium paid into an investment bond, an amount equal to 5% of that premium can be withdrawn each policy year for 20 years without an immediate liability to income tax.

If this 5% notional allowance is not fully used up in any year, the unused allowance will be carried forward to the next policy year and so on, on a cumulative basis. The total allowance is limited to 100% (5% x 20 years) of each premium paid.

Where a partial surrender is made, the total amount withdrawn in that policy year will be compared with the cumulative total of unused 5% allowances at the end of that policy year and any excess will be the chargeable gain which may be liable to tax. It should be noted that where a partial surrender is taken the chargeable event (if applicable) occurs on the last day of that policy year.

#### Example 2 Partial surrender

£45,000 premium

Year 3 Partial surrender of £10,000 is taken

Cumulative allowance at the end of year 3 = £45,000 x 5% x 3 = £6,750

**Therefore the taxable excess = £10,000 - £6,750 = £3,250**

### Policy segmentation

Most investment bonds can be issued as multiple policies (normally up to 100 individual segments). Whilst only one policy document is issued, **each segment represents a policy in its own right**. This gives the investment bond greater flexibility especially when it comes to tax and estate planning. The calculation to determine chargeable excesses ignores actual investment performance. In Example 2 it may be in the investor's interest to make a withdrawal by way of full surrender of individual segments rather than by partial surrender. N.B. surrendering a segment will reduce the original premium on which to calculate the 5% p.a. allowance.

#### Example 3 Full surrender of segments

£45,000 premium (100 segments)

Current value £50,000 (i.e. £500 per segment)

Year 3 £10,000 is taken by surrendering 20 policy segments

Initial premium = £9,000 (20 segments)

Surrender value = £10,000

**Chargeable gain = £10,000 - £9,000 = £1,000**

### Personal Portfolio Bonds (PPB)

In simple terms, a PPB is a life assurance or capital redemption policy which gives investors the freedom to invest in a wide range of assets beyond those described within the PPB legislation.

For example, where a UK resident policyholder invests in equities through their policy, the PPB legislation imposes a yearly tax charge on the PPB deemed gain. The PPB deemed gain is not based on actual gains. It assumes a gain of 15% of the premium and the cumulative gains for each year the policy has been in force. The tax charge on the PPB deemed gain will be at the highest rate of tax paid by the investor without top slicing relief.

### Calculation of the tax liability on a chargeable gain

The chargeable gain is subject to income tax, not capital gains tax. A gain, adjusted for non-UK residence if appropriate, is treated as the top part of the individual's total income for the tax year in which the gain is made.

The whole amount of the chargeable gain will be liable to the UK basic rate of tax on savings income (currently 20%), although the gain (or an appropriate part of it) would first be covered by any unused personal allowance.

In addition, a liability to higher rate tax (40%) and additional higher rate tax (45%) on income over £150,000 could arise depending on the individual's other taxable income.

To determine whether higher rate tax or additional higher rate tax is also payable, the chargeable gain is "sliced". On surrender or death the slice is calculated by dividing the gain by the number of complete years the policy has been in force up to the date of surrender or death. (See Example 4 overleaf)

The number of years' ownership in this calculation will be reduced by any complete policy years that the individual was not UK resident.

This slice of the gain is added to the individual's other taxable income during the relevant tax year. If for example, the "total amount" exceeds the higher rate tax threshold but not the additional higher rate threshold (£150,000), then, the portion of the slice which represents the difference between the "total amount" and the higher rate threshold is applied to higher rate tax. The balance of the slice is applied to basic rate tax. The total tax payable on the slice, is divided by the total amount of the slice to determine an effective rate of tax. This rate is then applied to the whole of the gain to determine the tax due. (See example 4)

This means that if the individual's other taxable income is already liable to higher rate tax, then the whole of the chargeable gain on the policy will be liable to higher rate tax (currently at the rate of 40%). The same would apply if the individual's other taxable income is already liable to the additional higher rate tax of 45%.

#### Example 4

Based on current tax rates for 2016/17 of 20% on taxable income up to £32,000, 40% on income between £32,001 and £150,000 and 45% on income in excess of £150,000:

The tax payable on a gain of £30,000 for example, after 5 years would be as follows:

- a) Assuming other taxable income is between £32,001 and £150,000, the full gain will be liable to 40% tax. If income is over £150,000 the full gain will be liable to 45% tax.

- b) Assuming other taxable income amounts to £27,000.

Slice for higher rate tax	
- divide gain by 5 (number of years)	£6,000
Other income	£27,000
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Total	£33,000
Less higher rate tax threshold	£32,000
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Amount applied to higher rate tax	£1,000
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Therefore amount applied to basic rate tax is £6,000 - £1,000	£5,000
Tax on slice is £5,000 @ 20%	£1,000
£1,000 @ 40%	£400
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Total tax on slice	£1,400
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Effective tax rate on slice is  $\frac{£1,400}{£6,000} \times 100 = 23.33\%$

Tax payable on total gain is  
23.33% of £30,000 = **£6,999**

#### 2.1 Non-UK residence

If the bondholder has been non-UK resident whilst owning the bond and subsequently becomes UK resident. The gain is reduced by a fraction relating to the number of years the bondholder has been non-UK resident and the number of years the bond has been held. The gains calculated in example 1, would be multiplied by the following fraction:

$$\frac{\text{Period of ownership as a non-UK resident (days)}}{\text{Period plan has been in force (days)}}$$

The periods in question are calculated from the policy commencement date to the date on which the chargeable event occurs.

#### Important notes

For financial advisers only. Not to be distributed to, nor relied on by, retail clients.

Please note that every care has been taken to ensure that the information provided is correct and in accordance with our current understanding of the law and Her Majesty's Revenue and Customs (HMRC) practice as at April 2016. You should note however, that we cannot take upon ourselves the role of an individual taxation adviser and independent confirmation should be obtained before acting or refraining from acting upon the information given. The law and HMRC practice are subject to change. Legislation varies from country to country and the policyholder's country of residence may impact on any of the above.