

taxing considerations

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Colin Jelley explains why it is crucial to consider the impact upon the client's tax position when encashing all or part of an existing bond.



I have said before that there remain many reasons why both investment bonds and collective investments can add value in the tax and financial planning process. The merits of investment bonds can include simplicity, an improved personal tax position or future capital extraction planning. Every client is different – issues such as attitude to risk, investment return expectations and investment time horizon will all shape advice on both tax and investment planning.

Focusing on the tax issues of investment bonds in isolation, consideration of when chargeable events might occur should form an integral part of the review process when deciding whether it is favourable to surrender all or part of an existing bond. Some clients, for instance, may attempt to access their capital without advice, and while no investment gain may exist, by taking a part withdrawal across all policies they could inadvertently create a taxable gain, resulting in an unexpected tax bill (see **example**).

The recent Budget has put an even greater focus on the need for advice regarding how and when an encashment is made. The new 50% rate (the 'additional' rate) for taxable incomes of £150,000 and above, as well as the tapered loss of personal allowances for those with incomes above £100,000, could mean that action taken today has serious consequences in the future.

Therefore, when looking to fully or partially surrender a policy, there are a number of key considerations to take into account which could impact upon the decisions made and advice given:

- Should the gain be realised in 2009/10 or 2010/11?
- When does the gain arise for tax purposes?
- How much is added to the income?
- What rate of tax will be applied?
- What is the impact on personal allowances?

The potential implications of these considerations are best demonstrated by considering some simple examples.

scenario 1: the policy year

Firstly, let's consider Jack. Jack invested £100,000 in a bond on 1 May 2006 and has not made an investment gain and has made no previous withdrawals. He has other income of £70,000 and wishes to make a partial withdrawal of £62,950.

As in the **example**, a liability to tax will arise even though the overall investment in the bond has not made a gain. Withdrawals taken by partial surrender are liable to UK income tax under the chargeable events regime on the amount of the withdrawals which exceed the cumulative 5% tax-deferred allowance, which in Jack's case is £42,950. This type of 'excess withdrawal' is treated for tax purposes as having occurred at the end of the 'policy year' and is calculated on all withdrawals taken in that 'policy year'.

The chargeable event or 'excess withdrawal', therefore, is not treated as arising until the final day of the policy year, ie 30 April 2010, which means it is assessable for tax within the 2010/11 tax year at 40% as all of the £42,950 is added to the income – not just the sliced gain. In addition, Jack's total income for 2010/11 is therefore £112,950 and so all of the personal allowance is also lost. Jack will have an income tax liability at an effective rate of 60% on £12,950 and 40% on £30,000. For a UK bond there would be credit for life fund taxation already paid at 20%.

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example – creating a gain

This simple example shows how a client could inadvertently create a chargeable gain despite there being no investment gain.

£100,000 invested 1 June 2008

£100,000 policy value 30 April 2009

£80,000 withdrawal 1 May 2009
(% across all 100 policies)

If this withdrawal is taken across all the policies then there would be an excess of £75,000 liable to income tax. This is calculated as follows:

£100,000 (investment) x 5% deferred allowance (one year's allowance available) = £5,000

£80,000 withdrawal - £5,000 (1st year's 5% tax deferred) = £75,000

The £75,000 gain would be added to the client's income. This would make a basic rate taxpayer aged under 65 a higher rate taxpayer and up to an additional 20% tax (£15,000) could be due, or up to £30,000 if an offshore policy.

In this example it may be more tax efficient to make withdrawals by surrendering a number of policies instead of a withdrawal across all policies.

If Jack had sought advice it may have been possible to lengthen the policy year by fully encashing the bond before the tax year had been completed. This would have meant there would have been no excess withdrawal as the calculation of gains on full surrenders includes withdrawals in the final policy year. If the client had acted before the end of the current tax year, the excess could have been ignored and only the full surrender chargeable event would trigger a potentially smaller tax charge.

scenario 2: timing the encashment

Let's now consider Jill's situation. Jill invested £100,000 in a UK bond on 1 May 1999. The bond has a surrender value of £200,000 and Jill has other income of £70,000 per annum.

Jill has made a £100,000 gain upon surrendering her policy. The advice issue here is determining the most favourable point at which Jill should realise the gain. If the bond is fully encashed it will be assessed for tax within the current tax year. For Jill there is no impact on her personal allowance and the gain is taxed at 40% if it is assessable in the 2009/10 tax year, reduced by the 20% tax treated as paid on a gain from a UK bond. In 2010/11, however, the

personal allowance would be lost and Jill could also suffer tax at 50% on some of her gain. Top slicing relief will, in this example, however result in no tax being paid at the additional rate, (and would again be reduced by the 20% tax treated as paid on a gain from a UK bond) but the need for advice is clear.

expert guidance

While these examples are simplistic in nature, they clearly demonstrate the need for advice to reduce or negate any tax liability created. ●

For further support from Skandia on chargeable event planning please see **final policy year and chargeable events**, available from the Skandia literature library or your regional Skandia office.

This article is based on Skandia's interpretation of the law and HM Revenue & Customs practice as at August 2009. We believe this interpretation to be correct but cannot guarantee it.



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