AF1 Taxation of Investments 2020/21
Part 3: Insurance Policies

This part will cover the taxation of insurance policies in the hands of the investor

The milestones are to understand:

- The principles of insurance policy taxation
- The difference between qualifying and non-qualifying policies.
- The taxation of onshore and offshore insurance/investment bonds
- How annuities are taxed

Key Principles

The underlying assets in a unit trust or OEIC are deemed to be held on behalf of individual investors who are liable for tax on any income and gains.

In an insurance policy, the company owns the assets and is subject to Corporation tax on the income and gains from these. Indexation was allowed to reduce any chargeable gains but cannot be used after January 1 2018.

Whether the investor has any further liability will depend on whether the policy is **qualifying or non-qualifying**.

- If the policy is qualifying the original policyholder will not be subject to **personal tax** on the proceeds. It is not tax free as the company has paid tax on the assets.
- If the policy is non-qualifying the policyholder may be subject to additional **income tax** on the gain. A credit of 20% is given to reflect the tax the company has paid.

The main non-qualifying plan is the Investment or Insurance Bond.

Investment/Insurance Bonds

- These are single premium (lump sum) investments.
- A range of open-ended unitised funds is available. The policyholder hopes that the price of the units will rise in value and so make a gain.
- It is structured as a whole of life policy. It has no fixed term ends on the death of a named person whereas unit trusts or OEIC can be left to someone else on the investor's death.
- An Investment Bond does not pay out an income stream to the investor. The insurance company will receive income from the fund's assets which is reinvested in the fund thus increasing the unit price.
- An IB cannot be placed into an ISA.

Taxation

An Insurance Bond is taxed in the same way regardless of the type of fund. With a unit trust the taxation of income from a gilt based fund is different to dividends from an equity fund. In an Insurance Bond the investor is taxed in the same way regardless of the assets in the fund.

The investor only becomes liable to tax when there is a **chargeable event.** There are a number of these but for the moment just one, a final encashment or surrender, will be considered to illustrate the principles.

Henry invested £50,000 in an Investment Bond on July 1 2009. On July 1 2019 he fully encashes the bond and receives £94,000, a gain of £44,000

Investment Bonds are often taken out in joint names, typically a husband and wife. In the event of a total surrender the gain is split 50/50 and taxed on an individual basis.

Tom and Geraldine surrender joint life Investment Bond and the gain is £50,000. Each has made a gain of £25,000.

All gains are subject to **Income Tax** and not CGT. The amount of tax, if any, will depend primarily on the investor's tax status and the amount of **top slicing relief.**

Top slicing relief: a major change

A chargeable gain is added to an individual's non-savings, savings and dividend income. Rather than being taxed on the whole gain in the year when the chargeable event occurs, HMRC allowed the gain to be averaged or spread over the whole period of investment using top slicing relief. This was primarily designed to reduce or eliminate the additional tax if the gain pushed a basic rate taxpayer into higher rate. It did not reduce the tax of someone who was a higher rate taxpayer before and after the gain was added to their income. Any additional tax that was due could be calculated using the **"short method".**

When the PSA was introduced, accountants questioned whether this method produced the correct amount of relief. Chargeable gains are classed as **savings income** so if an individual has no taxable savings income, for example all their deposits and gilts are sheltered in an ISA, can the PSA be used against the chargeable gain?

HMRC now allow this and have amended the top slicing rules. Whilst these will apply in all cases, where the available PSA has been used up by other savings income it's still possible to use the short method, so we'll go through this first.

Going back to the previous example, if Henry's other income is £60,000, the whole gain will be in the higher rate band. However there is a credit of 20% tax to reflect the tax paid within the fund so he will pay 20% rather than 40%.

Henry's liability will be £44,000 x 20% = £8,800

Similarly, if his income was £160,000 the tax due would be 25% and his liability would be £11,000.

If Henry is a basic rate taxpayer with a total income of £35,000 it might seem that he has no further liability. However, adding the £44,000 takes him into the higher rate tax band. Top slicing can be used to reduce his liability and works in this way.

The gain is divided by the **complete number of years** the bond has been in force.
In Henry's case this would be £44,000/10= £4,400 (This is the **slice**)
This is added to his salary to give £39,400. (threshold for HRT is £50,000)
This is still within the basic rate band so no tax is due.

If Henry's total income was £49,000 the top slice of £4,400 means that £3,400 is within the higher rate tax band and thus becomes chargeable. The calculation will be as follows:

Multiply the amount in the higher rate band by the complete years the bond was held.

In this case, £3,400 x 10 = £34,000.

This is chargeable at 20% to give a liability of £6,800

To summarise the key points using the short method (where the individual's PSA has already been used):

- Top slicing is used if the total gain takes a basic rate tax payer into higher rate tax.
- Divide the gain by the complete number of years the bond has been held
- Add this to the policyholder's other income.
- If all the top slice is within the basic rate band no tax is due.
- If part of the gain is in the higher rate band multiply this amount by the complete number of years the bond has been held.
- This is the chargeable amount and is taxed at 20%

Top slicing can also be used to prevent or mitigate a higher rate taxpayer being taxed at additional rate.

Cath has a total income of £140,000 and a chargeable gain of £50,000 which she has had for 10 complete years.

The top slice is £5,000 which added to her income is all within the higher rate band so her liability is £50,000 @ 20% = £10,000.

Without top slicing it would have been £10,000 @ 20% + £40,000 @25%, a total of £12,000

The new five step Method

This method must be used if the investor has unused PSA. In a case study the subject will probably have a mixture of cash and gilt/bond ISAs so has no taxable savings income. Assuming they are not an additional tax payer the PSA will either £1,000 or £500.

To establish an individual's highest tax band their adjusted net income must be calculated This is the whole gain plus their other income less gross Pension and grossed up Gift Aid.

If the ANI is more than £150,000 there is no PSA but we could use top slicing in the traditional way to try and ensure most of the gain is taxed at 40% rather than 45%

The amount of top slicing relief is the difference between **the relieved tax liability on the gain** and **the relieved liability on the slice**. Relieved tax liability is simply the individual's tax liability after credit is given for tax paid within the fund.

HMRC use a five step process:

1. Calculate the tax on the whole gain
2. Deduct the tax treated as being paid on the whole gain (usually gain @ 20%) This is the **relieved liability on the gain**
3. Top slice by dividing the gain by number of years held
4. Calculate the tax on the slice including the available PSA and deduct the tax deemed to have been paid on the slice. Then multiply by the number of years held. This is called the **Relieved liability on the slice**
5. Deduct the figure at stage 4 form the figure at stage 2 to give the top slicing relief

HMRC never seem to make things simple but the process might be easier to understand if it's put like this:

1. Calculate the net tax on the whole gain (steps 1 & 2)
2. Calculate the net tax on the slice and multiply by the number of years the bond has been held (Steps 3 & 4)
3. The difference is the amount of Top Slicing Relief (TSR)

Once TSR is calculated, it is then used to calculate any additional tax liability for the investor using this process.

- Individual tax liability as calculated in step 1
- Less tax deducted on the whole gain
- Less Top Slicing Relief

Or alternatively: The net tax due on the whole gain less TSR.

Let's look at an example.

Ted has a salary of £52,000. All his savings income comes from ISA accounts. He surrendered an investment bond for £40,000 having invested £20,000 exactly 10 years ago.

He is a higher rate tax payer so all the gain is in the higher rate band and has a PSA of £500

Step 1

PSA	£500 @ 0%	£0
Balance	£19,500 @ 40%	£7,800

Step 2

	£20,000 @ 20%	£4,000
Relieved liability on gain		**£3,800**

Step 3

£20,000/10 = £2,000

Step 4

	£500 @ 0% =	£0
	£1,500 @ 40% =	£600
Less	£2,000 @ 20%	£400
Relievable tax liability on slice		£200 x 10 = **£2,000**

Step 5

Top slicing relief is £3,800 less £2,000 = £1,800

Ted's additional tax liability is:

Tax liability on gain	£7,800
Less Tax Credit	(£4,000)
Less TSR	(£1,800)
	£2,000

Using the old short method there would be no top slicing relief as he was already a higher rate taxpayer. Under the new method he gets relief of £1,800

What happens if the PSA has been used up?

Everything is the same as in the last example but Ted now has £500 of taxable income

Step 1

Gain	£2000 @ 40%	£8,000

Step 2

	£20,000 @ 20%	£4,000
Relieved liability on gain		**£4,000**

Step 3

£20,000/10 = £2,000

Step 4

	£2,000 @ 40% =	£800
Less	£2,000 @ 20%	£400
Relievable tax liability on slice		£400 x 10 = **£4,000**

Step 5

Top slicing relief is £4,000 less £4,000 = £0

Ted's additional tax liability is:

Tax liability on gain	£8,000
Less Tax Credit	(£4,000)
	£4,000

Note that this is the same figure that you would get if you used the short method!

So what should you use in the exam?

Whilst the short method would give you the right answer if the PSA has been used up, it is probably better to show the full five stage calculation

Next we'll look at someone who is a basic rate tax payer before the chargeable gain is taken into account

Judy has a salary of £48,400 and all her savings income comes from ISA. She surrendered an Investment Bond and made a gain of £24,000 having held the bond for eight years.

Tax liability before the chargeable gain

Salary	£48,400
PA	£12,500
	£35,900 @ 20% = £7,180

At this point she has £1,600 of the basic rate band left

First the amount of TSR must be calculated. For simplicity some steps will be combined.

Step 1 & 2

PSA	£500 @ 0%	£0
Basic rate	£1,100 @ 20%	£220
Higher rate	£22,400 @ 40%	£8,960
Individual liability		£9,180
Less tax credit	£24,000 @ 20%	£4,800
Relieved liability		£4,380

Step 3 &4

Slice £24,00/8	£3,000	
PSA	£500 @ 0%	£0
Basic rate	£1,100 @ 20%	£220
Higher rate	£1,400 @ 40%	£560
		£780
Less tax credit	£3,000 @ 20%	£600
		£180
Relievable liability £180 x 8		£1,440
Step 5 £4,380 less £1,440		£2,940

Therefore her additional liability on the chargeable gain is

	£9,180
Less Tax credit	(£4,800}
Less TSR	(£2,940)
	£1,440

Under the old "short method" the top slice of £3,000 would have pushed her £1,400 over the HRT. This would be taxed at 40% to give £560 and multiplied by 8 to give an additional liability of £4,480.

In addition to using the PSA, the 0% starting rate can also be used.

Saba has a pension income of £14,500 and all her investments are held in ISAs. She surrenders an Investment Bond that she has held for 10 years making a gain of £60,000.

Her pension income is above the PA but she has £3,000 of the 0% band left. She will also have a PSA of £500 as her ANI is £74,500

Steps 1 & 2

0% rate	£3,000	£0
PSA	£500 @ 0%	£0
Basic rate	£34,000 @ 20%	£6,800
Balance	£22,500 @ 40%	£9,000
	£60,000	£15,800
Less tax deducted		£12,000
Relieved liability		£3,800

Steps 3 & 4

Slice £60,000/10 = £6,000

0% rate	£3,000	£0
PSA	£500 @ 0%	£0
Basic rate	£2,500 @ 20%	£500
Total	£3,000	£500
Less tax liability		£600
		-£100

As step 2 is a minus figure it is treated as zero so the TSR is £3,800

The end result is that she has no further liability

Personal Liability	£15,800
Less Tax credit	(£12,000)
Less TSR	(£3,800)
	£0

Before going any further let's recap where we have got to.

- The HMRC 5 step process is the official way to calculate Top Slicing Relief and **must be used if the individual has any remaining 0% starting rate or PSA.** In the exam watch out for the subject having no taxable savings income.
- If there is no available PSA or zero rate then the "short method" can be used but it's probably advisable to use the revised method in your answer.
- It is the difference between **the net tax the individual is liable for on the whole gain** and the **net tax payable on the slice multiplied by the total years the bond was held.**
- Once the TSR has been calculated it is deducted from the net tax due on the whole gain. The net tax is the amount after the tax credit has been deducted.

We'll now look at other chargeable events

Death

An Investment Bond is a life policy and ends when the **life assured** dies. This is another Chargeable Event. The exact position on any tax liability will depend on how the policy was set up. This could be:

- Single planholder who is also the life assured.
- Joint planholders who are also the lives assured
- Single/joint planholders but with different life(s) assured.

In the first example when the planholder dies, the policy comes to an end and this will be a chargeable event. The liability will be calculated on the deceased's own circumstances as if they were still alive. The deceased's executors will complete a self-assessment form for the deceased and pay any tax from the estate.

A joint life case is almost always written on a second death basis. This means when the first life dies, there is no chargeable event and the policy becomes the sole owner. When that person dies the process is the same as for a single life bond.

The life assured need not be the same person/people and this can be useful as it allows the plan to continue after the planholder(s) death.

Pete and Peggy take out an IB with their grandchildren as the lives assured. Pete dies first and this is not a chargeable event. Peggy becomes the sole owner.

She dies five years later (not a chargeable event) but her grandchildren are still alive so the Investment Bond continues. It becomes part of her estate and can be distributed according to her will.

If the executors surrender the Bond that will be a chargeable event and the liability will fall on the executors. The rate will be 20% regardless of the size of the gain but as 20% tax is deemed to have been paid within the bond, no further tax is payable.

Assigning a bond

As an IB is a life policy it can be assigned from the planholder to another person who in turn can assign it to someone else. This transfers the right to claim the benefits to another person. Provided the assignment is a gift it is not a chargeable event.

In the previous example Peggy's executors could assign the bond to her son. As no money had been paid it is not a chargeable event so there is no tax liability. The son will receive the bond rather the cash and can do what he wants with it. If he retains it for some years when he has a chargeable event the original value that Pete and Peggy invested and the term since it was taken out would be used in calculating any tax.

The bond had run for ten years when it was assigned to Peggy's son. He then decided to make a full surrender eight years later. In any top slicing calculation the total gain would be divided by eighteen years.

An assignment which is paid for is a chargeable event.

Income from an IB

Unlike a unit trust or an OEIC, an IB does not produce a separate income stream. Instead all income received by the insurance company (either as Gilt interest or dividends from shares) is reinvested in the fund which is then reflected in a higher unit price. It is possible to take an "income" from an IB by encashing units on a regular basis. The investor is therefore withdrawing capital rather than receiving a trues income.

The 5% rule

- It is possible to withdraw **5% of the original investment** without incurring an immediate tax charge. This can be withdrawn each **plan year**. A plan year starts on the day the plan is set up so the first plan year for an IB taken out on April 1 2019 will be April 1 2019 to March 31 2020.
- The 5% is cumulative so if it is not taken out one year it carries over to the next one. An initial investment of £10,000 in its 5th year means that 25% of the plan (£2,500) can be withdrawn without incurring an immediate tax liability.
- It is not tax free since when the plan is fully encashed, all the previous withdrawals have to be added to the gain to make the final tax calculation.
- IBs are always lump sum investments. If an investor wishes to make a further investment it is usually advisable to add the new money to the existing plan rather than set up a new one. This is because the original investment (on which the 5% withdrawal is based) is **the original investment plus the new money**

Here are some examples:

Alan invested £100K in an IB on July 1 2010. July 1 2020 is the first day of its 11th plan year so up to 55% or £55K can be withdrawn without creating a tax charge.

Beth invested £100K in an IB on July 1 2010. On December 1 2012 the policy was in its 3rd year so she withdrew 15% or £15,000. On August 1 2020 the policy was in its 11th year and the maximum withdrawal is £55,000. As she has already used up 15% (£15,000) a further £40,000 can be withdrawn without creating a chargeable event.

Carol invested £100K in an IB on July 1 2010. On December 1 2013 the policy was in its 4th year and she withdrew £10,000. This was below the £20,000 that could have been withdrawn so there is no chargeable event. On August 1 2020 the policy was in its 11th year and the maximum withdrawal is £55,000. As she has already withdrawn £10,000 a further £45,000 can be withdrawn without creating a chargeable event.

As has been mentioned the withdrawal is tax deferred rather than being tax free. This means that when the bond is finally surrendered the withdrawals are added to the overall gain.

Rachel invested £80,000 into a bond and over the years withdrew £20,000 all of which was in the 5% limit.

On final encashment Rachel received £100,000. Her total gain for tax purposes is:

Final encashment	£100,000
Less initial investment	80,000
	20,000
Plus 5% withdrawals	20,000
	£40,000

Rachel's liability will then be calculated in the normal way and can use TSR.

If more than 5% is withdrawn the excess is a **chargeable event**. This means tax may be due on the excess withdrawal over 5%. However, this will normally only affect a higher rate tax payer.

Yves invested £100,000 in an IB and one year withdrew £40,000 which was £10,000 more than the 5% allowance.

£10,000 would have been a chargeable event and taxed in that plan year. The £30,000 that was within the 5% allowance would be added to the gain on final encashment.

If the £40,000 withdrawal was made on 1 September 2020, it would seem to be chargeable in tax year 20/21 However, if the plan year was from 1 July to 30 June, it could be chargeable in tax year 21/22.

The reason is that the insurance company normally issues a certificate showing the amount of withdrawal at the end of the plan year, in this case 30 June 2021 which falls in 21/22. It shouldn't issue a certificate on 1 September 2020 because Yves make take further withdrawals before the end of the plan year.

Segmented policies

To give more flexibility most IBs are segmented, that is they are set up as clusters of small policies, say for £100 each.

Fiona invests £50,000 into an IB which is segmented into 500 policies each with an initial value of £100. Ten years later the whole plan has a value of £75,000 and each segment's value is £150.

Fiona decides to encash enough segments to give herself £15,000. She would surrender 100 segments £150 x 100 = £15,000

If the investor wishes to make a withdrawal the choice between surrendering whole segments and using the 5% facility can give different tax liabilities.

Bob invested £100,000 in an IB that was split into 1,000 segments with an initial value of £100. Nine months later the plan is worth £100,500 with each segment worth £100.50.

He has an emergency and needs £50,000. If he surrenders 498 segments that will produce £50,049. The gain will be £249 so if he was a higher rate tax payer the liability would be £49.80

If he used the 5% facility this would take £50 off each segment. However the maximum withdrawal in the first year is £5,000 so £45,000 becomes chargeable giving Bob a liability of £9,000.

Although an extreme example this is based on a real case that was appealed by the investor but the Court held that HMRC had acted correctly. They have accepted that the law needs to change and are consulting how best to rectify this.

Chargeable events

As has been seen the investor's liability to tax only occurs when there is a chargeable event. The full list of these is as follows:

- Death
- Full surrender of either the whole policy or individual clusters.
- Assignment for money, that is someone pays to have the policy assigned to them.
- Withdrawal of more than allowed under the 5% rule.

One point to note is that **switching** is not a chargeable event. Most plans offer a range of funds and it is possible to have several funds in one plan. If the investor wants to switch from one fund to another it can be done without incurring a chargeable event.

Offshore Investment Bonds

- These are investment bonds set up outside the UK
- There is no UK tax on the fund.
- All taxation rules are the same as an onshore bond but as no UK tax has been paid by the insurance company, the investor must pay the full rate (25%/40%/45%)

To calculate TSR, the same five stop process is used and although no tax will have been paid within the fund, a notional tax credit of 20% is still deducted from tax on the whole gain and the slice.

Once TSR has been calculated it is deducted from the tax that is due on the whole gain rather than the tax after deduction of the notional tax credit.

Debra has a salary of £47,000 and has used her PSA. She fully encashes an offshore IB making a gain of £25,000 having held it for 10years

Tax on whole gain

Basic rate	£3,000 @ 20%	£600
Higher rate	£22,000 @ 40%	£8,800
	£25,000	£9,300
Less £25,000 @20%		£5,000
		£4,300

Tax on slice (£2,500)

£2,500 @ 20%	£500
Less tax credit	£500
	Nil

TSR £4,300 less NIL = £4,300

Her liability is £9,300 less £4,300 = £5,000

Without TSR she would be liable to pay higher rate tax on most of the gain. With TSR Debra pays tax at basic rate on the whole gain.

If Debra's gain was £130,000 over 5 years the calculation would be as follows.

Debra's total income is £177,000 so loses her income tax personal allowance. This means that her salary uses up all her basic rate band and £9,500 of her higher rate band leaving a further £103,000

Tax on gain

Higher rate	£103,00 @ 40%	£41,200
Additional rate	£27,000 @ 45%	£12,150
	£130,000	£53,350
Less £130,000 @ 20%		£26,000
		£27,350
Tax on slice	£26,000 @ 40%	£10,400
Less	£26,000 @ 20%	£5,200
		£5,200 x 5 = £26,000

TSR £27,350 less £26,000 = £1,350

His liability is £53,350 less £1,350 = £52,000

Offshore bonds can be useful for non-taxpayers since the individual's personal allowance, the 0% savings rate and the PSA can absorb the gain. This is because the gain is technically savings income. This isn't possible with an onshore bond as tax paid within it cannot be reclaimed.

Tom set up an offshore investment Bond for his daughter shortly after she was born, When she is 18 he assigns sufficient segments to give her £15,000 to fund her first year at university. This produces an £8,000 gain.

She has no other income, so she has no tax to pay as the gain is all within her PA. In fact, based on 20/21 figures a gain of £18,500 (PA + £5,000 0% band + £1,000 PSA) could be made without incurring a tax liability.

Qualifying Life Policies

A qualifying policy means that the proceeds are free of any **individual tax liability**. It cannot be described as tax free since the investment fund will have been taxed.

Rules for a qualifying policy:

- It must be paid at least annually (e.g monthly, quarterly, six monthly or annually)
- The term must be at least 10 years
- The premiums in one year cannot be more than double that in any other year
- The premiums in any year must be at least 1/8th of the total premiums payable
- For an endowment policy, the life cover must at least be 75% of the premiums payable. If the age of the life assured is over 55, the 75% figure is reduced by 2% for each year over 55. For a whole of life policy. For a whole of life policy it is 75% of premiums paid to 75.
- Annual premium must be less than £3,600

- A qualifying policy can become non-qualifying. The main reason that it is cancelled within the lesser of 10 years or ¾ of the term

The main type of qualifying policy is an **endowment policy**. This policy runs for a specific period (minimum 10 years) and pays out a sum at the end of the term or on earlier death. They can either be **unit linked** or **with profits**

Unit Linked

- There is a guaranteed death benefit
- Premiums buy units one fund or range of funds
- At any time the value of the policy is the number of units multiplied by the unit price
- There are usually quite high charges with this type of plan and it may be some years until the value of the plan is greater than the premiums paid
- They are sometimes marketed as **Maximum Investment Plans**

With profits

- The plan starts with a guaranteed sum assured
- This will be paid out at maturity or on earlier death
- An annual bonus may be added each year
- This increase the promised payment on death or maturity and once paid it cannot be withdrawn
- When the plan matures there may be a terminal bonus

All the benefits in a with profits policy are expressed as a promise to pay. They do not give an indication of the plan's current value. If the plan is surrendered the amount payable will be determined by the life company.

An alternative is to sell the with profits policy on the second-hand market. The attraction to the buyer is that they know that they are certain to get the sum assured plus declared bonuses if they maintain the policy to the end of the term.

The new owner will be subject to **Capital Gains Tax** on the final gain. This is the maturity value less price paid and premiums paid by the new owner

Annuities

The main products are:

- Purchase life annuities
- Compulsory Purchase (Pension annuities)
- Immediate Needs annuities

Purchase life annuities

- Part of the income is deemed to be return of capital and no tax is chargeable on this.
- The remainder is treated as savings income with 20% deducted at source. This can be reclaimed by non-tax payers. Higher rate tax payers pay a further 20%, additional rate tax payers 25%
- As it is savings income the PSA can be used.

Compulsory Purchase annuities

- These are annuities bought with the proceeds of a money purchase pension
- All the income is taxable as non-savings income

Immediate Needs annuities

- These are annuities bought to pay for long term care.
- There is no income tax on the annuitant provided the income is paid directly to the care provider

That concludes this part so you should now understand:

- The principles of insurance policy taxation
- The difference between qualifying and non-qualifying.
- The taxation of insurance/investment bonds
- How annuities are taxed

Further reading

https://www.pru.co.uk/investments/investment-articles/guide-to-investment-bonds/

https://www.pruadviser.co.uk/knowledge-literature/knowledge-library/taxation-uk-investment-bonds/

https://www.pruadviser.co.uk/knowledge-literature/knowledge-library/top-slicing-relief-facts/

https://www.pruadviser.co.uk/knowledge-literature/knowledge-library/taxation-offshore/

https://www.oldmutualwealth.co.uk/Adviser/literature-and-support/knowledge-direct/investments/bonds/offshore/uk-taxation-of-offshore-bonds-part-2/