R02: Collective Investments
Part 3: Insurance Based Products 2020/2021

The taxation unit trusts and OEICS fall primarily on the investor. The underlying investments are deemed to be held on behalf of the investors who are responsible for paying tax on any income and gains.

In an insurance product, the assets are owned by the insurance company which is initially responsible for paying any tax. 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 never be subject to **personal tax** on the proceeds. It cannot be called tax free as the company will have paid tax on the investments.
- If the policy is non-qualifying the policyholder may be subject to additional **income tax** on the gain.

The main non-qualifying plan is the Investment or Insurance Bond and is a favourite topic in both R03 and R02.

Investment/Insurance Bonds

- These are single premium (lump sum) investments.
- They are structured as a whole of life policy. It has no fixed term and will come to an end on the death of a named person. This is clear difference between life based and non-life based investments. A unit trust or an OEIC can be left to someone else on the investor's death. If the policy holder is the same as the life assured, the plan will come to an end on their death.
- Unlike a unit trust or OEIC and Investment Bond does not pay an income to the investor. The insurance company will receive income from the fund's assets and this will be reinvested in the fund thus increasing the unit price.
- The policyholder hopes that the price of the units will rise and encash the units to make a gain.
- Insurance funds are open-ended funds

A range of funds is usually offered by the life company and a mix of these can be held in a single bond. Funds are unitised in the same way as a unit trust, that is, it is an open-ended fund but there are significant differences in taxation.

An Insurance Bond is taxed in the same way regardless of the type of fund. With a unit trust the taxation of a gilt based fund is different to an equity fund. In an Insurance Bond the tax is the same regardless of the assets within the policy.

Taxation

- 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 February 1 2010. On March 1 2020 he fully encashes the bond and receives £94,000, a gain of £44,000

The first point is that the £44,000 gain is subject to **Income Tax** and not CGT. The amount of tax, if any, will depend on Henry's tax status.

Gains under non-qualifying life policies are taxed after all other income so if Henry has an income of £50,000, the whole gain will be in the higher rate band. However as 20% tax is deemed to have been paid within the fund the rate he will pay is 20% rather than 40%.

His 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 tax payer with an income of £35,000 it might seem that he has no further liability but this may not be the case. If the £44,000 is added to his income it would take him into the higher rate tax band but in these cases **top slicing** can be used. It 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 added to his other income to give £39,400.
This is still within the basic rate band so no tax is due.

If Henry's income was £49,000 the top slice of £4,400 gives a total of £53,400 which means that £3,400 is within the higher rate tax band and tax is due. The calculation is done 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:

- Top slicing is mainly 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 an 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

Joint policies

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 an Investment Bond and the gain is £50,000. Tom's share is £25,000 as is Geraldine's.

Tom is a higher rate tax payer so has to pay £25,000 @ 20% = £5,000
Geraldine is a basic rate tax payer after applying the top slice to her income so she has no further tax liability

If Geraldine had no other income, £12,500 of this gain will be within her Personal Allowance. Unfortunately, the tax paid internally by the insurance company cannot be reclaimed.

Death

An Investment Bond is a life policy and when the life assured dies the policy will end. 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 survivor becomes the sole owner. When that person dies the process is the same as for a single life bond.

The life assured and planholder 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 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. Assignment effectively 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 the trustees could assign the bond to another person without creating a tax liability for themselves. It also means that the recipient receives the legacy as a fund rather than cash.

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 but this is done by encashing units on a regular basis. The investor is therefore withdrawing capital.

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 2016 will be April 1 2016 to March 31 2017. In a question watch out for "the plan was taken out just over 6 years ago. This means it is in its 7th year.
- 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 February 1 2010 On March 1 2020 the policy is in its 11th year so up to 55% or £55K can be withdrawn without creating a tax charge.

Beth invested £100K in an IB on February 1 2010. On December 1 2012 the policy was in its 3rd year so she withdrew 15% or £15,000. On March 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 February 1 2007. On December 1 2010 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 March 1 2017 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

Any liability on Rachel will then be calculated in the normal way.

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 remember that 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.

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

Chargeable event

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.

Unit Trust/OEIC/Investment Trust/ETF v Insurance Bonds

The "wrapper" around a pooled investment determines its tax treatment and advisers should select which is more tax advantageous for the client.

The main benefit of using a collective, that is a non-insurance based one, is the ability to place it into an ISA. An Investment/Insurance Bond cannot be held in an ISA.

Tax on gains

A collective would seem to be better as the investor can use the annual CGT exemption which used judiciously could enable them to avoid CGT completely. Even if CGT becomes payable the rate will be either 10% or 20%.

With an Investment Bond the gain is chargeable as income and whilst a basic rate tax payer may not have any further liability, they have effectively paid 20% and any gain in the higher rate will be taxed at 40%.

The investor is only liable for tax on an IB when a chargeable event occurs which may be many years in the future. Therefore you need to consider what is the investor's likely tax status when the CE occurs. For example recommending an IB for a newly qualified accountant may not be appropriate as they are likely to be paying higher rate tax when a CE occurs.

Since tax paid within the bond cannot be reclaimed it is likely to be unsuitable for a non-tax payer.

One benefit of an IB is that switching between funds is not a chargeable event whereas selling a collective would be a gain for CGT even if the whole gain was then reinvested in another fund. So if someone uses the CGT exemption on a regular basis, an IB may be preferable.

Tax on income

Outside an ISA all income from a collective will be either dividend or interest and be taxable. The PSA can be used against interest and the Dividend Allowance but the income will have to be declared to HMRC.

No income is payable from an IB but the 5% withdrawal can be used on a tax deferred basis. This can be useful for a higher rate tax payer who wants an income but plans to encash the bond when they are retired and will be a basic rate tax payer.

The one time when an IB is likely to be the right wrapper is when it is used by a trust for the following reasons:

- Trustees have a duty to ensure there is diversification in their investments and one IB can use a variety of different funds.
- The trustees will not have to make any tax returns to HMRC until there is a chargeable event.
- They can avoid paying tax completely by assigning all or part of the bond to a beneficiary as this is not a CE

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