

AF1 Taxation of Investments 2022/23

Part 3b: Investment Bonds

This part will focus on the main non-qualifying policy, the Investment Bond. (Also often referred to as an Insurance/Assurance Bond)

The milestones are to understand:

- The key characteristics of Investment Bonds
- How to calculate an individual's income tax liability on full surrender
- Other chargeable events
- The 5% withdrawal rule and the use of segmented policies.
- The taxation of Offshore Bonds

Key characteristics

- 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.
- Investors can have a range of funds in one single Bond.
- 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. Ten years later 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 a 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 the final income to be taxed after an individual's non-savings, savings and dividend income. As this can push someone into the next tax bracket HMRC allow the gain to be averaged or spread over the whole period of investment using **top slicing relief**. This can reduce or eliminate the additional tax if the gain pushed a basic rate taxpayer into higher rate. 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.

The short method

In the first example Henry had made a gain of £44,000 over ten years. If His other income is already in the higher rate band the gain will be taxed at 40%. 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 $£44,000 \times 20\% = £8,800$

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

If Henry was 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 £50,270)
This is still within the basic rate band so no tax is due.

If Henry's total income was £1,000 below the HRT. 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, $£3,400 \times 10 = £34,000$.

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

If the HRT has been increased by grossed up pension contributions that threshold is used rather than the standard one. (Gift Aid contributions are ignored)

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 **but not grossed up Gift Aid**.

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 using the PSA and all available tax bands
- 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 complete years held.
- 4 Calculate the tax on the slice including the available PSA and tax bands. 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 from 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 using all available bands (steps 1 & 2)
2. Calculate the net tax on the slice using all available bands 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%	<u>£4,000</u>
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%	<u>£400</u>
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	<u>(£1,800)</u>
	£2,000

Using the old short method there would be no top slicing relief as he was already a higher rate taxpayer. His liability would be £4,000 (£20,000 @ 20%)

Under the new method he gets relief of £1,800 and a liability of £2,000

The next example will cover the situation where no PSA is available.

Everything is the same as in the last example but Ted now has £500 of taxable savings income so has used his PSA.

Step 1

Gain £20,000 @ 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's other income is £1,600 short of the Higher Rate Threshold 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. This pushes her into higher rate tax so the PSA is £500.

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%	<u>£8,960</u>
Individual liability		£9,180
Less tax credit	£24,000 @ 20%	<u>£4,800</u>
Relieved liability		£4,380

Step 3 & 4

Slice £24,000/8	£3,000	
PSA	£500 @ 0%	£0
Basic rate	£1,100 @ 20%	£220
Higher rate	£1,400 @ 40%	<u>£560</u>
		£780
Less tax credit	£3,000 @ 20%	<u>£600</u>
		£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	<u>(£2,940)</u>
	£1,440

If she had no PSA, 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.

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.

Take Care!

The first question in the September 2021 exam was an IB calculation but some candidates may have failed to get maximum marks because they didn't answer the question that was asked.

The individual was a basic rate tax payer before encashing the bond and the slice took them into higher rate. The temptation was to use the short method and calculate the tax due but the question asked candidates to "calculate the top slicing relief and the relieved tax liability" and not how much tax was payable.

Have a look at this question in the exam guide.

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

Saba has a pension income of £14,570 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 £74,570.

Steps 1 & 2

Basic rate band used £2,000

0% rate	£3,000	£0
PSA	£500 @ 0%	£0
Basic rate	£32,200 @ 20%	£6,440
Balance	<u>£22,300 @ 40%</u>	<u>£8,920</u>
	£60,000	£15,360
Less tax deducted		<u>£12,000</u>
Relieved liability		£3,360

Steps 3 & 4

Slice £60,000/10 = £6,000

0% rate	£3,000	£0
PSA	£500 @ 0%	£0
Basic rate	<u>£2,500 @ 20%</u>	<u>£500</u>
Total	£3,000	£500
Less tax liability		<u>£1,200</u>
		-£700

As this is a minus figure it is treated as zero so the TSR is £3,360

The end result is that she has no further liability

An individual starts to lose their personal allowance if ANI is above £100,000. This would result in a reduced basic rate band when calculating the tax on the whole gain and the slice. However, following an amendment in the 2020 Finance Act this was modified so at stage 4 an individual can benefit from a higher basic rate band

Alistair has a salary of £45,270 (that is £5,000 short of the HR and surrenders an IB making a gain of £160,000 that has been held for just over 8 years. Because his ANI is over £150,000 he has no PA or PSA.

His tax liability before using top slicing would be as follows

Salary £37,700 @ 20% =	£7,540
£5,000 @40%	<u>£2,000</u>
	£9,540

Bond

£112,300 @ 40% =	£44,920
£47,700 @ 45% =	<u>£21,465</u>
	£66,385

Steps 1 & 2

The gain on the Bond before top slicing is

	£66,385
Less tax credit £160K @ 20%	<u>£32,000</u>
	£34,385

Step 3

The top slice £160,000/8	£20,000
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Step 4

At this stage HMRC allow the top slice to be added to his salary of £45,270 to give a notional income of £65,270. This means his Personal Allowance **is restored for this step only**. The PA must be set against non-savings and not the gain.

Salary	£45,270
Less PA	<u>£12,570</u>
	£32,700

This means there is £5,000 of basic rate band left when the tax on the slice is calculated.

£5,000 @ 20%	£1,000
£15,000 @ 40%	<u>£6,000</u>
	£7,000
Less tax @ 20%	<u>£4,000</u>
£3,000 x 8 =	£24,000 (relieved liability)

Step 5

Top slicing relief is £34,385 less £24,000 = £10,385

His final liability is £66,385 less £32,000 (tax credit) less £10,385 =£24,000

Other 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.

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) as 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 true 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	<u>80,000</u>
	20,000
Plus 5% withdrawals	<u>20,000</u>
	£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 $£150 \times 100 = £15,000$

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.

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.

Xan has a salary of £49,270 and no taxable savings income. He has made a gain of £40,000 over 10 years in an offshore bond.

Tax on whole gain

PSA	£500 @0%	0
Basic rate	£500 @ 20%	£100
Higher rate	<u>£39,000 @ 40%</u>	<u>£15,600</u>
	£25,000	£15,700
Less £40,000 @20%		<u>£8,000</u>
		£7,700

Tax on slice (£4,000)

PSA	£500	
Basic	£500 @20%	£100
Higher	£3,000 @ 40%	<u>£1,200</u>
Total		£1,300
Less tax credit	£4,000 @20%	<u>£800</u>
Total		£500
X 10		£5,000

TSR £2,700

This is deducted from £15,700 to give a liability of £13,000

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 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 reaches 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 21/22 figures a gain of £18,570 (PA + £5,000 0% band + £1,000 PSA) could be made without incurring a tax liability.

That concludes this part so you should now understand:

- The key characteristics of Investment Bonds
- How to calculate an individual's income tax liability on full surrender
- Other chargeable events
- The 5% withdrawal rule and the use of segmented policies.
- The taxation of offshore bonds.

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/>

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