Wealth Management

# [ Invest ]


## The ican guide to investment bonds and UK tax

For Professional adviser use only

canada life

# Explains how investment bonds are taxed

Understand how both onshore and offshore investment bonds are taxed in the hands of a UK resident policyholder.

# The ican guide to investment bonds and UK tax

This guide is designed to help understand the tax position for UK residents of onshore bonds issued by Canada Life Limited and offshore bonds issued by Canada Life International Limited, CLI Institutional Limited and Canada Life International Assurance (Ireland) DAC.

**It covers general information for comparison purposes only and the position of UK resident individuals who are the original owners of the investment. Different rules may apply to other owners. Individual circumstances may affect the tax position of any client.**

## Onshore investment bonds

Canada Life Limited (CLL) is a UK resident life assurance company and issues investment bonds on a life assurance basis.

As a UK resident company, its investment funds are subject to UK corporation tax and the investment bonds issued by the company are, generally, only suitable for UK residents.

- A client can switch the underlying fund selection without generating a personal liability to capital gains tax (CGT), as the switch is done within the bond itself.
- Any dividend income received within a fund from UK equities is not subject to tax.
- The company pays tax of 20% on any interest and other income received, such as rental income.
- The company pays 20% tax on any capital gains.

Due to the tax suffered, HM Revenue & Customs (HMRC) treat the tax paid as the equivalent of basic rate income tax and, therefore, a tax liability will usually only arise for higher or additional rate tax.

## Offshore investment bonds

Canada Life International Limited (CLI) and CLI Institutional Limited (CLII) are fully authorised Isle of Man resident life assurance companies that have been granted tax-free status by the Isle of Man Government. Canada Life International Assurance (Ireland) DAC (CLIAI) is based in Ireland and is not subject to Irish tax where the policyholder is resident outside Ireland.

- A client can switch the underlying fund selection without generating a personal liability to capital gains tax (CGT), as the switch is done within the bond itself.
- Any dividend income received within a fund from UK equities is free of tax. Dividends from other countries may be subject to a withholding tax and this cannot be reclaimed by CLI, CLII or CLIAI.
- Neither CLI, CLII or CLIAI pay any local taxes in the jurisdictions in which they are based.

**HMRC do not make any allowance for any withholding tax suffered under an offshore bond.**

## Personal taxation of investment bonds

Under current UK legislation, profits realised from investment bonds are usually only taxed when they are taken out of a bond and no liability will exist for any growth or profit that accumulates within the bond.

Certain transactions are treated as chargeable events and when one of these occurs a chargeable gain calculation is required to establish any tax that may be due.

- Death of a life assured that gives rise to the death benefit becoming payable.
- Assignment for money or money's worth.
- Maturity.
- Excess withdrawals.
- Surrender.

In addition to these, HMRC may regard any substantial change to the bond as a chargeable event, such as adding or removing a life assured.

It should be noted that chargeable gains from investment bonds are assessable to income tax, not CGT.

CLL, CLI, CLII and CLIAI will normally issue bonds as a series of separate policies, allowing greater flexibility when wanting to withdraw money. This allows for withdrawals across all the separate policies or the full encashment of a certain number to achieve the desired amount

**It should be noted that chargeable gains from investment bonds are assessable to income tax, not CGT.**

## The 5% allowance and excess withdrawals

After investing in an investment bond it is possible to make withdrawals across all the separate policies. Each year there is an allowance of 5% of the amount originally invested, meaning that up to this amount can be withdrawn across all the separate policies without any immediate personal liability to tax. For tax purposes these withdrawals are treated as a return of capital.

Any unused 5% allowance can be carried forward, therefore should no withdrawals be made in the first year, 10% would be available in year two. If no withdrawals were made for the first two years, 15% would be available in year three, and so on. If no withdrawals are taken, in year 20 and thereafter an amount equal to the original investment would be available as a withdrawal, without any immediate personal liability to tax.

Withdrawing in excess of the 5% allowance would give rise to a chargeable event and the amount of the excess would be a chargeable gain, potentially subject to income tax. An assignment for money or money's worth in excess of the 5% allowance would also give rise to a chargeable event in a similar way. This is irrespective of the value of the bond, so a tax charge could exist even if the overall value of the investment has fallen.

When a large withdrawal is to be made it is important to consider the different methods available in order to help minimise any tax payable.

**Example – Exceeding the 5% allowance for withdrawals**

Mr Smith invests £100,000 in a bond on 1 June.
Four-and-a-half years later he makes a withdrawal of £36,000.
As the bond is in its fifth policy year the allowance is
(£100,000 x 5%) x 5 = £25,000.
The chargeable gain is the excess withdrawal:
£36,000 - £25,000 = £11,000.

If an investor makes sufficient withdrawals to fully use the 5% allowance, such as 5% each year for 20 years, any subsequent partial withdrawals are treated as a chargeable gain.

## Corporate investors

All life assurance policies (except pure protection policies) are treated for tax as a non-trading loan relationship of the company. Non-trading debts and credits are brought into account under the loan relationship rules and therefore UK limited companies are not able to utilise the 5% allowance as the chargeable events legislation does not apply.

## On the event of death

Bonds written on a life assurance basis include a small element of life assurance. On death of the sole or last life assured, the chargeable gain tax calculation is based on the surrender value immediately before death and not the death benefit.

Where a policyholder dies and there is either a surviving life assured or the bond is written on a capital redemption basis, the value of the bond would form part of the estate of the deceased policyholder, but there would be no chargeable event for the purposes of income tax.

## Surrendering or maturity

If a bond or individual policy ends by either maturity or by full surrender, any profit may give rise to a tax liability. If a loss occurs then no tax liability should exist, but neither is any tax relief available on the loss unless, in certain circumstances, there have been previous withdrawals (deficiency relief).

The formula for calculating the chargeable gain is **TB – (TD+PG)**, where:

- TB is the total value. The total value will include the surrender or maturity proceeds plus any capital sum such as any previous partial surrenders or withdrawals to date.
- TD is the total allowable deductions. This is the total amount invested into the policy before the surrender or maturity.
- PG is the total amount of gains treated as arising on calculation events occurring before the surrender or maturity. This is the total amount of previous chargeable excesses created by partial withdrawals in excess of the 5% allowance.

**Example – Surrendering a bond**

Mrs Jones invests £100,000 in a bond and it is surrendered after 10 full years.
No withdrawals or partial surrenders have been made and the surrender proceeds are £250,000.
The calculation would be:

**TB** = £250,000 + £0 = **£250,000**

**TD** = £100,000 + £0 = **£100,000**

**PG** = **£0**

**Chargeable gain** = £250,000 – (£100,000+£0) = **£150,000**

If Mrs Jones had taken partial withdrawals of £5,000 each year and the final proceeds were £190,000, the calculation would be:

**TB** = £190,000 + (£5,000 x 10) = **£240,000**

**TD** = £100,000 + £0 = **£100,000**

**PG** = **£0**

**Chargeable gain** = £240,000 – (£100,000+£0) = **£140,000**

If Mrs Jones had taken partial withdrawals of £6,000 each year and the final proceeds were £180,000, the calculation would be:

**TB** = £180,000 + (£6,000 x 10) = **£240,000**

**TD** = £100,000 + £0 = **£100,000**

**PG** = £1,000 x 10 = **£10,000**

**Chargeable gain** = £240,000 – (£100,000+ £10,000) = **£130,000**

## Time apportioned reductions

For those clients that hold an investment bond, if they are non-UK resident for any time between the start of the bond and the date of the chargeable event, any chargeable gain will be reduced proportionately.

The formula used to reduce the chargeable gain liable for tax is:

$$\textbf{Total gain x } \frac{\textbf{Total number of days resident in the UK}}{\textbf{Total days bond has been in force}}$$

Therefore, as an example, if a client holds a bond for 10 years but has been living abroad for five years during the investment term, the chargeable gain is effectively reduced by half (ignoring leap years).

The period of non-residence is excluded from any top slicing calculation (see below).

If a client is non-UK resident for tax purposes in the tax year of a full surrender, irrespective of the type of bond, no UK tax should be payable on any gain provided that non-residence has been for at least five years.

## Top-slice relief

When calculating a client's tax liability, it is possible to use top-slice relief to potentially reduce the tax payable on the chargeable gain. This makes an allowance for the fact that any profit from a bond has been made over the number of years the bond has been held. This facility is not available when calculating the tax liability if it is being assessed on trustees.

Any chargeable gain is divided by the number of complete policy years of the investment term.

**Example – Top-slice relief 1**

Using the first example with Mrs Jones, her chargeable gain was £150,000.

This had been made over a 10 1/2 year period.

Using top-slice relief, the gain is deemed to be £15,000 a year.

As an offshore bond does not suffer tax within the investment, if the whole gain is within the client's current income tax band when added to their other income, then the gain is taxed at the client's highest rate. An onshore bond suffers tax within the investment, so the client does not pay basic rate tax on the gain.

Where a tax liability exists after top-slice relief, it is deemed that this 'slice' has been earned each year the investment has been in force and therefore the liability needs to be multiplied by the number of complete policy years.

When a withdrawal in excess of the cumulative 5% allowance has been taken, the gain from an onshore bond is top-sliced back to the most recent previous excess chargeable event or the start of the investment.

Top-slicing for an offshore bond taken out before 6 April 2013 will go back to the start of the investment irrespective of whether a chargeable event excess has occurred since. However, where the offshore bond is taken out on or after 6 April 2013 (or, if taken out before then and is varied, assigned or held as a security for a debt after that date), the gain is top-sliced back to the most recent previous excess chargeable event or the start of the investment.

## Personal allowances, tax credits and other state benefits

As any chargeable gain under an investment bond is potentially taxable as income, it can have a knock-on effect to other calculations.

These are important considerations as, whilst a tax charge may not appear likely, an increase in income could potentially change a client's tax position. The full amount of a chargeable gain (without top slicing) counts towards income.

### Personal allowance

Anyone with income over £100,000 will see their personal allowance reduce by £1 for every £2 of income over £100,000. Under this rule, the personal allowance can potentially reduce to zero. However, within the top-slicing calculation for gains arising on or after tax year 2018/19 the personal allowance is recalculated using the client's total income and the top-sliced gain.

### Personal savings allowance

Non and basic rate taxpayers are entitled to an allowance of £1,000 each year against savings income. This reduces to £500 for higher rate taxpayers and disappears altogether for additional rate taxpayers.

A chargeable gain can therefore take a taxpayer into a higher band and reduce or remove the entitlement to this allowance.

### UK dividend income

When considering a client's income tax calculation whilst any gains from both offshore and onshore bonds are treated as savings income, gains on offshore bonds are taxed before dividend income.

A chargeable gain from an offshore bond can therefore increase the amount of savings income and mean that UK dividend income in excess of the dividend allowance could be pushed into a higher tax band. So, whilst there may not be any tax on the investment bond chargeable gain, the tax payable on UK dividend income in excess of the dividend allowance could increase due to the gain. Remember if there is any unused personal allowance it is placed against the savings and dividend income in the manner most beneficial to the client.

Gains from onshore investment bonds, whilst treated as savings income, are included in the calculation after UK dividend income, even if it is within the dividend allowance due to the tax credit attached to them.

### Capital gains tax

When determining the rate of capital gains tax an investor pays, the top-sliced gain is added to their income. The gains from onshore and offshore investment bonds can potentially push capital gains in excess of the annual exempt amount into the higher tax rate.

Again, whilst there may not be any tax on the investment bond chargeable gain, the tax payable on capital gains in excess of the annual exempt amount could increase due to the gain.

### Tax credits and other state benefits

It is important to consider the state benefits and tax credits an individual may receive as some can be means-tested (dependent on their level of income). An increase in income (including the full amount of a chargeable gain without top slicing) could affect a client's entitlement to some benefits and it is important to check these. It can also give rise to a High Income Child Benefit Tax Charge and may require the repayment of a student loan.

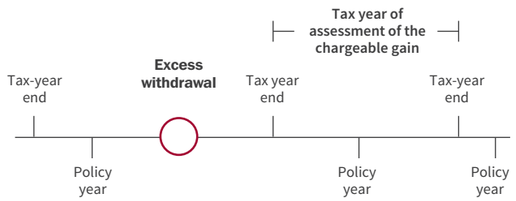


## Timing of tax liability

### Excess withdrawals or partial assignment for money or money's worth

Any liability is deemed to occur on the last day of the policy year and, therefore, it could potentially be chargeable in the tax year following the chargeable event.

For example, if a partial surrender was taken on 4 March and the policy anniversary was 7 July, the chargeable event would occur in the tax year following the excess withdrawal rather than the tax year in which it occurred.




### Maturity, full surrender, full assignment for money or money's worth, or death giving rise to benefits payable

Any tax liability is chargeable in the tax year in which the event occurs.

When a policy year starts and the policy is surrendered or matures in the same tax year, then the final policy year and the year preceding it are treated as one and any partial withdrawals during that time are added to the surrender value. This means that if an excess chargeable event arises in the same tax year as a subsequent surrender, it is only the final calculation on surrender that is taken into account.

For example, where a bond has a policy anniversary of 1 September and is fully surrendered on 1 December, as both are in the same tax year the final policy year will run for 15 months; September to the December of the following calendar year.

## Responsibility for any tax liability

Any potential tax liability is payable in the following order:

1. Where a policy is owned by an individual or held in a relevant property trust created by that individual, then that individual is liable to the tax. If the policy is held under a bare trust the beneficiary is liable to the tax, as the beneficial owner of the bond, unless the donor is a parent of the beneficiary and the chargeable event occurs while the beneficiary is an unmarried minor.
2. If that individual is non-resident or has died in a previous tax year and the policy is held in a relevant property trust created by that individual, then the trustees are liable for the tax if they are UK resident. In this instance the first £1,000 is taxed at the basic rate of income tax and anything over this at 45%. In addition to this, trustees are not able to use top slicing relief to reduce the tax payable.
3. If the trustees are all non-UK resident, the UK resident beneficiaries of the trust, to the extent that they receive benefit, are liable for the tax.

If the bond is jointly owned, then each owner is liable to tax on the chargeable gain in the same proportion that they own the bond. For example, a married couple could each be taxable on 50% of the gain.

## Calculating the tax liability

Once the chargeable gain is known it is added to the client's income to determine any potential tax liability.

- **Onshore bond**

  Due to the taxation of the underlying investment fund, an onshore bond is deemed to have already paid basic rate income tax. Providing the top-sliced gain falls under the higher rate tax threshold there should be no additional tax liability.

  If the top-sliced gain takes the client from basic to higher rate or higher rate to additional rate when added to the client's income then top slicing relief will be available.

- **Offshore bond**

  As no tax is deemed to have been paid within the investment, the whole amount is potentially taxable as income.

  If the whole gain when added to income keeps the client within the same income tax band then the gain is taxed at the highest rate for the client, apart from any that falls within the personal allowance, the starting rate of income tax or the personal savings allowance.

  If applicable, the number of years used for top-slicing relief is reduced for any years in which the policyholder was non-UK resident for tax purposes.

### Onshore bond

Mr Smith, aged 49, invests £50,000 into a onshore bond. After 5½ years he decides to encash the bond and take the surrender proceeds of £75,000; a profit of £25,000. His income for the current tax year from all sources is £20,000.

- **Personal allowance**

  To calculate Mr Smith's income, the whole gain is added to his income. Therefore, for the current tax year, his income is £20,000 + £25,000 = £45,000. As his income is below £100,000 the standard personal allowance remains unchanged.

- **Additional tax liability**

  The gain can be top-sliced. Therefore, the annualised gain is £25,000 ÷ 5 complete policy years = £5,000. Added to his current year's income this gives a total of £25,000.

This is still within the basic rate tax band and, as the bond is deemed to have paid basic rate tax, no further tax liability exists.

### Offshore bond

Mr Smith, aged 49, invests £50,000 into an international bond. After 5½ years he decides to encash the bond and take the surrender proceeds of £80,000; a profit of £30,000. His income for the current tax year from all sources is £30,000.

- **Personal allowance**

  To calculate Mr Smith's income, the whole gain is added to his income. Therefore, for the current tax year, his income is £30,000 + £30,000 = £60,000. As his income is below £100,000, the standard personal allowance remains unchanged, although his personal savings allowance will be reduced to £500.

- **Additional tax liability**

  The gain can be top-sliced. Therefore, the annualised gain is £30,000 ÷ 5 complete policy years = £6,000. Added to his current year's income this gives a total of £36,000.

Effectively, the whole gain is taxed at 20% but the top slicing calculation must be followed. Please refer to our calculating tax on a chargeable gain briefing note.



## Tax-efficient release of capital

When a policyholder wants to take a lump sum from the investment, this can be done in two ways; by surrender of individual policies or by taking withdrawals. The tax liability for each is calculated differently and can have different results.

**Example**

Mrs Stone invested £100,000 into a onshore investment bond 4½ years ago which has fluctuated in value and is now valued at £90,000. The policy was written with 100 individual policies. Therefore, each had an initial investment of £1,000 and a current value of £900.

She wants to withdraw an amount of £45,000. Her yearly income is £60,000.

The following examples show the two different ways of providing the required capital, each with its own tax implications.

### Withdrawals

The 5% allowances available are:

£100,000 x 5% x 5 years = £25,000

As the first £25,000 of the withdrawal is covered by the 5% allowance, the chargeable gain would be the excess of £45,000-£25,000 = £20,000.

A £20,000 gain would arise at the end of the policy year and Mrs Stone would be taxed accordingly.

### Surrendering individual policies

To provide the required amount Mrs Stone could combine her 5% withdrawals with the surrender of individual policies.

For example, the surrendering of 31 policies would provide 31 x £900 = £27,900. As each policy has shown a loss of £100 and suffered basic rate tax within the policy, no personal tax liability would exist.

The 5% allowance from the remaining 69 policies would provide £1,000 x 5% x 5 years = £17,250. As these withdrawals would be classed as a return of capital, no personal tax liability would be generated.

The total realised from this strategy would be £45,150.

**As no chargeable gain occurs on either the surrender or excess withdrawal there is no tax liability.**

This example shows it is evident that, when considering taking a lump sum from an investment bond, it is important to consider the tax implications of the different methods available.

The contents of this guide are based on Canada Life Limited and Canada Life International Limited's understanding of tax legislation as at March 2020 and may be subject to change. We recommend that investors take their own professional tax advice.

If you have any questions regarding this document please contact your account manager, or email **Canada Life's Technical Support Team** on **ican@canadalife.co.uk**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