Three reasons to choose a UK investment bond

UK investment bonds have, for too long, been overshadowed by alternative tax wrappers and the perception that tax within a life fund is a disadvantage. This thinking can automatically discount an investment solution that can be very favourable, especially when you consider the tax changes over recent years. UK investment bonds can offer the right client significant tax advantages, coupled with flexibility.

A credit for tax-free dividend income

In 2016 the Government changed the way in which dividend income was taxed. Due to the higher levels of corporation tax in the past there was a notional, non-reclaimable, 10% basic rate income tax on dividend income which was treated as paid, even though nothing was actually paid. As corporation tax fell, this needed to be reviewed. So, in April 2016, the Government removed this withholding tax but, to soften the impact for investors, the dividend allowance was introduced with only excess dividend income over this amount being subject to tax.

In reality the dividends paid by companies did not change in monetary value, but anything over the dividend allowance became taxable, so some portfolios were restructured to maximise the use of the allowance. Initially set at £5,000, a portfolio of around £147,000 with a 3.5% yield would use up the allowance. In April 2018 the allowance was reduced to £2,000, which now means that an investor's portfolio would need to be reduced to less than £60,000 to use the allowance. In addition to this, where the dividend allowance was used by dividends from a person's own company, their income tax liability increased.

But what does this have to do with bonds, I hear you ask? Dividend income received in a fund is not subject to tax although, in the past, life funds were deemed to have paid 10% withholding tax which was non-reclaimable. Consider an equity income fund – the income is tax free and any gains are subject to 20% tax, however any gains realised come with a 20% tax credit.

Taking a simplistic look at this and keeping within the FCA growth rates (of course), an equity-based portfolio with a 3.5% yield and 1.5% capital growth would produce a net yield of 4.7%. This would effectively be after paying 20% income tax. To achieve this in an environment without a tax credit, where the return is subject to 20% tax, the required yield would be 5.87%. A higher rate taxpayer will only pay 20% tax on the net gain, so the gross yield for them would be 6.78%.

Removal of indexation – so what?

Another recent change for life funds was the freezing of the indexation factor on gains made in an equity fund – no indexation exists under fixed interest or cash assets. A life fund pays corporation tax on the interest received in the fund and any capital gains in the fund – gains that are either realised or those that are deemed gains. Equity-based investments held by a company are deemed to be sold and repurchased at the end of the company financial year and the gains can then be spread over a seven year period.

The gains made by equity-based investments were indexed in line with RPI. However, following the Autumn Budget in 2017, the UK Government announced the freezing of the indexation factor, so companies no longer benefitted from any indexation after December 2017. The impact of this change was covered in the budget documents and showed the tax revenue increasing over the next five years, starting at £165m in 2018/19, £265m in 2019/20 and so on.

Whilst this increase in revenue for the Treasury is a significant amount of money, when you consider the amount of money invested in equities by companies, it is not a large percentage. These investments will include assets held by life companies, family investment companies or any other company which chooses to hold an equity-based investment.

Financial Express data shows that the assets in the ABI All Companies sector to be worth around £18bn. If you consider global equity funds and the holdings in various managed funds, specialist and with profits funds, then the tax-take spread across all these funds is relatively low, as is the impact on individual policyholders.

Impact with other investments

UK bonds can also offer an advantage where the same client may hold investments in other tax wrappers. This can be a very common scenario and relates to the order of taxation and where chargeable gains fall in the income tax calculation.

HMRC tax calculation summary notes [SA110] detail the order in which income is taxed. First is non-savings non-dividend income, then comes savings income, dividend income and finally life policy gains where tax is treated as paid.

Bond gains are savings income and many advisers who use international bonds will understand that gains fall into the calculation with other savings income where no tax has been suffered, which is before any dividend income. This can provide advantages for those who can offset gains against the personal allowance and the starting band of income tax, however there can be implications for any dividend income the client may receive in the same tax year.

Example:
Eric has pension income of £25,000 and dividend income of £5,000.

- His non-savings, non-dividend income uses up the personal allowance of £11,850 and is not eligible for the starting rate, so the remaining £13,150 is taxable at 20%.
- The first £2,000 of dividend income uses his dividend allowance and the remaining £3,000 is taxed at 7.5% = £225.

His income tax liability is £2,855.
Let us look at two scenarios where investment bond gains have been made over a 5 year period.

Scenario 1 - He realises a gain of £20,000 from an international bond.

- His pension income still uses the personal allowance and the remaining £13,150 is taxed at 20%.
- The bond gain falls into the basic rate band and, due to top slicing, there is no higher rate liability, so the whole gain is taxable at 20% = £4,000.
- The dividend income sits on top of the pension income and bond gain, so the first £2,000 uses the dividend allowance and the remaining £3,000 is taxable at 32.50% = £975.

Eric's income tax liability increases to £7,605. This is caused by the £4,000 payable on the bond gain and the increase in tax on his dividend income from £225 to £975.

Scenario 2 - He realises a gain of £18,000 from a UK bond.

- Again, the pension income uses the personal allowance with the remaining £13,150 being taxed at 20%.
- The first £2,000 of dividend income uses his dividend allowance and the remaining £3,000 is taxed at 7.5% = £225, as this still falls within the basic rate tax band.
- The bond gain sits on top of all the other income and, due to top slicing, it all falls into the basic rate band. As the gain has a basic rate tax credit, it is deemed paid and so no additional income tax is payable.

Eric's income tax liability remains at £2,855, despite realising a gain of £18,000 from a bond.

Although a simple example, this does highlight the importance of the order in which income is taxed. Whilst there may be tax on a chargeable gain, it can impact other income and cause that to be taxed at a different rate, inadvertently increasing an individual's overall tax liability.

In addition to these areas, with a suitable exit strategy the tax on any chargeable gain can be minimised or even removed, whether the bond is through a UK or non-UK provider. This could be a whole separate article and no doubt will be.

Bonds are classed as non-income producing assets and, when assessing a chargeable gain, in general the tax position of the client in the year of assessment is deemed to have applied in each of the policy years.

This can provide distinct advantages for some clients, especially those who may fall into a lower income tax band in future years when the gain is being realised. This could be a client who is a higher rate taxpayer during their working life and becomes a basic rate taxpayer in retirement. Such scenarios are becoming more popular as the introduction of the pension freedoms allows people to manage their income in a flexible way and manipulate the taxable and tax-free elements in order to reduce the potential tax payable on other investments.

A bond offers different ways in which a policyholder can realise money either through segment surrenders or partial surrenders. The client, with the adviser's help, can choose the most tax efficient method. The tax payable can differ greatly and HMRC has even introduced legislation so that taxpayers can appeal against wholly disproportionate artificial gains which may have been incurred by taking large partial surrenders in error.

Another way of reducing the tax payable on surrender is the ability to assign a gift. Other types of investments cannot be easily gifted, although hold over relief can be available in some instances.

Whilst there is an old saying regarding the 'investment tail of a tax dog', the effective use of tax wrappers can help increase the net return to an investor. In most cases, if not all, there will be an argument that an investor should use a variety of tax wrappers in order to maximise tax efficiency and utilise the various allowances they have available. It is therefore wrong to dismiss any particular wrapper without fully taking into account each investor's circumstances.

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