ADVISER FACTSHEET

JAMES HAY PARTNERSHIP

Guide to offshore bonds

Introduction

The purpose of this factsheet is to give you information about the use of offshore bonds as an investment vehicle, so that you can effectively consider their use when recommending tax and investment strategies to your clients.

What is an offshore bond?

For UK tax purposes, an offshore single premium investment bond is a non-qualifying policy which can be written on either a life (whole of life) assurance or a capital redemption basis.

Where a policy is written on a life assurance basis, the policy will come to the end on the death of the sole or last surviving life assured. Of course, the policy can be surrendered at any time, but may be subject to the deduction of early surrender fees over a specific period.

Where a policy is written on a capital redemption basis, it has a fixed term and a guaranteed surrender value at the end of that term.

As with a life assurance policy, a capital redemption policy can be surrendered at any time, subject to any early surrender fees that may apply.

Access

It is possible to withdraw up to 5% of the total premiums paid into a bond each policy year for 20 years, without your client incurring an immediate liability to income tax. If the 5% allowance is not fully used in a given policy year, the unused allowance carries forward to the next policy year on a cumulative basis. There is no need to detail these withdrawals on your client's self assessment tax form until the bond is surrendered or withdrawals in excess of the 5% allowance are taken.

Investment flexibility

An offshore bond could be a suitable investment vehicle for those clients that require a broad investment choice. Offshore bonds offer a much more expansive choice in comparison to most onshore counterparts. If your client demands a choice between thousands of investment funds, including pooled funds such as unit trusts and open-ended investment companies (OEICs), institutional funds, hedge funds, cash deposit accounts and many more, then an offshore bond may be worthy of your consideration.

Taxation

Offshore bonds are designed to accumulate income and gains within their funds. Consequently the owners of such bonds do not have an ongoing liability to tax if benefits are not taken. There is no tax liability on switching between the underlying funds, should investment conditions and/or individual circumstances change. However, any withholding tax levied at source on certain investment funds cannot be reclaimed. Apart from this, the policy allows for gross roll-up of investment income and capital gains.

Any gain on an offshore bond is subject to the Chargeable Events legislation. A chargeable event arises:

- In the case of a life assurance bond, on the death of the sole or last surviving life assured
- In the case of a capital redemption bond, on the maturity of the bond
- Upon the total surrender of the bond (or any policy segment)
- Upon the assignment of the bond in exchange for money or money's worth
- Upon any excesses on partial surrenders arising in any policy year (i.e. taking more than 5% each year of the total investment paid into the bond)

The assignment of an offshore bond to an individual aged 18 or over does not trigger a chargeable event for Income Tax purposes unless it is for money or monies worth. It is also not a disposal for Capital Gains Tax purposes. These are important considerations where your clients may wish to implement an Inheritance Tax or Income Tax planning strategy.

Top slicing

Top slicing can be applied where the gain pushes a basic rate taxpayer into the higher rate bracket. If, after adding the slice to a client's other taxable income, they remain within the basic rate tier, then the whole gain would be subject to income tax at 20% (for the 2019/20 tax year).

If a client is already a higher rate taxpayer, then top slicing will have no effect as higher rate tax would be paid on the whole of the gain. Below is an example of how top slicing could work for your clients.

EXAMPLE

Your client has £34,500 of taxable income and has made a gain of £15,000 on their offshore bond, which they have held for three complete policy years.

The top sliced gain equals £15,000 divided by 3 (number of complete policy years), resulting in a £5,000 slice.

Your client's total taxable income is £34,500, and the higher rate threshold for 2019/20 is £37,500. Effectively, part of the slice is within the basic rate and part is within the higher rate. Top slicing allows tax to be applied proportionately at different rates on each slice.

As a result, £3,000 is within the basic rate of tax and £2,000 within the higher rate.

£3,000 x 20% = £600

£2,000 x 40% = £800

The total tax on the slice is £1,400 (£600 + £800) which is effectively a tax rate of 28% ((£1,400/£5,000) x 100). As the bond has been in force for three policy years, £1,400 is multiplied by 3 to arrive at the final tax payable on the gain of £4,200.

For offshore bonds taken out from 6 April 2013 they will follow the same top slicing rules as onshore bonds. Top slicing will only be available going back to the date of the last chargeable event and not back to the start of the bond as is the case for offshore bonds taken out before 6 April 2013.

Time Apportionment Relief

This relief applies where an offshore bond is held by a chargeable person who is UK resident for only a part of the period between the policy's inception and the chargeable event. Where this happens any chargeable gain is proportionately reduced based on the number of days absent from the UK divided by the number of days since the policy commenced.

Time apportionment relief is only available to individuals and cannot be claimed if the policy has ever been owned by a non-UK resident trustee.

Also, this does not apply to offshore bonds issued as life assurance policies before 18 November 1983, or capital redemption policies issued prior to 23 February 1984, as a basic rate tax credit is available for these.

Corresponding Deficiency Relief

It is not possible to offset the loss on one offshore bond against a loss on another offshore bond, but it is possible to offset it against other income which falls into the higher rate tax bracket.

This relief is called 'Corresponding Deficiency Relief'.

However, there is a limit on the amount of income subject to higher rate tax against which the loss on an offshore bond can be offset. This is determined by the amount of any previous chargeable gains. The amount used to offset against higher rate tax cannot be any more than the total amount of the previous chargeable gains.

EXAMPLE

Client invests £50,000 into an offshore bond.

The policy runs for 5 complete policy years and the client withdraws 5% every policy year with the exception of the third policy year when they withdraw 10%. 10% of £50,000 = £5,000. £2,500 of this is within the cumulative 5% but £2,500 would be a chargeable excess gain and taxable.

Therefore, if upon surrender there was a loss of £6,500 and they had £5,000 worth of income outside the bond which would be subject to higher rate tax, then they are entitled to offset some or all of their higher rate tax liability against the chargeable gains on the bond. The higher rate liability on the £5,000 income could be reduced by £2,500 saving £500 in tax. An important point to remember is that the amount of the bond loss used to offset tax on other income cannot exceed the sum of previous chargeable gains.

Also, this relief can only be used by individuals and can only be claimed by the person who has actually suffered the chargeable gain. For example, chargeable gains suffered by one policy owner cannot be used by any subsequent policy owner following an assignment.

Opportunities for income tax planning using an offshore bond

Most offshore bonds can be issued as multiple policies (say a 100 individual segments). Whilst only one policy document is issued, each segment represents a policy in its own right. This affords greater flexibility especially when it comes to Income Tax and estate planning.

Where the cumulative 5%s have been fully utilised, the surrendering of segments can sometimes result in a lower income tax liability. This is because only the gain on each segment is liable to income tax as opposed to a partial encashment where the entire excess over the cumulative 5% allowance is liable for tax.

Suitability

How can the features of an offshore bond be used to meet your clients' financial objectives?

The high net worth individual

Consider:

- the benefits of gross roll-up.
- the absence of a policyholder tax charge until a chargeable event occurs.
- the ability to take part-surrenders of the bond within a cumulative 5% of the premium each policy year without triggering an immediate tax charge.
- the ability to select the time at which a tax charge arises.
- the ability to change investment strategy without a capital gains tax charge.
- the possibility of using the bond, with a suitable trust, as part of an inheritance tax planning strategy.
- offshore bonds may be suitable for clients who wish to top up their existing pension arrangements because offshore bonds suffer no internal taxation apart from non-reclaimable withholding tax on certain investment income.

The (potential) retiree

Consider:

- the absence of a policyholder tax charge until a chargeable event occurs.
- the benefits of gross roll-up.
- the possibility of top-slicing relief should a chargeable event occur whilst the policyholder is a UK tax resident.
- the ability to take part-surrenders of the bond within a cumulative 5% of the premium each policy year without triggering an immediate tax charge.
- the possibility of using the bond, with a suitable trust, as part of an inheritance tax planning strategy.
- the ability to select the time at which a tax charge arises.
- the ability to change investment strategy without a capital gains tax charge.
- offshore bonds may be suitable for clients who wish to top-up their existing pension arrangements because offshore bonds suffer no internal taxation apart from non-reclaimable withholding tax on certain investment income.

The trustee

Consider:

- the benefits of gross roll-up.
- the absence of a policyholder tax charge until a chargeable event occurs.
- the ability to take part-surrenders of the bond within a cumulative 5% of the premium each policy year without triggering an immediate tax charge.
- the ability to select the time at which a tax charge arises.
- the possibility of assigning (transferring) a bond to a beneficiary (aged 18+), without triggering a tax charge.
- the ability to change the trust's investment strategy without a capital gains tax charge.
- reduced trust administration in respect of self assessment tax returns as a bond is a non-income producing asset.

Important notes

Please note that every care has been taken to ensure that the information provided is current and in accordance with our understanding of current law and Her Majesty's Revenue and Customs' (HMRC) practice as at April 2019. You should note, however, that we cannot take upon the role of an individual taxation adviser and independent confirmation should be obtained before acting or refraining from acting upon the information given. The law and HMRC practice are subject to change.

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