JAMES HAY PARTNERSHIP

UK Taxation of Offshore Single Premium Bonds

Non-qualifying policies

For tax purposes, an offshore single premium investment bond is a non-qualifying life assurance policy. Investment bonds are designed to accumulate income and gains within their funds. Consequently, policyholders do not have an ongoing liability to tax if benefits are not taken. In any event, the normal Capital Gains Tax rules, which apply to most UK investments, do not, in most circumstances, apply to investment bond capital. Special rules were introduced in the form of "chargeable events" which, when they arise, give rise to a potential charge to income tax.

Circumstances where a tax liability may arise

For non-qualifying policies, a chargeable event will occur on:

i) the death of the life assured, or last life assured in the case of last survivor policies

ii) the maturity of the policy

iii) the total surrender of the policy

iv) the assignment of the policy in exchange for money or money's worth

v) any excesses on partial surrenders arising in any policy year

vi) a personalised bond, a gain will arise on the final day of the policy year

vii) a fundamental reconstruction of the policy (i.e. changing a life assured).

Calculation of the gain

When all the benefits are taken from a bond by way of maturity, full surrender, death or assignment for money, the amount chargeable to tax is calculated using the following formula:

[surrender value *plus* all previous withdrawals] *less* [total premiums paid *plus* all previous chargeable excesses].

Where the chargeable event is as a result of the death of the life assured (or last life assured) the taxable gain (if any) is calculated following notification of death and will not include any additional life cover.

EXAMPLE 1

Gain = [a + b] – [c + d]

Where

a = surrender value
b = all previous withdrawals
c = total premiums paid
d = all previous chargeable excesses

i) Initial premium £45,000

Surrender value after 10 years = £89,000

Gain = [£89,000 + £0] – [£45,000 + £0]

Gain = £44,000

ii) Initial premium £45,000

5% withdrawal each year for 10 years
i.e. £45,000 x 5% x 10 = £22,500

Surrender value after 10 years = £66,500

Gain = [£66,500 + £22,500] – [£45,000 + £0]

Gain = £44,000

iii) Initial premium £45,000

6% withdrawal each year for 10 years
i.e. £45,000 x 6% x 10 = £27,000

Surrender value after 10 years = £62,000

Chargeable excess = 6% (£2,700) – 5% (£2,250) x 10 = £4,500

Gain = [£62,000 + £27,000] – [£45,000 + £4,500]

Gain = £39,500

Partial surrenders

For each premium paid into an investment bond, an amount equal to 5% of that premium can be withdrawn each policy year for 20 years without an immediate liability to income tax.

If this 5% notional allowance is not fully used up in any year, the unused allowance will be carried forward to the next policy year and so on, on a cumulative basis. The total allowance is limited to 100% (5% x 20 years) of each premium paid.

Where a partial surrender is made, the total amount withdrawn in that policy year will be compared with the cumulative total of unused 5% allowances at the end of that policy year and any excess will be the chargeable gain which may be liable to tax. It should be noted that where a partial surrender is taken the chargeable event (if applicable) occurs on the last day of that policy year.

EXAMPLE 2: PARTIAL SURRENDER

£45,000 premium

Year 3, partial surrender of £10,000 is taken

Cumulative allowance at the end of year 3 =
£45,000 x 5% x 3 = £6,750

Therefore the taxable excess =
£10,000 – £6,750 = **£3,250**

Policy segmentation

Most investment bonds can be issued as multiple policies (normally up to 100 individual segments). Whilst only one policy document is issued, **each segment represents a policy in its own right**. This gives the investment bond greater flexibility especially when it comes to tax and estate planning. The calculation to determine chargeable excesses ignores actual investment performance. In Example 2, it may be in the investor's interest to make a withdrawal by way of full surrender of individual segments rather than by partial surrender. N.B. surrendering a segment will reduce the original premium on which to calculate the 5% p.a. allowance.

EXAMPLE 3: FULL SURRENDER OF SEGMENTS

£45,000 premium (100 segments)

Current value £50,000 (i.e. £500 per segment)

Year 3 £10,000 is taken by surrendering 20 policy segments

Initial premium = £9,000 (20 segments)
Surrender value = £10,000

Chargeable gain = £10,000 – £9,000 = **£1,000**

Personal Portfolio Bonds (PPB)

In simple terms, a PPB is a life assurance or capital redemption policy which gives investors the freedom to invest in a wide range of assets beyond those described within the PPB legislation.

For example, where a UK resident policyholder invests in equities through their policy, the PPB legislation imposes a yearly tax charge on the PPB deemed gain. The PPB deemed gain is not based on actual gains. It assumes a gain of 15% of the premium and the cumulative gains for each year the policy has been in force. The tax charge on the PPB deemed gain will be at the highest rate of tax paid by the investor without top slicing relief.

Calculation of the tax liability on a chargeable gain

Top-slicing relief allows individuals to potentially avoid paying higher rate or additional rate income tax, on some, or even possibly all, of a chargeable gain on a bond. In the simplest of terms, where a bond is being fully surrendered, the relief works by averaging the gain over the number of years the gain has accrued, rather than taxing the full gain in the tax year it's crystallised.

The full calculation can be broken down into six steps. Before looking at the steps please note the following key points and rules.

Key points in relation to the personal allowance (PA), starting rate for savings (SRSB) and personal savings allowance (PSA)

If an individual's Adjusted Net Income (ANI) exceeds £100,000, then their PA is tapered by £1 for every £2 of income above this amount. So, for tax year 2021/22, where ANI exceeds £125,140 then the PA of £12,570 is lost completely. ANI is your total taxable income, including full chargeable gains, less certain tax reliefs such as trading losses, pension contributions paid gross, grossed up pension contributions where relief has been given at source and gross Gift Aid payments. So the ANI using the full gain is used for calculating the amount of PA available in both Steps 1 & 2, but for gains on or after 6 April 2018 when calculating the tax liability on the top slice at Step 4, it's the top sliced gain that is used for determining the ANI and therefore the PA (see example). Before 6 April 2018 it was the full gain that was used.

The tax free SRSB of £5,000 is reduced by £1 for every £1 of non-savings income (e.g. earnings, pension income, or rental profits) above the available PA. So, in the 2021/22 tax year for example, if non-savings income is £14,570, the £2,000 above the PA reduces the SRSB from £5,000 to £3,000.

The PSA is applied after the SRSB. Where the individual is a basic rate taxpayer, then the first £1,000 of savings income is tax free. If they are a higher rate taxpayer, then the first £500 is free of tax. The PSA is not available to additional rate taxpayers. The full chargeable event gain is always used to determine the level of the PSA, even when calculating the tax liability on the top slice at Step 4 (see example).

Rules when calculating top slicing relief (Steps 2 & 4)

When calculating top-slicing relief the gains on both offshore and UK bonds are taxed after dividends, forming the highest part of income.

UK bond funds have paid corporation tax on income and gains so benefit from a non-refundable 20% tax credit. As income and gains on offshore bonds have not been subject to UK corporation tax there is no tax credit available.

The general rule that deductions are treated as reducing income from different sources in such manner as will result in the greatest reduction in income tax liability, is disapplied for the purposes of top slicing calculations. Deductible reliefs and allowances in Steps 2 & 4 can only be set against the full, or the top sliced, gain to the extent that they cannot be set against other income.

Relief under Gift Aid and relief for gifts of property to charities are ignored when calculating top slicing relief.

Step 1 – Establish the total taxable income and total income tax for the year and how much of the PA, SRSB and PSA are available.
First work out the ANI for the tax year which includes the full chargeable gain. From this figure you establish the individual's entitlement to the PA, SRSB, and PSA. Then calculate the income tax liability using the normal order of income rules. It's important to note that at this stage gains on offshore bonds are taxed before dividends, and gains on UK bonds are taxed after dividends. So, the order is:

a. non-savings income

b. savings income (including full offshore bond gains)

c. dividends

d. full UK bond gains

Where an individual's ANI, including the full chargeable gain, falls within the basic rate tax band then there's no need to proceed to the further steps.

Step 2 – Calculate the tax on the whole chargeable event gain less notional basic rate tax.
Re-do the calculation in Step 1 but following the rules used when calculating top slicing relief that are covered above, which means that the income order is:

a. non-savings income

b. savings income

c. dividends

d. full UK and offshore bond gains

From this work out the tax due on the total of the chargeable gains. As top-slicing relief applies only for higher and additional rate tax purposes, then notional basic rate tax needs to be deducted at this stage from the full tax liability due. This is the case for both UK and offshore bonds. If any part of the chargeable gain is covered by the PA, the deemed basic rate tax credit on the gain is reduced accordingly.

The resultant figure is called the total liability.

Step 3 – Calculate the top slice.
Divide the gain by the number of relevant years.

For full surrender of the bond, relevant years is the number of complete years the bond has been in force.

For part surrenders (in excess of the 5 % allowance), the relevant years is the number of full years between the current chargeable event and the previous one. The exception to this is for offshore bonds established before 6 April 2013, where the relevant years will be the complete number of years the bond has been in force, providing that since that date:

- it has not been varied to increase benefits payable
- it has not been assigned by way of gift or for money or money's worth
- the rights under it have not been held as security for debt of the individual

Step 4 – Calculate the tax liability on the top slice less notional basic rate tax.
Re-do the calculation in Step 2 but substitute the full gain with the top sliced gain. As in Step 2, for both UK and offshore bonds, a deduction should be made for basic rate tax treated as paid but this time on the top-sliced gain. The resulting figure should then be multiplied by the number of relevant years used for working out the top slice.

If a negative tax liability arises on the top-sliced gain, it is treated as zero.

This is called the relieved liability.

Step 5 – Calculate the top-slicing relief and net tax on the gain.
Deduct the relieved liability at Step 4 from the total liability at Step 2 to give the amount of top-slicing relief due.

Step 6 – Calculate the total tax liability on income and chargeable event gains.
Deduct the top-slicing relief from Step 5 from the tax liability Step 1.

EXAMPLE 4

John had pension income of £30,600 and dividend income of £3,000 in 2021/22. In the same tax year, he fully surrendered an offshore bond creating a chargeable gain of £91,000. He had held the bond for just over seven years.

Step 1 – Establish the total taxable income and total income tax for the year, and how much of the PA, SRSB and PSA are available.

Calculate ANI

Income	£
Pension	30,600
Chargeable gain	91,000
Dividends	3,000
	124,600

PA reduced to £270 (£12,570 – (£124,600 – £100,000)/2)

Higher rate taxpayer so PSA = £500

Non-savings income exceeds £17,570 so no SRSB

Calculate total tax liability due

Income	Tax rate	Tax due £
Pension £270	@ 0%	0
Pension £30,330	@ 20%	6,066
Bond £500	@0%	0
Bond £6,870	@20%	1,374
Bond £83,630	@40%	33,452
Dividend £2,000	@0%	0
Dividend £1,000	@ 32.5%	325
		41,217

Step 2 – Calculate the tax on the whole chargeable event gain less notional basic rate tax.

Income	Tax rate	Tax due £
Pension £270	@ 0%	0
Pension £30,330	@ 20%	6,066
Dividend £2,000	@0%	0
Dividend £1,000	@7.5%	75
Bond £500	@0%	0
Bond £3,870	@20%	774
Bond £86,630	@40%	34,652
Tax due		41,567
Tax on gain	£774 + £34,652	35,426
Tax deemed paid	£91,000 x 20%	18,200
Tax liability on gain		17,226

Step 3 – Calculate the top slice.

£91,000 / 7 = £13,000

Step 4 – Calculate the tax liability on the top slice less notional basic rate tax.

Income	Tax rate	Tax due £
Pension £12,570	@ 0%	0
Pension £18,030	@ 20%	3,606
Dividend £2,000	@0%	0
Dividend £1,000	@7.5%	75
Bond £500	@0%	0
Bond £12,500	@20%	2,500
Tax due		6,181
Tax on gain		2,500
Tax deemed paid on top slice	£13,000 x 20%	2,600
Relieved liability on top slice		0
Relieved liability	£0 x 7 years	0

ANI calculated using top slice is £46,600 (£30,600 + £3,000 + £13,000). Therefore, full PA of £12,570 is available.

Higher rate taxpayer so PSA = £500

Step 5 – Calculate the top-slicing relief and net tax on the gain.
Deduct the relieved liability at Step 4 from the total liability at Step 2 to give the amount of top-slicing relief due.

£17,226 – 0 = £17,226

Step 6 – Calculate the total tax liability on income and chargeable event gains.
Deduct the top-slicing relief from Step 5 from the tax liability at Step 1.

£41,217 – £17,226 = £23,991

Note that if the chargeable gain was on a UK bond a non-refundable tax credit of £18,200 (£91,000 x 20%) would be available to offset against the total tax liability.

Non-UK residence

If the bondholder has been non-UK resident whilst owning the bond and subsequently becomes UK resident, the gain is reduced by a fraction relating to the number of years the bondholder has been non-UK resident and the number of years the bond has been held. The gains calculated in example 1, would be multiplied by the following fraction:

$$\frac{\text{Period of ownership as a non-UK resident (days)}}{\text{Period plan has been in force (days)}}$$

The periods in question are calculated from the policy commencement date to the date on which the chargeable event occurs.

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 5

A 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.

Important notes

Please note that every care has been taken to ensure that the information provided is correct and in accordance with our current understanding of the law and Her Majesty's Revenue and Customs (HMRC) practice as at April 2021.

You should note, however, that we cannot take upon ourselves 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. Legislation varies from country to country and the policyholder's country of residence may impact on any of the above.

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