

Introduction

A Distribution Bond is an extremely useful form of investment for clients who want **a moderate, but tax efficient and rising income**, without exposing their capital to a high risk of loss.

The Underlying Investments

A Distribution Bond is at the lower risk end of the investment spectrum. The bond invests in a wide range of assets including **UK company shares** (normally between 20% to 50%), **gilts and other fixed interest securities** (normally between 20% to 50%), **index-linked stocks** (normally between 0% to 30%) and **commercial property** (normally between 0% and 30%).

Gilts and fixed interest securities will play **a major part in producing the income of the fund**. Property will provide a stable rising income if rents rise over time. Although the main aim of the property investments will be to produce income, property also offers the potential for capital growth.

Equities (ie stocks and shares) will **provide most of the growth in the fund**. The shares will normally be high yielding shares and will generally but not always be blue chip companies.

Distribution Funds will also invest in index-linked stocks as appropriate. The actual investment mix at any time will depend upon the fund manager's views as to which assets will give the best prospects of maximising income and capital growth within an acceptable level of risk.

'Natural' Distributions

You can normally elect to receive the 'natural' distributions on the bond. Such distributions are typically around 3.0% to 4.0% but **this amount is already net of basic rate tax**.

The level of income therefore compares with both the net interest available on deposit accounts and the dividends available on shares. You can **normally take the natural distributions half yearly**, or arrange to have them paid monthly or quarterly.

Where they are paid more frequently than half yearly you are still taking the actual half yearly distribution but it is simply divided into monthly or quarterly amounts for the convenience of your income needs.

The particular advantage of the Distribution Bond is that by taking the natural distributions from the bond **you are not disposing of units** from the main Distribution Fund holding.

The income is therefore achieved by effectively passing on the income received within the fund itself in an efficient manner.

By leaving the capital within the fund intact, the idea is to **reduce the risk of capital erosion**.

Furthermore, the level of risk adopted by the fund managers is usually a little lower than that of the average managed fund, as a higher proportion of the fund is held in more secure, fixed interest investments and sometimes also in property.

Other Regular Withdrawals

Automatic regular withdrawals of capital can also be set up on a monthly, half yearly or annual basis. If these are within the level of natural distributions and growth that is being achieved on the bond, **these regular withdrawals of capital will effectively provide 'income'**.

You can **amend the level of such withdrawals at any time**, to suit current income needs irrespective of the actual distributions and capital growth of the bond. There is therefore a known 'income' at any time, the level of which is fully controlled by you.

A Distribution Bond is particularly useful for clients who have some years to go before retirement and **can allow the distributions to accumulate** before taking a regular income in retirement.

Capital Growth

A Distribution Bond holds out the prospect of **capital growth**, albeit at a fairly low level. Such growth would have the effect of increasing the level of distributions, whereas capital left on deposit is likely to lose its value over the longer term as a result of inflation.

Where They Fit In

A Distribution Bond **cannot guarantee a particular level of return**, as both the level of distributions and the underlying capital value will fluctuate.

A Distribution Bond fits in **somewhere between the security of a deposit account and the volatility of a wholly equity linked investment**.

Its closest neighbour in the investment spectrum is the With Profit Bond which was once seen as a lower risk investment than a Distribution Bond because of the system of annual bonuses under a With Profit Bond which, once added, could not be taken away.

However, the wholesale introduction of huge market value reductions (MVRs) by With Profit Bond providers has increased the risk of using such bonds.

A Distribution Bond could be considered as a **low to medium risk investment** depending on the breakdown of the underlying investments. It is certainly **not a direct replacement for a building society deposit account** or a National Savings account, but it holds out the possibility of a higher return than such accounts where you are unlikely to require access to your capital for five years or more.

As with any long term investment, a period of at least five years should be envisaged for a Distribution Bond **before any planned capital withdrawals** of any magnitude are required. It is possible to access money in an emergency but there can be circumstances in which such withdrawals would result in a loss of part of the capital. Having said the foregoing, it is possible to receive distributions from the bond from the outset.

The Taxation Advantages

Where your need is for **growth with a greater measure of security**, or your **main need is for income**, the Distribution Bond is likely to be appropriate for you.

Neither 'income' from the bond, nor its final encashment, should be taxable to most basic rate tax payers. This is because the Distribution Fund itself will have suffered tax on income and capital gains under the special rate of corporate tax (not exceeding 20%) applicable to life assurance companies.

The Revenue has agreed that this tax is equivalent to basic rate income tax and **the growth on the bond is therefore not liable for further basic rate tax** in your hands.

For basic rate tax payers who have **relatively large amounts of money invested elsewhere** such that their annual capital gains tax allowance is exceeded, a Distribution Bond can be an extremely useful investment. This is because there is **no capital gains tax liability** on a Distribution Bond.

Clients who are **higher rate tax payers** and are looking to reduce the tax on their investments can benefit from a Distribution Bond. This is because **an allowance of 5% is given for each year that the bond is held** to a maximum of 20 years.

The 5% per annum allowance can be taken as an 'income' or count towards occasional lump sums, or a final encashment. In addition 'income' and gains in excess of the 5% per annum are **only taxable at the higher rate band level** (which is currently 20%).

In no circumstances will a higher rate tax payer pay tax on a Distribution Bond at the basic rate tax of currently 22%.

Other tax planning benefits can be achieved for higher rate tax paying clients who hold a Distribution Bond until their retirement. If, at that time, they are no longer higher rate tax payers the whole of the gain from the bond can be totally tax free.

The Security of Your Bond

As life assurance companies issue such bonds, there is **no question of there being any difficulty in realising the investment**. Most bonds do, however, have redemption penalties during the first five years, although these do not normally apply on death. On your death, the current value of the bond is available to your estate.

Investments into Distribution Bonds taken out via independent financial advisers (IFAs) are **protected by the Financial Services Compensation Scheme (FSCS)**, which provides compensation of 100% of losses up to £30,000 and for 90% of the next £20,000 making a maximum payment of £48,000.

Furthermore, investors in UK authorised insurance companies are further covered by the Policyholders Protection Act, which gives 90% compensation without limit.

Inheritance Tax Provision

A Distribution Bond is ideally suited as a vehicle to be used for the mitigation of Inheritance Tax because the bond can very easily be written under trust. We would be very happy to provide further information on the options available.

Distribution Funds via An ISA

Any investment is only appropriate for a particular client if the taxation situation is favourable. Clients who want the benefits of a Distribution Bond but have **not yet used their ISA allowance** for the year should first look at investing into a distribution fund via a Stocks and Shares ISA.

Where a distribution fund is 'wrapped' in an ISA it can have the advantage of **providing the distributions completely free of tax**. The ISA has to hold a minimum of 60% of the fund in corporate bonds and it will then be able to pay out the total income from the fund without deduction of tax or liability for tax in your hands.

Not all distribution funds obtain this advantage so it is important to make sure that you investigate this point before investing.

Distribution Funds via An 'Unwrapped' Unit Trust

Clients who are not tax payers may wish to look at investing into a distribution fund via 'unwrapped' unit trusts before they consider investing into a Distribution Bond.

Although tax at the investment rate, currently 20%, has to be deducted at source where the distribution fund is not 'wrapped' in an ISA, **a non tax payer is able to reclaim the tax deducted at source from the Revenue.**

Again, it is important to make sure that the particular unit trust maintains the 60% minimum in corporate bonds to gain this advantage.

Risk Factors

- ❑ An investment into a Distribution Bond is intended as a long-term investment.
- ❑ The Distribution Bond is unit linked. The price of units in the fund can go down as well as up, as too can the 'income' distributions from them. The value of the investment, therefore, and the income from it will fluctuate and is not guaranteed.
- ❑ Where past performance is mentioned please note that the past is not necessarily a guide to future performance.
- ❑ For funds that have an element of property, it may be necessary to defer encashment during periods when property is not readily saleable. The value of property is generally a matter of valuer's opinion rather than fact.
- ❑ If you surrender the contract, especially during the early years, you may get back less than the amount originally invested.
- ❑ An investment into an ISA, PEP, unit trust, OEIC or other collective investment scheme is intended as a long-term investment. The risk factors given above apply equally to a distribution fund held in this type of investment.

For Further Info

If you would like to discuss whether an investment into a distribution bond might be appropriate for you please ask your usual Arch adviser or contact us via one of the following:

Tel: **01483 204600**
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Online: **www.arch-fp.co.uk**

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