

Introduction

Life assurance bonds are a **very useful type of investment product**, not least because of **their unusual tax treatment**. They can provide benefits for all types of investors and are particularly useful for investors who **require a regular income**, or wish to **reduce the tax on their investments**, or wish to **reduce their inheritance tax bill** or are thinking of a possible need **at some time in the future for residential nursing care**.

What Are Life Assurance Bonds?

The term 'life assurance bond' is **the general term for a range of investments** that are more often known by the type of underlying fund or funds which they offer. In this respect **a life assurance bond could be likened to an ice cream cornet** into which different combinations of scoops of ice cream can be held.

Typical names for such bonds could therefore describe a single 'flavour' of investment fund such as a **Distribution Bond, With Profits Bond or Property Bond**, or a selection of 'flavours' as would be found in an **Investment Bond or Capital Investment Bond**.

Life assurance bonds are, not unexpectedly, **investments offered by life assurance companies** and it is this that provides them with their unusual tax treatment. The actual life assurance element will be very small, ie usually no more than 1% of the amount invested.

Technically they are 'single premium whole of life' policies. In other words the 'premium' is the lump sum investment amount and **the investment has no term**, rather it can be continued for as long as you want.

The Taxes Act 1988 specifies that single premium life assurance policies cannot be 'qualifying' policies. It is not important for the purposes of this fact sheet to understand what a 'qualifying' or 'non-qualifying' policy is. However, we can say that **it is as a result of the 'non-qualifying' designation given to life assurance bonds that determines their tax treatment** under that Act.

Taxation of the Underlying Funds

No matter what type of fund is used in a life assurance bond **the tax treatment of the underlying fund is always the same**.

We could say that no matter what flavour, or combination of flavours, of fund you choose, what you end up with is a blob of ice cream!

In fact the distinction between 'qualifying' and 'non qualifying' life assurance policies only has relevance to the individual who owns the policy. The underlying funds of both are treated in exactly the same way when held as an asset of a life assurance company.

The underlying fund suffers **tax on investment income and capital gains under the special rate of corporate tax** applicable to life assurance companies, which from 1st April 2003 was 20%. However the overall rate of tax on a well managed life assurance fund **could be much lower than this at around 11% to 15%**.

The bond (or 'cornet') which holds the different funds (or 'flavours') enables you to **switch from one fund to another** (ie change your mind about the flavour or combination of flavours you want) **without a personal capital gains tax charge arising**.

Tax Treatment in Your Hands

An important feature of the taxation of life assurance bonds is that the 'chargeable gains' under such products are **taxed as income tax rather than capital gains tax**. We use the term 'chargeable gains' because not all gains made by a life assurance bond are chargeable to tax.

The Revenue has agreed that the corporation tax suffered by the underlying fund on its investment income and capital gains is roughly equivalent to basic rate income tax.

Chargeable gains made on a life assurance bond are **therefore not liable for further basic rate tax** in your hands. The fact that a well managed life assurance fund could actually be paying much less than 20% **creates a tax advantage for both basic rate and higher rate tax payers**, particularly when investments are held for the longer term.

Furthermore, for many people, particularly those who are not higher rate tax payers, using a life assurance bond means that they **do not have to worry about accounting for tax** either on the 'income' they receive from the investment or on any gains when the bond is encashed.

When a life assurance bond is encashed, or withdrawals are made from it, **there may be a higher rate tax charge of 20% on the chargeable gain**.

However, this will not be of concern to anyone who income is not close to the level at which higher rate tax is required.

Furthermore, even for higher rate tax payers there may be no additional tax on a gain which is less than a cumulative rate of 5% a year of the original investment.

We can consider the implications for different types of tax payers.

Basic Rate Tax Payers

If you are a basic rate tax payer the issues concerning life assurance bonds can be summarised as follows:

- you may be in a **fairly neutral position from a pure tax point of view**. Tax equivalent to basic rate tax is deducted from your investment in the underlying fund or funds.

Therefore **neither regular withdrawals of 'income' from the bond, nor the partial or full encashment of the bond will be taxable** unless the chargeable gains on such withdrawals are sufficient to push you into the higher rate tax band.

- you have the convenience of being able to **withdraw a regular amount of 'income'** without worrying about the tax implications.
- you have the availability of **the With Profits concept** not found in ISAs or unit trusts.
- you have the flexibility of being able to **switch funds at any time**, and as is the case with many life assurance bonds, without any charge.
- you have the ability to place the life assurance bond under trust for your heirs and possibly **avoid Inheritance Tax**.

Where you simply want to invest for capital growth in the long term, you may first wish to consider **using Stocks and Shares ISAs and unit trusts**.

Stocks and Shares ISAs do not need to deduct capital gains tax within the fund, or in your hands, although there will still be a 10% tax charge on the dividend income which cannot be reclaimed.

Unit trusts do not need to deduct capital gains tax within the fund but gains are liable to capital gains tax on encashment of the units. **Relatively few investors are subject to capital gains tax**, however, because of the annual exemption.

As a basic rate tax payer, you may still have **relatively large amounts of money invested elsewhere** such that your annual capital gains tax allowance is normally exceeded.

In such a situation a life assurance bond can be an extremely useful investment simply because **there is no capital gains tax liability** on such bonds.

Non Tax Payers

If you are a non tax payer the issues concerning life assurance bonds can be summarised as follows:

- you may be in a **worse position from a pure tax point of view**. Tax equivalent to basic rate tax is deducted from your investment in the underlying fund or funds. **This tax cannot be reclaimed** by you even though you are a non tax payer.
- you have the convenience of being able to **withdraw a regular amount of 'income'**, however, you may have paid tax unnecessarily on this income.
- you could use a **life assurance bond offered by an offshore company**. Such companies are outside of the UK tax jurisdiction and they do not have to deduct tax from the underlying fund.
- you have the availability of **the With Profits concept** not found in ISAs or unit trusts.
- you have the flexibility of being able to **switch funds at any time**, and as is the case with many life assurance bonds, without any charge.
- you have the ability to place the life assurance bond under trust for your heirs and possibly **avoid Inheritance Tax**.

Where you simply want to invest for capital growth in the long term, you may first wish to consider **using Stocks and Shares ISAs and unit trusts** for the reasons mentioned under the previous heading 'Basic Rate Tax Payers', or you may wish to consider using an **'offshore' life assurance bond**.

Higher Rate Tax Payers

If you are a higher rate tax payer the issues concerning life assurance bonds can be summarised as follows:

- you may be in a **fairly neutral position** from a pure tax point of view. This is because the basic rate tax is accounted for at source and **there is a further 20% tax charge on the chargeable gains**.
- you may achieve a tax planning benefit if you are a higher rate tax payer now but **hold the bond until, say, your retirement** if, at that time, you are no longer a higher rate tax payer.

The whole of the chargeable gain from the bond **could then escape any further tax charge** unless the chargeable gain pushes you into the higher rate tax band.

Furthermore, **chargeable gains are 'top-sliced' by the number of complete years which the bond has been held** and this may help to avoid pushing you into the higher rate tax band, or at least limit the amount of the chargeable gain on which higher rate tax has to be paid.

- A** you may have an advantage **if you are looking for income** as the first 5% pa of regular withdrawals of 'income' from the bond **will not involve you in any further tax at the time**. 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% a year allowance can be taken without any higher rate tax charge as an 'income', or count towards occasional lump sums, or a final encashment. **'Income' and gains in excess of the 5% a year are only taxable at a further 20%.**

- A** the **partial or full encashment of the bond may involve you in a 20% tax charge** although this may not be the case if you are no longer a higher rate tax payer at that time. Furthermore, **whilst it would seem that the total tax on the gain** on a life assurance bond, if you were to remain a higher rate tax payer, **would be identical to the treatment of interest from a deposit account**, that is not quite the case.

Let us consider £1,000 of gross interest generated by a deposit account. You would actually receive a payment of £800 net interest. To account for the rest of the tax on this (as you are assumed to be a higher rate tax payer) this amount is grossed up to £1,000 and a further 20% tax is charged on the grossed up amount, **making a tax charge of £400 in all (ie 40%).**

If we now consider £1,000 of capital gain in a life assurance bond, we have seen that this is taxed in the hands of the life assurance company at 20%. You (as a higher rate tax payer) would then be required to pay 20% tax **on the £800 gain** which you have actually received (ie £800 x 20% = £160) rather than on the nominal gross amount. **This makes a tax charge of £360 in all (ie 36%).**

- A** you have the convenience of being able to **withdraw a regular amount of 'income'** of up to 5% pa without worrying about accounting for tax at the present.
- A** you have the availability of **the With Profits concept** not found in ISAs or unit trusts.
- A** you have the flexibility of being able to **switch funds at any time**, and as is the case with many life assurance bonds, without any charge.

- A** you have the ability to place the life assurance bond under trust for your heirs and possibly **avoid Inheritance Tax.**

Where you simply want to invest for capital growth in the long term, you may first wish to consider **using Stocks and Shares ISAs and unit trusts** for the reasons mentioned under a previous heading 'Basic Rate Tax Payers'.

As a higher rate tax payer, you may have **relatively large amounts of money invested elsewhere** such that your annual capital gains tax allowance is normally exceeded.

In such a situation a life assurance bond can be an extremely useful investment both from the point of view of obtaining **up to 5% pa 'income' on a tax deferred basis**, and because **there is no capital gains tax liability** on such bonds.

The Benefits of Top Slicing

In view of the fact that any chargeable gain on a life assurance bond **will have arisen over a period of years**, a measure of relief is allowed rather than simple attributing the whole chargeable gain as additional income in the year of encashment. The process is known as 'top-slicing'.

Top slicing **requires calculation of the appropriate fraction, or 'slice' of the chargeable gain** by dividing the chargeable gain by the number of complete policy years that the bond has been in force.

This slice, rather than the whole of the chargeable gain is treated as the top part of your income for tax purposes, and the average rate of tax applicable to the slice (less the basic rate) is calculated.

That tax rate (which may be zero if the slice did not push you into the higher rate tax band) **is then applied to the whole of the chargeable gain** to determine the actual tax liability on the gain.

The result is that **relief is given to you if the level of your other income would mean that you pay tax at no more than the basic rate**, but where you would be taken into the higher rate of tax if the whole of the chargeable gain were added to your income.

Where **the chargeable gain is caused by a partial surrender**, top slicing is determined by dividing the chargeable gain by the number of complete policy years since the last chargeable gain (ie over the cumulative 5% pa) caused by a partial surrender.

If it is the first partial surrender then the top slicing uses the number of complete years for which the bond has been in force.

Taking an 'Income' From the Bond

You can arrange to receive automatic regular withdrawals of capital on a monthly, half yearly or annual basis. If these are within the level of growth that is being achieved on the bond, **these regular withdrawals of capital will effectively provide 'income' to you.**

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

The first 5% a year paid as regular withdrawals suffers no tax at that time. However, the cumulative withdrawals up to 5% a year are deemed to be added back into the value of the life assurance bond when it is fully encashed.

If you are a higher rate tax payer when your life assurance bond is fully, therefore, **you will effectively pay a further 20% tax on the withdrawals that you have made over the years.**

Even a basic rate tax payer might find themselves pushed into the higher rate tax band when the bond is fully encashed and have to pay up to 20% tax on these withdrawals.

As we have seen, however, the ability to use top slicing reduces this likelihood.

Withdrawals **in excess of the 5% cumulative annual allowance** will suffer tax at the higher tax band rate of 20% if you are a higher rate tax payer at the time, or the withdrawal pushes you into that band.

The Timing of Taxation

Life assurance bonds **are usually segmented** so that an investment of, say, £40,000 might actually be set up as 20 separate bonds of £2,000 each. This gives greater flexibility to you in order to try and reduce or remove any tax liability.

The **tax treatment of the full encashment of a bond can be favourable** compared to the partial encashment of a bond. If, therefore, you want to make a partial encashment from your life assurance bond you might be better off making a full encashment of a number of segments of your bond.

The **timing of the taxation of chargeable gains can also be used to good effect.**

Where the chargeable gain is as the result of the full encashment of your bond (or complete segments) **the gain is treated as arising at the time of the encashment**, that is, in the current tax year. That may be beneficial, for example if your current year's income is low for any reason.

Where the chargeable gain arises from a **partial withdrawal, it is regarded as arising at the end of the policy year** in which the withdrawal occurs. The reason for this is quite simple. You might make further partial withdrawals and it makes things tidy for the Revenue to have them all regarded as happening on one date.

The policy year might end in your next tax year and if that is the case **you will want to think through whether it is likely to be a higher earning year or a lower earning year.**

If the next tax year is going to be a high earning year then it might be better to fully encash segments of your bond and have them taxed in the current year.

The Security of Your Bond

As life assurance companies issue such bonds, there is usually **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.**

Where the underlying investment is in commercial property there may be additional restrictions on encashing your investment and these should be fully taken into account before you invest.

Investments into life assurance 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.

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

Life Assurance Bonds and Age Allowance

Once you reach age 65 **you enjoy an enhanced personal allowance**, known as the 'age allowance'. This is £7,550 in the 2007/08 tax year whereas the standard personal allowance is only £5,225.

However, the full amount of the enhancement for age allowance **is only available where your total income for the tax year is below a certain amount** - currently £20,900.

Your age allowance is reduced by £1 for every £2 by which your total income exceeds £20,900, **until it falls back to the standard personal allowance** for the under 65s.

Within this band, every £2 of income can cost 66p in tax (44p on the £2 itself, plus 22p on the £1 of allowances withdrawn). **This is an effective tax rate of 33%.**

For those who are caught in the 'age allowance trap' **it may be possible to improve the situation by using the right kind of investments.** For example the income from certain National Savings Certificates is tax-free and does not count towards age allowance, as is the income from PEPs and ISAs.

More of interest to us currently, however, is the fact that **the first 5% of regular withdrawals from a life assurance bond does not count as income for age allowance purposes.**

Simply by moving capital from, say, a deposit account to a life assurance bond, you could **regain a lost age allowance and pay a lot less tax.**

There is a potential drawback, however, in that **any chargeable gain that you take from your bond** will count in full towards your income for age allowance purposes with **no allowance made for any top slicing relief.**

You will find further information in our Guide: *Investments and Age Allowance.*

Inheritance Tax Provision

A life assurance 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.

There are a number of 'estate planning bonds' available from insurance companies. The main types are the **Gift Trust**, the **Discounted Gift Trust** and the **Loan Trust**.

We would be very happy to provide further information on the options available.

Assignment of Bonds

Where a life assurance policy is owned by a higher rate tax payer **it is possible to assign the bond to a spouse or child**, or indeed any other person, **prior to it being encashed.**

The advantage of this is that if the new owner of the bond is not a higher rate tax payer **there may be not tax to pay on the gains made during the life of the bond**, particularly when 'top slicing' is taken into account.

This is all well and good **provided that you are genuinely intending to give the bond to the other person** so that they can use the capital for their benefit.

If, for example, you wish to gift the bond to your child or children for their use then the Revenue are unlikely to have any problem with this.

However, if you gift the bond to your non tax paying spouse so that he or she is able to encash it without suffering a tax charge **and then the money is subsequently invested in a new investment in your name** or even in your joint names then beware.

In such a situation the Revenue would content that your gift by assignment of the bond was not a genuine gift but was merely a sham and an effort to evade tax.

An Additional Benefit Later in Life

When investors first retire their thoughts are naturally centred on themselves and their future income needs.

With the passage of time, however, **they may start to think in terms of leaving capital to their children or grandchildren** or other members of their family.

Inheritance Tax is one issue to be faced as this can reduce their estate by up to 40% of its value. For some elderly investors there is **another, potentially more damaging, drain on their assets**, however, the possibility of needing to pay for residential nursing care over a long period.

The proper use of life assurance bonds as part of a balanced portfolio of investments **can be very beneficial in helping more of the portfolio to survive** the damage done by expensive residential nursing care costs.

The Charging for Residential Accommodation Guidelines (CRAG) **sets out the basis under which local authorities must apply the means testing system.**

The objective of the means test is to determine the extent, if any, to which individuals are required to contribute towards their care costs when care is arranged by the local authority.

Many local authorities have sought to include life assurance bonds as assessable assets under the means test, on the basis that the life assurance element is not their primary purpose.

However, **a recent update to the CRAG guidelines** makes it clear that 'if an investment bond is written as one or more life insurance policies that contain cashing-in rights by way of options for total or partial surrender, then the value of those rights has to be disregarded as a capital asset in the financial assessment for residential accommodation'.

If you were to transfer your assets into life assurance bonds to deliberately try and obtain assistance for residential nursing care fees from a local authority this would be unlikely to be an effective strategy as **it would almost certainly be classified as 'deliberate deprivation'**.

However, by making use of life assurance bonds as part of your overall investment planning **well ahead of any need for nursing care** the possibility of having them disregarded under a local authority means test could be a valuable additional benefit for you in later life.

Types of Life Assurance Bond

Distribution Bond – Here the underlying investment would be a **Distribution Fund**. This is so called because it **distributes the dividend income from the various shares that are being invested in** to the bondholder, usually twice a year.

The underlying investments are usually a combination of equities (ie stocks and shares) and bonds (ie fixed interest investments) and in some cases property. If you are seeking income this can be preferable to taking regular withdrawals from the bond because under a Distribution Bond **the capital is not used to provide income**. This does not mean that the capital is secure, however, because it is still invested in an equity linked fund with daily price movements. You will find further information in our Guide: *Distribution Bonds*.

With Profit Bond – Here the underlying investment would be a **With Profit Fund**. In such a fund the daily price movements inherent in an equity linked fund are exchanged for **an annual bonus which is declared by the life office**.

This process attempts to smooth the volatility associated with an equity linked investment and provides a lower risk option. With Profit Bonds are **particularly suitable for investors who wish to receive a known level of 'income' or for more cautious investors**. You will find further information in our Guide: *With Profit Bonds*.

Property Bond – Here the underlying investment would be a **Property Fund**. This type of fund invests in a range of commercial rather than residential properties, or in commercial property shares.

Over the last decade commercial property, as an asset class, **produced real returns ahead of equities, corporate bonds, gilts and cash**. Furthermore, it was only just beaten to first place by equities over 20 years.

It is a very useful part of any investment portfolio because **commercial property behaves in a way that is unrelated to the movements of other assets**. You will find further information in our Guide: *Property Funds*.

Capital Investment Bond – Here the underlying investment would be **one or more unit linked funds** set up and managed by the life office, or it could include a number of **external fund managers**.

The value of units in such funds can fall as well as rise daily. There is no underlying security of capital, therefore, in such a bond but it can make an excellent investment when held for the longer term.

The choice of funds is quite wide although most people prefer to put a reasonable portion of their investment into **one or more managed funds where the investment choices are made entirely by the professional fund manager**. Other funds are usually specific to a particular market, for example European Fund, North America Fund or Far East Fund or type of investment such as Smaller Companies Fund, Ethical Investment Fund or Technology Fund.

The Most Competitive Bonds

We recommend the most competitive Life Assurance Bonds to our clients based on a number of tools at our disposal together with ongoing research.

We use **Defaqto's research software Aequos Engage**. This is product research and analysis software which is built on the latest technology and updated daily with real-time data. Established in 1994, Defaqto uses the analytical skills and industry expertise of its dedicated research team, to provide innovative solutions designed to assist us as we strive to select the most effective products for our clients. Defaqto offers respected expert commentary via monthly market reports and is the data collection agent for the FSA's Comparative Tables Service.

Risk Factors

An investment into a life assurance bond is intended as a long-term investment. Where past performance is mentioned please note that the past is not necessarily a guide to future performance. Because this investment may go down in value as well as up, you may not get back the full amount invested.

The return on a With Profit Bond depends on the profits made by the life office and on its policy as to their distribution (whether on early encashment or in adverse market conditions or other circumstances). Bonuses come from profits which are yet to be earned, there is therefore no guarantee that current rates will be maintained beyond any special offer period. If you surrender the contract, especially during the early years, you may get back less than the amount originally invested.

The price of units in a Distribution 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.

For funds that are wholly invested in, or have an element of property, it may be necessary to defer encashment during periods when property is not readily saleable. The general market for commercial property may during the period of any investment in shares in a property fund with the result that the value of the fund's property investment portfolio falls. The value of any individual property may fall, for example, due to the insolvency of a tenant. The monthly valuation of the fund will be predominantly based on the opinion of the valuer of the fund of the current market value of the fund's property portfolio.

Please note that **this information does not constitute personal advice** and should not be treated as a substitute for specific advice based on your circumstances. If you are in any doubt as to whether an investment in commodities is suitable for you, then **you should discuss the matter with a suitably qualified independent financial adviser** such as ourselves.

For Further Info

If you would like to receive advice on an investment into a Life Assurance Bond, please ask your usual Arch adviser or contact us via one of the following:

Tel: **0845 3700 661**

Email: **enquiries@arch-fp.co.uk**

Online: **www.arch-fp.co.uk**

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