ENCASHING AN INVESTMENT BOND?

WATCH OUT FOR HMRC'S TAX TRAP

YOUR PERSONAL CFO
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Onshore and offshore investment bonds remain a popular investment vehicle and be very tax efficient when used correctly. However an interaction with another piece of tax legislation can have terrible consequences in certain situations – care needs to be taken when encashing these investments, especially when large gains are made.

There are two methods of withdrawing funds from an investment bond; 1) a proportional surrender across a policy, generally used for smaller amounts within a '5% cumulative' allowance and 2) the full encashment of policy segments[1], generally used for withdrawals beyond this allowance. **This paper refers to the second type of withdrawal only; the encashment of whole policies or policy segments**.

The taxation of onshore and offshore bonds is not identical, but the basic premise is the same. When an investment bond (some or all segments) is encashed, the investment gain is split across the number of years the policy has been held, called **'top-slicing'**. The sliced gain is then added to an individual's taxable income in the year it is encashed. The tax band the income falls into determines the tax rate applied.

> *For example, a 10 year old policy encashed with a £100,000 gain would give a 'top-sliced' gain of £10,000. If an individual had an income of £50,000 that tax year, the top-slice would entirely fall within the higher rate (40%) tax band. The full £100,000 gain would then be taxable at the higher rate. If an individual had an income of £30,000 that tax year, the £10,000 slice would fully fall within the basic rate tax band and be chargeable at the basic rate.*

The other tax rule which causes this dangerous interaction is the **loss of the personal allowance** (income on which you pay no tax, £10,000 for 2014/15) for those earning over £100,000. For every £2 an individual earns over £100,000, their personal allowance is reduced by £1. The entitlement to the personal allowance is therefore lost when income exceeds £120,000.

The pernicious tax grab by HMRC comes in the form of **not** using the top-sliced gain on a bond for this purpose. Instead HMRC takes the full investment gain on the bond in addition to other income when assessing entitlement to the personal allowance. This is despite the fact that an investor will be using the top-sliced gain to calculate the applicable tax rate. This will lead to many investors losing their personal allowance and incurring heavy tax bills, without realising it. There has been so little coverage of this tax trap that unfortunately many professional advisers remain unaware of it.

[1] Most investment bonds are divided into a number (typically 100) of identical sub-policies e.g. a £100,000 investment bond will typically be split into 100 £1,000 sub-policies or 'segments'.

How it works – an example

The problem is best understood through the use of an example:

Charles invested £200,000 in an onshore investment bond 10 years ago. He did this as he was a higher rate tax payer and wished to defer the tax liability on his investments until he retired and had a lower income. He retired last tax year and has seen his total income drop to £30,000. He decided to encash his offshore bond as he wished to take advantage of his ISA investment and capital gains allowances.

The offshore bond had grown to £300,000, giving him a £100,000 investment gain. Charles thought he understood the tax rules surrounding bonds and thought the gain would be top-sliced to £10,000 and the full investment gain would fall within his basic rate tax band. As such he would have no additional tax liability, as basic rate tax is incurred at source on an onshore bond.

Unfortunately this was not the case. For the purpose of Charles' eligibility to the personal allowance, the full £100,000 investment gain is taken. When added to his other income (£30,000), this gives a total of £130,000. As such Charles lost his entitlement to the personal allowance.

There were two severe consequences to this. Not only has Charles lost an amount of income on which no tax is paid, it has also resulted in virtually the full £100,000 gain on the bond being subject to higher rate tax at 40%!

Once Charles' personal allowance is lost, he is left with his basic rate tax band (£31,865 for 2014/15). This is almost entirely used by his other income. When the £10,000 top-slice gain is added, just £1,865 falls within the basic rate band, the remaining £8,135 becoming subject to higher tax. This resulted in an unexpected tax bill of **£16,270** (£8,135 x 10 years @ 20% - the difference between the basic and higher rates).

Solution

If Charles had been aware of this tax rule he could have chosen to encash his bond over a number of years, (encashing a number of sub-policy segments)[2], keeping his total income under £100,000 at all times. For example if he had surrender the policy over two tax years, splitting the gain in each year to £50,000, he would never have lost his personal allowance and wouldn't have had any tax bill on encashment.

It is very important that you understand the tax consequences when withdrawing amounts from an investment bond, especially when larger amounts are involved or incomes are high. If you have any doubts we would recommend you seek professional advice before acting.

[2] It is worth noting that he should **NOT** do this by taking a proportional withdrawal across segments.

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