Technical

Policy segmentation

For financial advisers only

What is segmentation?

Most single premium offshore bonds are issued with a number of mini policies within them (usually a maximum of 100). These are known as segments or sub-policies. Each segment is a policy in its own right. The investment, including any additional investments, will be spread over these segments. Only one policy schedule is issued (for convenience sake) and makes reference to the number of segments issued.

One of the attractions of having multiple segments within an offshore bond is that these can be cashed in individually or they can be assigned to a new owner. This process is known as "segmenting".

The attractive alternative

There are a number of very good reasons for segmenting an offshore bond. We've outlined some potential benefits of choosing segmenting below.

Flexibility

- Joint policyholders (perhaps husband and wife) no longer want to own a bond jointly. Husband can assign segments to his wife (or vice versa) so she becomes the sole policyholder.
- Parent policyholder(s) (who may be a higher rate tax payer in the UK) assigns segments to their adult child who is in higher education. Adult child becomes the legal owner of assigned segments and provides an instruction to cash them in to fund education fees and expenses. This may benefit an adult child who is a nil or lower rate tax payer.
- Trustees can appoint some of the trust capital by assigning segments to beneficiaries.

Please note: Policy segments can only be assigned to person(s) who 18 years old or above.

How many segments?

Giving some thought at the start of the policy about how many segments to choose may reduce administrative hassle at a later date.

For example, where there are 3 intended beneficiaries, choosing a number divisible by 3 (i.e. 90 rather than the default 100) may help trustees to dispose of the trust property where the benefits are to be paid in equal parts. But what if the number of beneficiaries is not known or, as is the norm, the policy is issued and the trust is added at a later date? A tip is to choose a number of segments at the outset, which will give an element of flexibility.

For example, 60 segments can be split equally between 2,3,4,5,6 potential beneficiaries, rather than a default of 100 segments.

UK tax planning

As you may already be aware, if your client is UK resident for tax purposes, it is possible for them to withdraw up to 5% of the total premiums paid into an offshore bond each policy year for 20 years, without incurring an immediate liability to UK 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 the UK self assessment tax form until the bond is surrendered or withdrawals in excess of the 5% allowance are taken.

The 5% withdrawals can be taken equally across all of the offshore bond's segments (usually a maximum of 100 segments are created at outset) or by cashing in whole segments. These could prove useful when it comes to funding education fees.

The following is an example of how surrendering whole policy segments can be more "UK tax friendly" than surrendering across all segments or from 1 segment (if segmentation is not chosen from the outset).

Example

- £50,000 Single Premium Offshore Bond
- £15,000 withdrawal required in year 4

Partial surrender (across all 100 segments)	
Initial contribution	£50,000
Surrendered in year 4	£15,000
Cumulative 5% allowance: £50,000 × 5% × 4 =	£10,000
Chargeable gain: £15,000 - £10,000 =	£5,000
Chargeable excess =	**£5,000**

Full surrender of segments (cashing in 25 of 100 segments)	
Initial contribution	£50,000
Initial value of each segment	£500
Current bond value in year 4	£60,000
Current value of each segment	£600
Surrender value of 25 segments (£600 x 25)	£15,000
Chargeable gain: £15,000 - £12,500 =	£2,500
Chargeable excess =	£2,500

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Whilst it can be seen that in most cases surrendering full segments will have immediate tax benefits, one downside is that the 5% per annum allowance will be based on the original value of the remaining segments. In the example above:

£50,000 (initial contribution)

less

£12,500 (original value of 25 segments)

= £37,500

£37,500 x 5% = £1,875

Trustee investments

When a chargeable event occurs and a policy is in trust, any tax liability will fall to the creator (Settlor) of the trust at their highest marginal rate if they are still alive and UK resident.

If the Settlor of the trust is dead or non-UK resident the liability will fall to the trustees (if UK resident) at the trustee rate of 45% (from 6 April 2013).

One of the ways of passing the trust property (the proceeds of the investment bond) to a beneficiary is by assignment. Assigning a policy absolutely or policy segments to a third party is not a chargeable event for tax purposes as long as the assignment is done by way of a gift.

After the segments have been assigned, the assignee, as the new legal owner of the policy, can surrender the segments, providing of course that the assignee is over 18 years old.

The surrender of the policy segments will be a chargeable event and any gain will be assessed on the beneficiary's highest marginal rate of UK income tax.

If the beneficiary is a non-basic or 40% tax payer, then this is a simple way of passing on the benefits to the beneficiary in a tax effective manner.

If there is only one beneficiary, then segmentation isn't an issue. In reality, however, some trusts have the option of passing the benefits to a number of potential beneficiaries (Discretionary Beneficiaries). If this is the case then segmentation is invaluable as a means of splitting the benefits between a varying number of beneficiaries.

Family tax planning

Finally, where the policyholder is a higher rate tax payer, assigning individual segments to a non tax (or lower rate tax) paying spouse or adult child can be a tax effective way of passing capital on between family members.

Important note

For financial advisers only. Not to be distributed to, nor relied on by retail clients.

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 September 2015. You should note however, that we cannot take on 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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