UK TAXATION
REGULAR PAYMENT OFFSHORE BONDS

FOR FINANCIAL ADVISERS ONLY

INTRODUCTION

The aim of this guide is to explain the UK tax treatment of regular payment offshore bonds issued by RL360.

WHAT ARE OFFSHORE BONDS?

Offshore bonds are 'foreign policies of life insurance and foreign capital redemption policies' for UK tax purposes and are referred to as such by HM Revenue & Customs (HMRC).

PERSONAL TAXATION OF BONDS

Contrary to most investments for UK tax residents, any capital gain realised from an offshore bond is subject to income tax, not capital gains tax.

Bonds are subject to the UK chargeable events regime, which is contained within Part 4, Chapter 9 of the UK income tax legislation, the Income Tax (Trading and Other Income) Act (ITTOIA) 2005.

CHARGEABLE EVENTS

Where certain transactions happen, they are treated as chargeable events and a chargeable gain calculation is then required to establish any tax that may be due.

A list of chargeable events that can occur is as follows:

- Death of a life assured that gives rise to the death benefit becoming payable.
- Maturity of a policy.
- Full surrender of a bond or a full surrender of individual policy segments within the bond.
- Regular part surrenders or one off part surrenders taken from the bond, which are in excess of the 5% cumulative tax deferred allowance.
- Full assignment of a bond for consideration in 'money or money's worth'.
- Part assignment of a Bond for consideration in 'money or money's worth' which are in excess of the 5% cumulative tax deferred allowance.
- A fundamental reconstruction of the policy (e.g. an addition or a removal of a life assured).

RL360°

THE 5% ALLOWANCE AND PART SURRENDERS WHICH EXCEED THE ALLOWANCE

For each payment into a bond, an amount equal to 5% of that payment can be withdrawn each policy year for 20 years without an immediate liability to income tax. This is due to the fact that for tax purposes, part surrenders taken within the 5% allowance are treated as returns of the original capital paid.

If the 5% annual allowance is not fully used in any policy year, the unused allowance will be carried forward to the next policy year and so on, on a cumulative basis.

Where a part surrender is made, the total amount withdrawn in that policy year will be compared with the cumulative total of unused 5% allowances at the end of that policy year and any excess will be a chargeable gain.

The total allowance is limited to 100% (5% x 20 years) of each payment. Therefore, where the regular payments cease and the total allowance for the payments has been used in full, any further part surrenders taken are treated as chargeable excess gains.

Example – exceeding the 5% allowance

- £2,000 regular annual payment.
- Policy Years 1 – 4, no monies withdrawn.
- Policy Year 5, £3,000 withdrawn as a part surrender.

The cumulative allowances at the end of policy year 5 are:

£2,000 x 5 years x 5% = £500
£2,000 x 4 years x 5% = £400
£2,000 x 3 years x 5% = £300
£2,000 x 2 years x 5% = £200
£2,000 x 1 years x 5% = £100

Total cumulative allowance = £1,500.

Therefore, **the chargeable excess gain** at the end of policy year 5, is:

£3,000 - £1,500 = **£1,500** – which will need to be declared for UK income tax.

WHEN DOES A CHARGEABLE EXCESS GAIN BECOME A CHARGEABLE EVENT?

It should be noted that where a part surrender is taken which creates a chargeable excess gain, **the event does not occur for tax purposes until the last day of that policy year**.

For example, if a part surrender was taken on 4 March 2018 and the next policy anniversary is 7 July 2018, the chargeable excess event would occur on 6 July 2018, i.e. in the 2018-19 tax year and not in the 2017-18 tax year.

In addition, where there is a chargeable excess event and the policy is then surrendered, the last life assured dies or the policy matures in the **same tax year**, then the previous chargeable excess event is ignored (i.e. is wiped out as though it never happened), it is only the final calculation on surrender that is taken into account.

This is known and referred to by HMRC as 'extending the final insurance year'.

For example, where a bond has a policy anniversary of 1 August and is fully surrendered on 1 December, as both are in the same tax year, the final policy year will run for 16 months, August to December of the following calendar year.

FULL SURRENDER, SURRENDER OF POLICY SEGMENTS, MATURITY OR DEATH

If a bond or individual policy segments end by full surrender maturity or death, any profit may give rise to a tax liability.

If a loss occurs, then no tax liability should apply.

Please note that contrary to a full surrender or maturity, the chargeable gain calculation on the event of the death of the sole or last life assured **is based on the surrender value of the policy immediately before death and not the death benefit that is paid**.

Needless to say, if there is a gain and policy has increased in value since the date of death, this increase is free of income tax.

However, if the policy decreases in value in this period (i.e. results in a reduction in the death benefit payable), then it is still the value immediately prior to death that applies for chargeable event calculation purposes. There is no relief available if this happens.

As per S.491 of the Income Tax (Trading and Other Income) Act 2005, the method to calculate a chargeable gain is as follows: **TB – (TD + PG)**, which is defined as:

- **TB** = Total Value

  This is the surrender value of the policy, plus any previous part surrenders.

- **TD** = Total allowable deductions

  This is the total amount of the monies invested into the bond, for the policy segments which are maturing or being surrendered.

- **PG** = Total Amount of gains treated as arising on calculation events occurring before the surrender or maturity.

  This is the total amount of previous chargeable excesses created by part surrenders in excess of the 5% cumulative allowance.

Example – Full Surrender

Mrs Williams invested £10,000 per year over a 10 year period, therefore a total investment of £100,000. No part surrenders have been taken and the policy is then surrendered with a value of £200,000.

The calculation would be:

TB = £200,000 + £0 = £200,000
TD = £100,000 + PG of £0 = £100,000

Chargeable gain = £200,000 – (£100,000 + £0) = **£100,000**

However, if Mrs Williams had taken part surrenders of £10,000 in total with £2,000 of which exceeded the 5% allowance, the calculation would be:

TB = £200,000 + £10,000 = £210,000
TD = £100,000 + PG of £2,000 = £102,000

Chargeable gain = £210,000 – (£100,000 + £2,000) = **£108,000**

TIME APPORTIONMENT RELIEF (TAR)

Time apportionment relief is used to reduce a UK chargeable gain. It allows the chargeable gain to be proportionately reduced by the amount of time the policyholder has been resident outside the UK, during the term of the bond.

For policies issued on or after 6 April 2013

As a result of the Finance Act 2013, time apportionment relief (TAR) for bonds issued on or after 6 April 2013, is now defined as 'a reduction in the chargeable gain on an offshore bond, if the person liable to UK income tax was not UK resident throughout the life of the bond.

Therefore, where there have been previous bond owners (with the exception of gifts between spouses and civil partners who live together), only the residence history of the person liable to the tax can now be claimed.

For policies issued prior to 6 April 2013

The TAR rule which applies to bonds issued prior to 6 April 2013 that have not been topped up or been assigned since this date (including security assignments), is 'TAR is available for the bond holder, for any period the bond has been held by a non-UK resident individual since the bond started.'

So, if for example, a bond had been assigned prior to 6 April 2013, from a non-UK resident individual to a UK resident individual, the assignee could benefit from the original owners period of non-UK residence.

When TAR doesn't apply

TAR is only available to individuals and cannot be claimed if the policy has ever been owned by a non-UK resident trustee.

TAR Calculation

$$\text{Chargeable gain} \times \frac{\text{Number of days held as a UK resident}}{\text{Total days policy has been in force}}$$

To illustrate this:

Mr & Mrs Miller invested £200,000 into an offshore bond on 18 May 2010, whilst non-UK resident.

They returned to the UK on 30 May 2017 and then surrendered the bond on 20 February 2018, for a value of £300,000. Therefore creating a gain of £100,000 as no withdrawals were taken.

TAR will reduce the £100,000 gain as follows:
Gain of £100,000 x 266 days/ 2835 days = **£9,382.72 net gain, i.e. a 90.62% reduction**.

TOP-SLICING RELIEF

Top-slicing relief allows individuals to potentially mitigate paying higher rate or additional rate income tax, on some or even possibly all of a chargeable gain.

Top-slicing relief is available for UK resident individuals who 'do not pay higher or additional rate income tax on other income (excluding the gain) however, when the gain is added to income, the individual becomes subject to higher or the additional rate.'

This is applied to the chargeable gain **for any complete bond years the policyholder was a UK resident**.

The Finance Act 2013 brought the following changes for top-slicing relief on **chargeable excess events only** i.e. where part surrenders have exceeded the 5% allowance:

For policies issued on or after 6 April 2013

The number of top slicing years equals the number of years since the previous excess event.

However, for those UK residents who have not been UK resident throughout, TAR will also apply.

Where TAR applies, the number of years available for top-slicing remains the period back to the commencement, subject to the figure being reduced for periods of non-UK residence.

For policies issued prior to 6 April 2013, which not been varied since

The number of top-slicing years available remains the number of years since the bond commencement.

For all other chargeable events, such as surrenders, deaths and maturities, the top-slicing relief period has not changed and always goes back to the commencement date of the bond for any complete bond years the policyholder was a UK resident.

When top-slicing relief doesn't apply

- It's not available to assist taxpayers already liable to tax at the higher rate before the chargeable event gain is added to their income.
- It doesn't reduce income below £100,000 to preserve full entitlement to the personal allowance.
- Top-slicing is only available to individuals, therefore it cannot be claimed by trustees, executors/ personal representatives, or corporate entities.
- This does not apply to annual gains that arise on 'personal portfolio bond events'.

Example:
Mr Smith, who has recently retired is permanently resident in England and has a current total taxable income of £25,000 after allowances.

He invested £30,000 per year for 5 years (i.e. £150,000 in total), which started on the 10 April 2012 and he then surrendered the bond on the 15 April 2017 for £190,000.

No part surrenders were taken.

So, the chargeable gain is £190,000 - £150,000 = £40,000.

No TAR relief will apply, as there has been no period of non UK residence.

Top-sliced gain
£40,000/5 policy years = £8,000 to be added to the policyholder's income.

So, the top-sliced gain of £8,000, plus £25,000 other income is £33,000, which is within the basic rate threshold for England & Wales of £33,500 for the 2017-18 tax year.

Therefore, the income tax payable is £40,000 x **20%** = £8,000

Let's also consider what would happen if Mr Smith had a total taxable income after allowances of £27,500. The income tax payable would be:

Remainder of the basic rate threshold = £33,500 - £27,500 (other income) = £6,000

£6,000 x 5 policy years = **£30,000 x 20%** (Basic Rate Tax) = **£6,000**

£40,000 gain - £30,000 taxed at BRT = **£10,000 x 40%** (Higher Rate Tax) = **£4,000**

Total Tax payable = **£10,000**

Effective Tax Rate = £10,000/ £40,000 x 100 = **25%**

Who does the income tax liability for a chargeable gain fall upon?

The income tax liability for a chargeable gain is payable in the following order:

1. Where a bond is owned by an individual or is held in a flexible trust created by that person, then he/she is liable to income tax at his/her marginal rate.

2. If the bond is held under a bare trust, the beneficiary is liable to the tax, as the beneficial owner of the bond, unless the donor is a parent of the beneficiary and the chargeable event occurs whilst the beneficiary is an unmarried minor.

   In this situation, the donor would be liable to the tax.

3. If the bond is held in a flexible trust and the settlor is non-UK resident or has died in a previous tax year, then the trustees are liable for the tax if they are UK resident.

   In this instance the first £1,000 is taxed at the basic rate of income tax and anything over this is taxable at the trustee tax rate, currently 45%. Please note that the trustees are not able to use top slicing relief to reduce the tax payable.

4. If the trustees are all non-UK resident, the beneficiaries of the trust resident in the UK, to the extent that they receive benefit, are liable for the tax.

How is a chargeable gain declared for UK income tax purposes?

Gains on foreign policies should be inserted into the 'Foreign' pages of the UK tax return referenced as the 'SA106'.

HMRC help sheet HS321 (Gains on foreign life insurance policies) provides further information and guidance for completing UK tax returns.

IMPORTANT NOTES

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

This information is to be used by financial advisers only. RL360 accepts no liability for any action taken or not taken by an individual or a firm as a result of the contents of this material. The tax treatments and information contained in this document are based on our understanding of current tax law and HMRC practice as at March 2018 and may be subject to change in the future.

RL360 Insurance Company Limited. Registered Office: International House, Cooil Road, Douglas, Isle of Man, IM2 2SP, British Isles. Registered in the Isle of Man number 053002C. RL360 Insurance Company Limited is authorised by the Isle of Man Financial Services Authority.

RL360°