ONSHORE BOND

A fresh look at Onshore Bonds

Financial advisers increasingly recognise the growing importance of bonds as the tax environment becomes progressively more challenging. The capital gains tax and inheritance tax changes in the October 2024 budget have underlined the relevance of bonds as tax wrappers for both individuals and trusts.

It, therefore, seems a good time to take a fresh look at Onshore Bonds, which are likely to be more relevant than their offshore counterparts for most UK investors.

1. **Tax and other changes making Onshore Bonds more important for financial planning.**

In the last decade or so, bonds have become less popular for several reasons:

- The income tax band thresholds have been frozen since 2022, and the tax-free dividend allowance reduced from £5,000 to £500.
- The capital gains tax annual exempt amount was over £12,000 for several years, which allowed switching and rebalancing to be mostly tax free in all but the largest general investment account portfolios but this is now much lower.
- Inheritance tax became relatively easy to plan after pension freedoms introduced IHT-free pension death benefits. Other more established IHT strategies grew more popular – in particular, investments that qualify for 100% IHT business assets relief.
- Fixed interest yields – an important component of Onshore Bond investment – were historically extremely low until recently.

What's changed?

Now all this has either changed or seems very likely to alter radically:

- The freezing of the income tax thresholds – widely called 'fiscal drag' – has pulled millions more taxpayers into higher rate and additional rate tax.
- The dividend allowance that was £5,000 as recently as 2017-18 was cut to a tenth of that level – £500 – in 2024-25.
- The capital gains tax exempt amount has been cut from £12,300 in 2022-23 to the current level of £3,000, which will require many more investors to report their gains and pay the tax on them. And there could well be more changes to come. The annual exempt amount for most trusts is now only £1,500, which is divided between trusts that have the same settlor, with a minimum of £300.
- The rates of capital gains tax have been increased in the October 2024 budget from 10% to 18% for basic rate taxpayers and from 20% to 24% for higher and additional rate taxpayers and most trusts.

- Unused pension death benefits will be subject to inheritance tax from 2027/28 and investments that qualify for business assets relief will be halved to 50% from 2026/27 on AIM shares and other business investments. These radical changes are already triggering a wholesale review of estate and investment planning by advisers and their clients.
- Fixed-interest investments have started to generate attractive yields again, following more than a decade of historic lows. Fixed-interest investments are particularly suitable holdings for Onshore Bonds.

2. Using tax wrappers to add value for clients.

Tax planning has become even more essential as a means for financial advisers to add value for their clients – for both commercial and regulatory reasons.

Tax alpha

Choosing the right tax wrapper can add valuable extra percentage points to investors' after-tax returns.

For many advisers in the recent past, tax planning has been a lower priority than portfolio construction. Yet outperformance because of tax-planning – sometimes called tax alpha – can highlight the added value of advice in the new fiscal environment. Financial advisers now need to reacquaint themselves with the full range of tax wrappers – especially Onshore Bonds.

Tax wrapper diversification

Another concept tax planners can borrow from investment is the concept of diversification – but of tax wrappers rather than just holdings. Each tax wrapper has its advantages and drawbacks, strengths and weaknesses. Onshore Bonds should be part of many clients' portfolio of tax wrappers. It can play its part in generating net income, building a growing investment resource, simplifying a client's affairs and helping with estate planning.

The tax environment is constantly shifting as governments face new challenges, and new administrations come into office with new aims and ideas. It makes sense for many clients – especially those with higher value portfolios – to diversify across the full range of tax wrappers available, so that they are well prepared for change.

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