For financial advisers only

Comparing the main tax wrappers

An adviser's guide to understanding tax wrappers' key characteristics and planning strategies with onshore bonds

Countrywide Assured

Comparing the main tax wrappers: their key tax characteristics

Individuals and trustees can hold broadly the same investments in all the main tax wrappers: equities, fixed interest securities and cash. The differences lie in their various tax characteristics. A tax wrapper is a financial product or account that holds investments like equities and fixed interest securities and provides some protection from tax for as long as the investments stay in the wrappers. Onshore bonds are one of several tax wrappers.

Unwrapped individual equities and fixed interest securities

Investors can hold equities and fixed interest securities outside tax wrappers and this brief section covers the way such unwrapped or direct holdings are taxed. On platforms, investors normally hold these investments in general investment accounts (GIAs).

Equities – unwrapped UK and overseas shares

- Dividends are mostly taxed as the top slice of the investor's income – but before onshore and offshore bond chargeable gains. Dividends may also be subject to foreign withholding taxes.
- Dividends paid to individual investors are tax free up to the dividend allowance of £500 in 2024/25 – down from £1,000 in the previous year.
- Above the dividend allowance, the income tax rates on dividends are 8.75% for basic rate taxpayers, 33.75% for higher rate taxpayers and 39.35% for additional rate taxpayers.
- Capital gains on the sale or gift of equities are taxed to the extent that an individual investor's net realised gains exceed the annual exempt amount of £3,000. The rates are 18% for basic rate taxpayers and 24% above the basic rate tax band.
- Equities normally form part of an investor's estate when they die. However, no capital gains is normally payable on assets when an investor dies and there is an uplift in the value of the assets at the date of death.

Fixed interest securities – unwrapped government and corporate bonds

- The tax-free personal savings allowance on interest is £1,000 for basic rate taxpayers and £500 for higher rate taxpayers, but nil for additional rate taxpayers. Some low-income taxpayers also qualify for a nil rate band on savings income. Above that, the tax rates are the normal percentages of 20%, 40% and 45%.
- Capital gains on most fixed-interest securities are tax free.
- Individual fixed-interest securities normally form part of the investor's estate when they die.

i The effectiveness of each type of wrapper should be measured against this strategy as well as compared with the advantages and drawbacks of the other wrappers.

ISA (individual savings account)

- The assets held in an ISA are free of UK tax on the investment income and capital gains.
- The proceeds paid to the investor from encashing the ISA are also free of tax.
- Foreign dividends and other income may be subject to foreign withholding tax.
- An ISA can't be gifted or held in trust and is part of the investor's estate when they die. Special provisions allow the effective transfer of a deceased spouse's/civil partner's ISA to their surviving spouse or civil partner.
- There are annual subscription limits – currently an aggregate £20,000.

i Special kinds of ISAs called Lifetime ISAs (or LISAs) can benefit from a 25% annual bonus of up to £1,000, which investors can use to buy their own home, take when they are at least 60 years old or draw if they are terminally ill with less than 12 months to live. There's a 25% withdrawal charge if the proceeds are used for any other purpose. Other restrictions that apply to LISAs include: the £4,000 subscription counts towards the investors overall £20,000 ISA allowance, and the plan has to be started between the ages of 18 and 40.

Registered pensions

- The initial input into the pension qualifies for income tax relief at up to 45%, depending on the individual's tax position and subject to limits.
- The funds held in the pension are free of UK tax on the investment income and capital gains, like the ISA funds.
- Foreign dividends may be subject to foreign withholding tax.
- The benefits are mostly subject to income tax, although a proportion is tax free.
- The benefits on death can currently pass free of inheritance tax to beneficiaries. But after 5 April 2027, they will generally be subject to IHT.

Employer contributions are allowable deductions for corporation tax or income tax purposes, subject to certain limits. They are also not subject to national insurance contributions (subject to limits) and are not taxable on the employee as a benefit in kind.

Directly-held UK and international mutual funds (dividend-paying)

Mutual funds allow investors to pool their money to buy a portfolio of stocks and shares which a fund manager invests on their behalf. In UK they are mostly either unit trusts or OEICs (open-ended investment companies).

Where investors have direct holdings of mutual funds in platforms' general investment accounts – outside such wrappers as ISAs, pensions or onshore bonds – the tax position is as follows:

- Funds with at least 40% of their investments in equities qualify as dividend-paying.
- Dividends are mostly taxed as the top slice of income – but before chargeable gains on onshore and offshore bonds.
- Interest received by the fund is subject to 20% corporation tax.
- Foreign dividends may also be subject to foreign withholding tax.
- Dividends paid to individual investors are tax free up to the dividend allowance of £500 in 2024/25.
- Above the dividend allowance, the income tax rates are 8.75% for basic rate taxpayers, 33.75% for higher rate taxpayers and 39.35% for additional rate taxpayers.
- Capital gains are tax free within the fund but are taxed to the extent that net realised gains exceed the annual exempt amount of £3,000. The rates are 18% for basic rate taxpayers and 24% for higher and additional rate taxpayers.
- The fund is part of the investor's estate when they die. However, no capital gains is normally payable on assets when an investor dies and there is an uplift in the value of the assets at the date of death.

Directly-held UK and international mutual funds (interest-paying)

Mutual funds allow investors to pool their money to buy a portfolio of stocks and shares which a fund manager invests on their behalf. In the UK they are mostly either unit trusts or OEICs (open-ended investment companies).

Where investors have direct holdings of mutual funds in platforms' general investment accounts – outside such wrappers as ISAs, pensions or onshore bonds – the tax position is as follows:

- Interest-paying funds are those that less than 40% invested in equity and are mostly invested in government and/or corporate bonds.
- The tax-free personal savings allowance on interest is £1,000 for basic rate taxpayers and £500 for higher rate taxpayers. Some taxpayers also qualify for a nil rate band. Above that, the tax rates are the normal (20%, 40% and 45%).
- Dividends within the fund are taxed at 20% corporation tax.
- Capital gains in the fund are not taxed. Individual taxpayers pay tax on gains above the annual exempt amount of £3,000. The rates are 18% for basic rate taxpayers and 24% for higher and additional rate taxpayers.
- The fund is part of the investor's estate when they die. However, no capital gains is normally payable on assets when an investor dies and there is an uplift in the value of the assets at the date of death.

Offshore bond

An offshore bond is an investment wrapper, set up by a life insurance company that is resident in a jurisdiction with a favourable local tax regime such as the Isle of Man. Bondholders can invest in different types of assets, including equities, fixed interest securities, property and cash deposits either through funds or directly. Offshore bonds have many of the same features as onshore bonds.

The UK taxation of the underlying insurance company funds

The underlying funds' tax position within an offshore bond is broadly as follows:

- Interest and capital gains are free of UK and local tax.
- UK dividends are tax free but overseas dividends and other income may be subject to foreign withholding tax.
- Gains on both equities and fixed-interest securities are also free of UK and local tax.

Bondholders' UK tax position

The tax position of a UK resident end-investor on encashing an offshore bond is broadly as follows:

- Gains are subject to full income tax, including tax at the basic rate, because the offshore insurance company does not pay UK corporation tax on its income – unlike UK life companies. This is the biggest difference between offshore and onshore bonds.
- Investors may benefit from top-slicing relief and time apportionment relief for periods of overseas residence.
- Investors can draw up to 5% a year with no immediate tax charge, up to 100% of the value of the original investment.
- The bond is part of the deceased investor's estate on death, although it can be held in trust.

Capital redemption bonds
Some offshore life companies offer a variation of offshore life assurance bonds, called capital redemption bonds (CRBs). They are similar to offshore life assurance bonds in terms of their taxation and most other respects, except they have two important differences that can be useful for estate planning:

- CRBs do not have lives assured on whose death the bond could come to an end
- The maximum term for a CRB is 99 years from inception.

The CRB can therefore remain invested for up to 99 years regardless of any deaths. If the bond owner dies, the CRB passes to their heirs; the bond does not expire or create a chargeable event until it is surrendered or the 99 year period comes to an end.

Onshore bond

The taxation of the UK insurance company's underlying funds
The underlying funds held by a UK life company on its funds are broadly taxed as follows:

- The underlying funds are subject to a special rate of tax of 20% on income from interest and rent.
- For equity funds, UK and foreign dividends are free of UK tax.
- Overseas dividends and other income may be subject to foreign withholding tax.
- Realised net capital gains on equities and fixed-interest securities (i.e. after taking account of capital losses on other equity funds) are taxed at 20%.

Bondholders' UK tax position
The end-investors' tax position on encashing an onshore bond is broadly as follows:

- Realised chargeable gains are free of basic rate tax, but they are potentially subject to higher rate tax at up to an effective rate of 20% and additional rate tax at up to an effective 25%.
- Investors may benefit from top slicing relief and time apportionment relief for periods of overseas residence.
- Investors can draw up to 5% a year with no immediate tax charge, up to 100% of the value of the original investment.
- The bond is part of the investor's estate on death, although it can be held in trust.

Tax planning strategies with onshore bonds

Evaluating the general tax advantages and drawbacks of the main types of tax wrappers

Every tax wrapper has both advantages and drawbacks.

ISAs and registered pensions
ISAs and pensions have the most powerful positive tax characteristics for most people. So many people prioritise their investing into these two tax wrappers and also typically hold some easily accessible money in cash deposits.

But the maximum that can be invested in ISAs and pensions is limited, and each has some possible drawbacks. For example, it is not possible to gift an ISA and pensions are normally inaccessible until the investor reaches 55 years (57 from 2028/29).

Directly held mutual funds (dividend-paying)
Dividend paying mutual funds include both equity-only products and multi-asset funds. They provide the most attractive way to hold equities (but not necessarily fixed interest) for capital growth outside ISAs and registered pensions. But mutual funds' advantage over, say, onshore bonds has lessened recently.

- The position of mutual funds is much less attractive than it was before 6 April 2023, when investors could realise net gains of up to £12,300 a year before paying any capital gains tax.
- The top rate of tax on investors' gains on their holdings of mutual funds is still only 20%, although there are signs that this could change.
- The dividend allowance in 2024/25 means that dividends of up to £500 are free of income tax. As recently as 2017/18, the dividend allowance was 10 times higher than this, so it is hardly surprising that some investors have not quite caught up with the fast-changing tax environment.
- Interest from fixed-interest investments in dividend-paying funds is taxed twice – once within the fund and then again for taxpaying investors.

Directly-held mutual funds (interest-paying)
Interest-paying funds that mainly hold cash, government and corporate debt avoid the double taxation on interest of dividend-paying funds. But capital gains on equities and fixed-interest investments are taxed both in the fund and probably again in the investor's hands.

Onshore bonds

Onshore bonds have become more attractive for many UK taxpaying investors, especially if they hold income-producing underlying assets.

- Dividends in the bond fund are free of UK tax. When they encash the bond, higher or additional rate taxpayers only pay tax on the chargeable gains at up to 20% or 25%, because of the basic rate tax credit they receive. So the tax rate that applies is a good deal less than the current individual top tax rates on dividends. And with careful tax planning, it might be possible to reduce or eliminate the investor's tax on the bond, typically because most people are subject to lower rates of tax after they have retired.
- The relative position on capital gains has also changed. Net gains within the onshore bond are taxed at 20%, but it is offset by the basic rate tax credit when the investor eventually encashes the bond. Of course, investors may have to pay higher or additional rates of tax on the bond profit, depending on their income at the time.

Capital gains in dividend-paying mutual funds are generally more lightly taxed than in onshore bonds. But capital gains on fixed-interest securities in interest-paying mutual funds are likely to be more heavily taxed overall than in onshore bonds.

Offshore bonds

Offshore bonds tend to be attractive for investors who expect to be non-taxpayers when they encash their offshore bonds.

The largest segment of investors in offshore bonds from a UK tax perspective is likely to be people who expect to be non-UK resident when they cash the bond.

Offshore bonds may also be attractive for some non-taxpayers, such as people investing for children. The gains are generally taxed as savings income, and so low-income investors can potentially reduce the tax charge by setting the gain against their personal allowance, personal savings allowance and 0% savings rate band. However, top-slicing relief can only be used to determine the extent to which higher or additional rate applies to the bond gain – not basic rate tax.

Summary – key tax characteristics

1 ISAs' and pensions' tax advantages make them the priority investments for most investors.

2 Bond structures are at their most effective when sheltering accumulating income, especially for fixed-interest investments.

3 The capital gains tax position on equities is currently more advantageous for mutual funds than for onshore or offshore bonds.

4 Onshore bonds are generally more attractive than offshore bonds for most UK residents, mainly because of the 20% tax credit on surrender or death of last life assured.

Any questions?

If you have any questions please call us on 0333 0155600

Or go to **countrywideassured.co.uk**

Financial advice

This note provides details of the structure, taxation and uses in financial planning of onshore life assurance bonds and is for your guidance only. Countrywide Assured plc (“Countrywide Assured”) accepts no liability for any action taken or not taken by an individual or firm as a result of the contents of this material.

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