For financial advisers only

Advantages of onshore bonds

An adviser's guide to understanding
the main advantages and uses

Countrywide Assured

Advantages of onshore bonds: main advantages and uses

The main uses of onshore bonds from a tax perspective are to:

- Provide administrative simplicity.
- Draw an income in a tax efficient way making use of allowances.
- Build up a portfolio for the future.
- Inheritance tax and estate planning.

Administrative simplicity

Bonds are non-income producing assets in the years when there are no chargeable events, and so they don't generate income or gains that have to be reported to HMRC in a tax return. Investors don't have to report their annual withdrawals on their tax returns as long as they don't breach the 5% rule.

This feature is especially useful for investors who don't normally submit a self-assessment return. But the administrative cost and time saving are welcome even to those who do make annual tax returns, and they can be exceptionally helpful for trustees.

Drawing an income

Bonds can generate regular withdrawals that take advantage of their unique tax characteristics in two main ways.

- Taking 5% annual withdrawals across all 1,000 segments.
- Cashing some of the 1,000 identical segments of the overall bond.

Both strategies involve a total return approach to generating income. The bondholder draws on both the income and capital returns from the underlying funds.

Taking the 5% withdrawals

Each year, the bond owner can draw up to 5% of their original investment without incurring an immediate tax charge. That means they could draw 5% a year for 20 years on this basis or in other patterns, say, 4% for 25 years.

After a bondholder has used up their cumulative 5% annual withdrawal allowance by taking back the whole of their original investment, the proceeds are potentially taxed at the prevailing higher or additional rate of income tax. If the investor never takes out more than their original investment within the 5% annual allowance, there won't be a tax charge until final encashment or the death of the life assured.

The main advantage of taking 5% withdrawals is the absence of any immediate tax complications or payments. In contrast, the same strategy with selling down mutual funds can prove more complicated, especially after the recent drastic cuts to the CGT annual exempt amount.

The main potential drawbacks to taking 5% withdrawals are:

- The income is static and may fail to keep up with the investor's expenditure needs, which are likely to rise with inflation. If the bondholder decided to draw more than the 5% allowance, it would cause an excess chargeable event. This could trigger a tax charge that would not be related to the actual performance of the bond. It would also restart the clock for top slicing relief back to the date of the latest excess.

- Payments for adviser fees from the onshore bond count towards the investor's 5% allowance, if it is set up this way.

One way to increase the level of withdrawals after a few years without breaching the 5% allowance would be to invest a further sum into the existing bond. The investor could then make additional withdrawals of up to 5% based on the new level of investment. The top slicing relief would continue to be based on the original start date of the bond.

Example – taking 5% annual withdrawals from an additional investment in an existing onshore bond

Joan invests **£50,000** into an onshore bond. She can draw **£2,500** a year from her onshore bond each year without incurring a tax liability each year, because this amount is within her 5% allowance. As long as she stays within the allowance and does not draw cumulatively more than the value of her original investment, she won't pay tax until final encashment or maturity.

But even with annual inflation of only 2%, her annual **£2,500** income will have lost nearly a fifth of its real value after ten years. And after 20 years, the whole amount of any withdrawal is potentially taxable.

If Joan invested a further **£40,000** in the same bond after eight years, she would be able to draw an extra 5% from the bond – i.e. a total of **£4,500** a year – and the top slicing relief on final encashment or maturity would potentially continue to be based on the original start date from 10 years earlier.

Where an investor is considering investing in an onshore bond, it is often worth considering adding to an existing bond rather than starting a completely new one.

Encashing full bond segments

The main alternative to taking 5% withdrawals is to encash complete segments each year. This would involve a chargeable event for each segment taken and a possible higher or additional rate on any gain. But there are various compensating benefits if the underlying funds grow:

- The amount an investor can encash each year should grow too.
- The investor should be able to maintain the income on a reasonably tax-efficient basis for longer than 20 years.

A drawback of encashing full segments is that it reduces the 5% tax deferred annual allowance. Encashing a segment loses the 5% allowance for the encashed segment, including any unused allowance, i.e. 5% withdrawals that haven't been taken and that have been rolled forward.

Example – taking withdrawals by encashing segments

Miriam invests **£50,000** in an onshore bond that is divided into 1,000 segments, each with an initial value of **£50**. She decides to take an initial **£2,500** a year from the bond by encashing 50 segments annually.

At the end of year one, her bond has grown by 6% to **£53,000**, so each segment is worth **£53**. If she encashes 50 segments, she can draw **£2,650** before tax. If she is a basic rate or non-taxpayer in the year of encashment, she will have no tax to pay on the **£150** profit on the bond segments. If she is a higher rate taxpayer, she will have to pay 20% tax of **£30** on the **£150** profit.

In years two to five, Miriam continues to encash enough segments to provide about **£2,500** a year. The value of the withdrawal will depend on the growth of the underlying portfolio. After the first year, she will qualify for top slicing relief, which could affect the tax rate on the encashment.

In the sixth year, the bond has grown to **£57,000** and by then she has encashed 200 segments, leaving 800 segments with each segment worth **£71.25**.

This year, Miriam decides to encash 40 segments with a total value of **£2,850**. The total gain on each segment is **(£71.25 - £50) x 40 = £850**. Top slicing relief for this total gain is based on six complete years ownership with no chargeable events applying to any of these segments.

Miriam continues in this manner until she finally encashes the bond several years later.

Building up a portfolio for the future with onshore bonds

Onshore bonds can be used to accumulate capital for the future, because they have the classic characteristics of a tax shelter.

Investors can shelter the income and gains in the non-income producing asset of an onshore bond during a period when they are paying high rates of tax, perhaps when they are high earners. They can then encash their bond when the income tax rates applying to them might be lower. Investors who try to build capital when they are high earners face several challenges:

- The income generated by their investments generally suffers 40% or 45% tax and therefore has limited capacity to be reinvested to compound for future invested growth.
- Having unwanted income in their hands personally could adversely affect some taxpayers. For instance, having extra income could limit or even eliminate their income tax personal allowance if their income is between £100,000 and £125,140. Similar problems can occur with child benefit.

A common scenario is a high earner wants to grow their portfolio of investments for retirement. Once they are retired or are earning less than they were at the peak of their career, they will likely be paying tax at lower rates on their income – or at least can engineer their finances to have one or more years of relatively low tax liability.

The onshore bond can act as a shelter for rolling up income and gains until the time when the investor needs to draw on it. The impact of top slicing relief may then reduce the impact of higher or additional rate income tax.

Example – the onshore bond tax for tax sheltered reinvested income and gains

Ahmed earns **£100,000** a year and has a portfolio of **£200,000** in a mix of equities and fixed-interest funds. Any income from his investments will be subject to 40% higher rate income tax. In addition, his personal allowance of **£12,570** is reduced by **£1** for every **£2** of adjusted net income over **£100,000**. In effect, this adds another 20% marginal income tax up to **£125,140** and puts him on a total marginal rate of 60% for that **£25,140** band.

Investing in an onshore bond would therefore shelter the income from the underlying portfolio. It would be subject to an internal rate of only 20% maximum on income and gains, and no UK tax on dividends.

Eventually, Ahmed might be able to encash the bond in a year when he can arrange for his other income to be taxable at basic rate or less. Alternatively, he could assign the bond to another low-taxpaying member of his family to encash (see our guide on bond use for higher rate taxpayers).

Any questions?

If you have any questions please call us on 0333 0155600

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

Financial advice

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