For financial advisers only

The onshore bond for the higher rate taxpayer

An adviser guide to understanding tax planning for higher rate and additional rate taxpayers

Countrywide Assured

The onshore bond for the higher rate taxpayer

Investors need to take professional advice about the most advantageous ways of encashing their onshore bonds. Many people find that they become basic rate taxpayers after they stop work. But retirement does not always free investors from paying higher or additional rates of tax – this has become especially common after the freezing of income tax thresholds brought millions more people into paying 40% income tax or more.

Tax on bond encashments may be reduced or eliminated in circumstances where:

- Much of the bondholder's other income falls outside the tax year in which they encash their bond.
- A pension contribution has the effect of bringing down the bondholder's chargeable event gains.
- The bondholder has a period of non-UK residence during which they encash their offshore bond.
- The bondholder assigns the bond to a non-taxpayer or basic rate taxpayer who can then encash it.

Moving other income outside the tax year of bond encashment

Some investors are in a position to encash their bond in a tax year in which they receive relatively little taxable income. They may be able to achieve this by advancing income into a tax year before they encash their bond or by postponing it into a later tax year.

- **Earnings** Shareholder directors typically have some control over when they distribute profits to themselves as salary or dividends. Self-employed people may also have some flexibility. However, most employees are not able to plan their earnings in this way.
- **Pension income** Pension fund withdrawals from money purchase schemes can also be accelerated and/or postponed without much difficulty. However, defined benefit pension receipts can't usually be arranged in this way. Likewise, pension annuity payments are fixed, unless the insurance company pays them into the SIPP which then passes the payments onto the pensioner.
- **Other investment income** If bondholders change their other investments, they may be able to reduce their taxable income for a year of bond encashment. Cash deposits can be timed so that a single payment in a 12-month period will occur outside the target year. Investors could also invest in an offshore non-distributor cash roll-up fund, where the taxable income is paid outside the tax year in which the onshore bond is encashed.

The costs and other tax consequences of rearranging the investor's income and switching the investments need to be carefully gauged against the potential tax saving on the bond.

How a pension contribution can reduce chargeable event gains

An investor may be eligible to make a pension contribution under the tax relief at source system without breaching the annual allowance. Top slicing relief could reduce the higher or additional rate tax they might otherwise have to pay on a chargeable event gain.

Personal inputs to a pension generally benefit from the tax relief in two ways:

- Basic rate tax relief at 20% is given immediately through tax relief at source.
- Higher and additional rate tax relief is provided by extending the individual's basic rate and higher rate bands by an amount equal to their gross pension contribution.

Example: pension contribution can reduce higher rate on an onshore bond

Ben has a UK onshore life assurance bond on which there is a chargeable event gain of **£50,000**, that he held for 10 complete years. He is a higher-rate taxpayer earning **£55,000** a year. He makes a net personal pension contribution of **£8,000** (gross £10,000) which reduces his income tax liability. Ben's personal allowance is **£12,570** and his higher-rate threshold is therefore **£50,270**.

Without his pension contribution the tax liability is as follows:

The top-sliced gain is **£50,000 ÷ 10 = £5,000** (top slice).

Ben's adjusted income including both his earnings and the top slice is **£55,000 + £5,000 = £60,000**.

So Ben's income above the higher rate threshold is **£60,000 - £50,270 = £9,730**.

The higher tax liability of 20% on the chargeable event would be: **£50,000 × 20% = £10,000**.

With the pension contribution Ben's net pension contribution **£8,000** grosses up to **£10,000** including 20% relief at source, which raises his the higher-rate tax threshold from **£50,270 to £60,270**, which is more than his earnings plus the top slice of **£60,000**. So none of his income now falls within the 40% higher rate band and none of the bond is subject to higher rate tax – saving **£10,000** income tax.

The effect of non-UK residence on the tax liability on an onshore bond chargeable gain

The owner of an onshore bond is unlikely to be subject to UK tax on any chargeable event gain if they are treated as being resident outside the UK. However, the gain might be taxable in the overseas country, depending on its tax laws.

- Becoming resident outside the UK for tax is more difficult than it might initially seem. HMRC generally ignore periods of temporary non-residence lasting fewer than five years. So, any gains made while a bondholder is temporarily absent from the UK could be subject to UK tax, in the same way as if they had remained in the UK.

- Investors who expect to be non-UK resident when they encash their onshore bond should seek specialist advice. They should normally expect to remain non-UK resident for at least five years to gain non-resident tax status but the rules are complicated and strictly applied.

- If a non-resident investor returns to UK with the onshore bond and then encashes it, they may be entitled to overseas residence relief on a proportion of any gain (see our guide on the taxation of onshore bonds for more detail on overseas residence relief).

Assigning the bond to a basic rate or non-taxpayer to encash

An important feature of a UK bond is that the bondholder can assign it by gift to another individual or even a trust without triggering an income tax liability. If a bondholder gifts their onshore bond to another person who pays tax at a lower rate than the person making the gift, the tax liability on encashment is also likely to be lower. The underlying investments and the lives assured do not necessarily change because of the gift.

- It is essential that the bondholder does not assign the bond to the recipient in return for any value – i.e. not for 'money or money's worth' in the words of the legislation.

- The assignment of the bond does not affect the top-slicing relief available. The number of complete years on which the relief is based will continue to start from the original date of the investment (or last excess event).

The recipient of the assigned bond can encash it then or later and may not be liable for tax on the chargeable event gain. However, this will depend on their other income in that tax year, the size of the bond gain and the number of years' top-slicing relief available.

Under current law, a bond could be assigned and then reassigned multiple times. So, for instance, it would be possible to assign the bond to a trust for a beneficiary. Then, instead of the trustees encashing the bond, they could assign it to a beneficiary (see our guide on planning with onshore bonds in trust).

It is important to remember that there may be inheritance tax implications where a bondholder gifts it to another person or trust.

In contrast, mutual funds or direct holdings of equities are potentially subject to capital gains tax if they are gifted, just as if they were being sold. Holdover relief on capital gains tax may be available on transfers into and out of a discretionary trust.

Example – bond assignment to a basic rate taxpayer

Mike is a higher rate taxpayer with an onshore bond that he started ten years ago. There is a potential chargeable gain of **£30,000** on the bond. He doesn't need the money and would like to help his young nephew, Ian, who wants to buy a flat. Ian earns **£35,000** a year at present.

Ian could hold onto the bond for a year or two, or he could encash immediately. Adding the **£3,000** of top sliced gain would not breach his combined personal allowance and basic rate tax band. So he could encash the bond without incurring any tax; in contrast, the tax liability for Mike would have been **£6,000** if he had encashed the bond himself.

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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