

## Clever planning with offshore bonds

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**While many investors, whether they are holding cash, fixed interest or risky assets such as property or equity, may presently not be experiencing either high income or capital gains, the fact is that eventually we will get back to some sort of 'normality', even if it takes 5-10 years or even longer.**

Now is therefore is a great time to take stock of one's investment portfolio and restructure it, both from an asset allocation and asset location perspective, so as to be correctly positioned for the medium to long term.

*....reports of the death of investment bonds..... have been greatly exaggerated.*

When the Chancellor introduced the flat 18% capital gains tax rate from 6<sup>th</sup> April 2008, many experts predicted that investment bonds, both on and offshore, were doomed and would become irrelevant for most UK investors. In a recent article we explored the tax effect of using different tax wrappers for various asset allocation strategies.

Since then we've carried out more research and analysis and our conclusion is that the reports of the death of investment bonds, particularly the offshore version, have been greatly exaggerated. In this article we are going to explain three ways to gain additional tax advantages from holding an investment portfolio within an offshore bond.

### The basics

Let's just remind ourselves of the basic tax treatment of offshore bonds:

- All income and capital gains arising within the bond are tax-free, when they arise, with the exception of any non-recoverable withholding tax which may apply, such as to dividends arising from UK equities or funds;
- Up to 5% of the original capital invested may be withdrawn each policy year without an immediate charge to UK tax;
- Any gains (whether from income or capital gains) arising from a chargeable event will be subject to tax at the owner's highest **income** tax rate i.e. nil, 20 or 40% (expected to increase to 45% for high earners);
- A chargeable event arises upon: full encashment, partial encashment in excess of the 5% cumulative unused annual allowance; or the death of all the lives assured;

The bond, or individual segments thereof (many comprise multiple segments to provide flexibility for investors), can be assigned to another person or entity without immediate tax charge, as long as it is a gift and not for consideration (i.e. where the recipient compensates the donor). As such the taxation of any latent gain also moves to the assignee.

### Strategy one: How to take more than 5% per annum without immediate tax

If the bond owner takes a partial withdrawal which exceeds 5% per annum of the original capital invested, or the cumulative annual 5% amount (if no previous withdrawals have been made in previous years), then the **whole amount withdrawn** would be taxable at the investor's highest

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marginal income tax rate, regardless of whether there were actually any gains in the portfolio. For this reason partial withdrawals are usually best avoided and instead full encashment is preferred so that tax is only paid on actual gains.

However, most offshore bonds are structured as 100 segments, which are treated separately for tax purposes. So if, for example, the investor wants to encash, say, half the bond, they would only pay income tax on gains arising from the 50 segments which had been fully encashed to meet the withdrawal. This avoids the need to pay tax on the whole gain arising within the bond when one wishes to withdraw amounts in excess of the 5% annual allowance.

But what if we could arrange the bond in such a way that all gains accrued within segment 100, and segments 1-99 were only ever worth the original amount invested or market value of the portfolio if less? This would have the effect of allowing much larger tax-deferred withdrawals (from segments 1-99) than the 5% annual allowance would otherwise permit. Well this can be done by establishing an offshore bond with special policy conditions which determine how gains and losses are allocated to segments 1-99 and segment 100.

Let's look at two simplified scenarios:

#### Bond with gains

Martin is UK resident and domiciled. He invested £2m in an offshore bond seven years ago and it is now worth £3m. He now needs to withdraw £1m but wants to leave the rest invested in the bond for the long term. He has not taken any withdrawals to date.

Under a standard offshore bond with 100 segments, many advisers might simply surrender 39 segments to realise £1.17m, giving a chargeable gain calculation of £1,170,000 (surrender value) - £780,000 (premium paid to those segments) = £390,000 gain with tax due at 40% of £156,000.

The most tax-efficient withdrawal method here though is to take the maximum unused 5% allowance across all segments first of £700,000 (7 years x £2m x 5%, so £7,000 per segment) followed by full surrender of now just 14 segments which will have a reduced value of £23,000 (£3m - £700,000 / 100 segments) each, a total of £322,000. The chargeable gain calculation now is £322,000 (surrender value) + £98,000 (all withdrawals, i.e. £7,000 x 14 segments) - £280,000 (premiums paid, i.e. £2m / 100 x 14 segments) + £0 (excess withdrawals) = £140,000, with 40% tax due of £56,000.

If, however, Martin had used an offshore bond with special policy conditions as described earlier the outcome would have been much more favourable. Because the bond is showing a profit segments 1-99 are valued at the original amount invested i.e. £20,000 each. So Martin needs to encash segments 1-50 to obtain his £1m (50 x £20,000) and as these are equal to the amount invested there is no taxable gain on which tax is due – an improvement in cash terms of £56,000. No tax is due until the gains has been crystallised upon encashment of segment 100.

*....partial withdrawals are usually best avoided.... full encashment is preferred so that tax is only paid on actual gains.*



## Bond with losses

Charlotte is UK resident and domiciled. She invested £2m in an offshore bond three years ago and with all the mayhem in financial markets the value has fallen to £1.5m, i.e. a loss of £500,000. She needs to withdraw £1,000,000 from the bond but wants to leave the rest invested to benefit from the eventual market recovery.

Under a standard offshore bond with 100 segments, ignoring the 5% allowance, she would need to make total encashments of 67 segments ( $(£1m/£1.5m) \times 100$ ) to realise £1,005,000, and crystallise a loss of £335,000 which may not be offset against either her other taxable income or any future gains that may arise within the retained bond segments.

Alternatively, she could take the maximum unused 5% allowance first of £300,000 and then 58 segments at £12,000 each giving £696,000 and crystallising a loss now of £290,000. Future growth arising in the remaining segments would be taxed at Charlotte's highest marginal income tax rate when finally encashed.

If, however, Charlotte had used an offshore bond with special policy conditions as described earlier, the outcome would again have been much more favourable. Even though the whole bond is showing a loss, segments 1-74 are valued at the original amount invested, i.e. £20,000 each, and policies 75-100 are each valued at £769.23. Charlotte needs to encash segments 1-50 to obtain her £1,000,000 ( $£1,000,000/£20,000$ ) and as these are equal to the amount invested there is no taxable gain. She has also not realised any losses which would be unable to be used for offsetting elsewhere in her portfolio.

*It is, therefore, possible to defer tax on any eventual encashment indefinitely*

While there is no immediate tax benefit compared to the standard bond scenario, the real benefit will arise when Charlotte decides to encash the remaining segments. Any growth arising within the remaining segments will first be allocated to segments 75-99 until they equal in value the original £20,000 amount invested in each segment. If and when the value exceeds the original amount invested in segments 75-99, the gain will then be allocated to segment 100. No tax is due until the gains have been crystallised upon encashment of segment 100.

In both Martin's and Charlotte's situations, it is segment 100 that contains any gains and any losses are allocated to segments with a higher number. It is, therefore, possible to defer tax on any eventual encashment indefinitely. Another option would be to gift segment 100 to a non- or lower rate taxpayer in the future and allow them to encash segment 100 themselves. Alternatively, the bond owner might defer encashment of segment 100 until they are a lower rate taxpayer or have become UK non-resident, possibility if they retire or go to work abroad.

## **Strategy two: Repatriation**

In order to avoid capital gains tax, UK domicile investors, in simple terms, have to be neither UK resident nor ordinarily resident for a minimum of five tax years. For income tax this time frame is reduced to one tax year. The structure of the chargeable events regime for offshore bonds, which come under the income tax regime, therefore provides an opportunity to undertake tax-efficient investment planning when the bond owner expects to, or can arrange to, work overseas after investing in the bond, and as such can demonstrate without doubt that they are UK non-resident for at least one tax year. The result is that growth can be 'washed' out upon eventual encashment when the individual becomes UK resident again.



Consider the case of Sarah, 41, who has £1m of cash and is looking to invest the money in a tax-efficient manner for future use. Later in the year she is to leave the UK to spend two years working overseas in the Middle East. During this period her accountant has told her that she will not be resident in the UK for income tax purposes and that she will need £500,000 to fund her overseas project. Her intention is to retire in nine years, i.e. 2018.

This is what she does:

March 2009	Sarah invests £1m in an offshore bond.
June 2009	She moves overseas to work.
July 2009	She makes a part surrender of £500,000 to fund her overseas project. There are no tax consequences of making the withdrawal in her new country of residence.
June 2011	She returns to the UK.
June 2018	She 'retires', surrendering her bond with a value of £950,000.

The tax position is calculated as follows:

$$\begin{aligned}
 & (£950,000 + £500,000) - (£1,000,000 + £450,000) \\
 & = £1,450,000 - £1,450,000 \\
 & = \text{Nil chargeable event gain}
 \end{aligned}$$

Sarah could have invested £500,000 in the bond, retained the other £500,000 for her overseas project and encashed the bond in June 2018, in which case she would have received relief for the two years in when she was UK non-resident but she would still be liable for UK income tax on 7/9ths of the gain that related to her period of UK residency during the period she owned the bond. By overfunding the bond initially and then withdrawing those funds while UK non-resident, Sarah has received an effective tax-free growth on her investment of £450,000.

*....deficiency rules work even where the individual policyholder has spent some time as a UK non-resident.*

### Strategy three: Deficiency

The structure of the chargeable events regime for non-qualifying life policies means that it is possible for a charge to income tax to arise on a part surrender, which when taken into consideration on final surrender or death of the last life assured produces a deficiency. This deficiency can be used to reduce the liability to higher rate income tax of an individual and works by effectively extending their higher rate income tax threshold. The deficiency rules work even where the individual policyholder has spent some time as a UK non-resident.

Consider Steve, who has £1m of cash following the sale of a business and is looking to invest in an offshore bond. He will become UK non-resident for periods of time but will ultimately be a UK resident higher rate tax payer.

This is what he does:

March 2009	Steve invests £1m in an offshore bond.
June 2009	He becomes non-UK resident.
March 2011	He makes a partial surrender for £950,000. There are no tax considerations on partial surrender in country of residence
June 2011	He makes an additional investment of £950,000.
March 2013	He becomes UK resident.
April 2015	He surrenders the bond for £1.3m while he has a higher rate tax liability.

The tax position is calculated as follows:

$$\begin{aligned} & (\text{£}1,300,000 + \text{£}950,000) - (\text{£}1,950,000 + \text{£}800,000) \\ & = \text{£}2,250,000 - \text{£}2,750,000 \\ & = \text{£}(500,000) \end{aligned}$$

Steve therefore has a 'deficiency' of £500,000 that can be used to increase his basic rate income tax band by the same amount; effectively giving relief of 20% against his normal higher rate earnings up to the full amount of the deficiency. This strategy is likely to be unsuitable if you do not like the idea of claiming the deficiency on your tax return, as it might give HMRC reason to launch an (unfounded) enquiry into your return. However, if you are relaxed about that possibility and the tax relief is meaningful it is certainly an effective planning strategy worth exploring.

### The big picture

Many investors are likely to be reviewing their investment portfolios in the aftermath of the financial meltdown that has occurred over the past few years. In addition, with UK tax rates likely to rise significantly in the medium term and economic activity and opportunities subdued, more UK residents are likely to consider at least a temporary period working abroad. For these reasons, offshore bonds, although not a panacea, can offer many opportunities to minimise taxation on investment capital.

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