



The Tax Wrap

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If you combine a spoken poem or story with a pronounced drum beat and repetitive melody you end up with 'rap music'. The 'rapper', as the rap musician is known, recounts stories about love, loss or the difficulties of life on 'The Street' and some might describe the general tone as aggressive.

In this article we are going to look at 'wrap' in the context of investment taxation and how to minimise it in the brave new capital gains tax world by the use of different tax 'wrappers'.

A number of academic studies have demonstrated that the main determinant of the variation in investment returns between one portfolio and another is the asset allocation decision i.e. the combination of asset classes in which one invests. Tax and charges, however, can have a big impact on how much of those returns the investor ends up receiving.

Investment returns can take the form of interest, dividends or capital gains and most portfolios will usually have a combination of all three. Understanding the composition of these returns helps us to consider how the returns will be taxed using different tax wrappers. For the rest of this article we are going to focus on the situation for UK resident and domiciled individuals and the tax effect of using three types of tax wrapper to hold an investment portfolio: a collective fund, and onshore and offshore investment bonds. The position for non-domiciled individuals is more complicated and we will cover this in a future article..

The major change arising to investment taxation for UK-resident individuals is to capital gains tax (CGT) at the investor level, not the tax wrapper level. All companies (including UK life assurers) continue to be taxed under the existing rules and, in particular, will qualify for indexation allowance.

Collective funds

Unit trusts and investment trusts, as well as offshore funds with distributor status, are exempt from CGT on disposals arising **within** the fund and generally corporation tax is not payable providing that income is distributed to investors. At the investor level, a new CGT rate of 18% will be charged on disposals of units or shares in such a collective fund arising after 5th April 2008, with taper or indexation relief no longer applicable. As readers are probably aware, CGT is only payable if such gains exceed the investor's annual exemption (currently £9,200 per individual), after first taking into account any current tax year or brought forward losses.

Dividends from collectives are taxed at 10% for non- and basic rate tax payers and 32.5% for higher rate taxpayers with a non reclaimable tax credit equal to 1/9th of the net dividend paid. So a £9 dividend would come with a £1 notional tax credit making the gross dividend £10. The non taxpayer cannot reclaim the notional tax credit, whereas it settles the liability of the basic rate taxpayer. The higher rate taxpayer, on the other hand, is required to pay 22.5% of the grossed up dividend not represented by the notional tax credit. This is equivalent to 25% of the net dividend paid.



For higher rate taxpayers investing for growth with low dividends, the new 18% CGT rate will mean that they get to keep more of their returns compared with the current 24-40% (according to the degree of taper relief applicable) rate. In the case of dividends the tax treatment is unchanged.

Investment bonds

Investment bonds are single premium life insurance policies issued by either a UK (onshore) or overseas (offshore) life assurance company. Whilst the policy usually pays a slightly higher amount than the policy value on the death of the bond life assured, this is usually very small and probably, based on case law, unnecessary.

Capital gains arising within an onshore bond will be subject to the life company's tax rate (currently 20%) after allowing for indexation relief and expenses. Gains arising within the offshore bond will be exempt from tax.

UK dividends received inside a UK life fund bear no further tax and the investor has no tax liability on reinvested dividends either. Under an offshore bond the dividends will be received and no further tax will be payable but there will be no reclamation of the tax credit either. Foreign dividends will be subject to tax inside a UK life fund but typically not inside an offshore bond. In practice, however, the average yield on foreign equities and funds tends to be comparatively low and in any event, there are often non-reclaimable withholding taxes applied before receipt.

Interest received by a UK life fund will be taxed at 20% - the life company tax rate. Interest received inside an offshore bond will not be subject to tax and the benefits of almost gross roll up will be most keenly seen in connection with interest.

Unlike collectives, on which the investor suffers income tax on dividends and interest on an arising basis and capital gains tax on eventual encashment, the tax treatment of an investment bond means that the investor suffers **income tax** on any gain (whether arising from interest, dividends or capital). This provides the investor with a fair degree of flexibility over the timing of such liability, although with the disadvantage for taxpayers that this may be higher than the new 18% CGT rate if the underlying gain arises mainly from capital growth.

With an onshore bond, the whole gain arising on **encashment** is added to the investor's other taxable income arising in the same tax year and taxed by a further 20% for a higher rate taxpayer. There is no further tax liability for nil and basic rate taxpayers. With an offshore bond the gain will be taxed at nil, 20% or 40% for non, basic and higher rate taxpayers respectively.

If, however, the investor is a basic rate taxpayer before the bond gain is added to their other taxable income, but a higher rate taxpayer once the gain is added, then the gain will be subject to 'top slicing' relief (i.e. the total gain arising on encashment is divided by the number of complete policy years to determine the 'sliced' gain). The sliced gain is then added to the investor's other taxable income to determine whether it still exceeds the higher rate income tax threshold. To the extent that each slice does exceed the threshold an onshore bond will be taxed at 20% on the net gain while that on an offshore bond will be taxed at 40%.

Side by side

The balance between capital gains and reinvested income can have a huge effect on the relative merits of the available investment tax wrappers. We have carried out a detailed analysis of the tax effect of different tax wrappers for a variety of scenarios under the new CGT rules. For simplicity, we disregarded charges levied for the tax wrapper, although in practice these vary considerably and may cause different results.

In the example in *Figure 1*, where the return arises entirely from interest, the onshore bond looks the most attractive, closely followed by the offshore bond. In *Figure 2*, where capital gains are the main driver of performance then the collective looks most tax attractive – although, before investor tax, the offshore investment bond can match it. In *Figure 3*, where reinvested dividends exceed capital growth, the onshore investment bond looks the most attractive.

Figure 1

Higher rate taxpayer – Interest @ 6% per annum – wrapper charges disregarded				
Values @ year 10	Collective +AE	Collective – No AE	Onshore bond	Offshore bond
Gross	£142,429	£142,429	£159,813	£179,085
Net	£142,429	£142,429	£147,851	£147,451

AE= Annual CGT exemption

Figure 2

Higher rate taxpayer – Growth @ 6.5% + divs @ 1% per annum – wrapper charges disregarded				
Values @ year 10	Collective +AE	Collective – No AE	Onshore bond	Offshore bond
Gross	£201,360	£201,360	£192,708	£206,103
Net	£187,199	£185,003	£174,166	£163,662

Figure 3

Higher rate taxpayer – Growth @ 2% + divs @3.5% per annum - wrapper charges disregarded				
Values @ year 10	Collective +AE	Collective – No AE	Onshore bond	Offshore bond
Gross	£157,165	£157,165	£170,814	£170,814
Net	£154,911	£152,715	£156,652	£142,489

A point to bear in mind is the probability of actually paying the tax shown in the examples detailed. A transfer of the collective by way of gift to a third party other than a spouse or civil partner will give rise to capital gains tax unless it is to trustees and an election is made to 'hold over' the gain to the trustees. A bond, in contrast, may be assigned to a third party as a gift and there is no immediate tax charge on any gain. The gain is also gifted to the recipient and



subject to their own tax position. It takes five full tax years of non-residence for a previously UK-resident individual to avoid CGT on subsequent disposals, whereas it would currently take them only one complete tax year to avoid the gains on an investment bond. A one-year period of non-residence is often easier to envisage and engineer than five years. Whether the current tax treatment of investment bonds will continue is anyone's guess but it might be vulnerable if lots of people take advantage of the 'anomaly'. In that scenario, having all investment returns classed as income rather than capital gains might turn out to be rather expensive!

Given the many variables to take into account and the inherent uncertainties with regard to the future (e.g. in respect of actual performance, individual investor tax rates and what the tax system will look like), it must be accepted that with any investment wrapper choice, an element of risk is assumed, i.e. that what is assumed will be the case does not come to pass. It is to diminish the degree of risk assumed in making portfolio choices (for what will always be an uncertain future) that the principle of asset allocation has been developed.

This principle of 'spreading' or 'allocation' can also be applied in connection with tax wrapper selection where there is some uncertainty into the future. Where this uncertainty could make a decision made on an 'all or nothing' basis the wrong one, then it may make sense to diminish this risk by spreading investments across appropriate investment wrappers. Ignoring pensions and ISAs, it may be most appropriate to ensure that high growth funds are held inside collectives and high yield/interest funds held within investment bonds. For balanced/managed portfolios it will be important to strike a balance and so across a whole portfolio one could see (subject to charges and unnecessary complexity) a range of wrappers being selected. It is also worth bearing in mind the possible need to rebalance in the future, which would entail moving capital between different asset classes in order to maintain the required risk exposure, which can be compromised if each asset class is held within a different wrapper type.

Getting the right tax wrapper needs a careful analysis of the facts and the likely future circumstances. Get it right and you'll be singing from the rooftops. Get it wrong and you'll be singing that aggressive 'rap' music about how tough it is living on 'The Street'!

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