

## Investment Taxation

July 2009

**We've previously explained ways to minimise or avoid tax on gains arising within offshore bonds but we've come up with another idea to boost your spirits.**

### **More sneaky planning using offshore bonds**

If you are one of those people who is nursing a loss on your investment portfolio held within an offshore bond and you want (or need) to withdraw the funds, you won't be able to claim the loss against other taxable income or capital gains. However, there is a way that you can soften the blow and increase your proceeds beyond the actual value. What you need is another person who wants to buy your bond, including the inherent losses, on commercial terms. But why, you ask, would someone want to pay you more than your bond is worth? Well, from the buyer's perspective, he or she would have a very tax efficient structure for their own investment portfolio, which they wouldn't otherwise have been able to obtain.

### **Insurance bond taxation**

Before we look at the planning opportunity, we just need to remind ourselves of the general taxation principles of non-qualifying second hand life policies, as much has changed over the last few years. Bear with me on this as all will become clear.

A second hand policy is one that has been previously assigned for consideration in money or money's worth. The Finance Act 1983 amended the chargeable event legislation so that where, on or after 26 June 1982, a policy is assigned for consideration in money or money's worth, the chargeable event regime will continue to apply to that policy. If it's raining and you are looking for something to do, the relevant legislation is now in paragraph 102 Schedule 2 ITTOIA 2005 (previously section 544 ICTA 1988). This means that there can be a double tax charge on the gains arising under such a policy - an income tax charge under the chargeable event regime and a capital gains tax charge (under S210 TCGA 1992).

*....subject to satisfaction of certain conditions.....any amount chargeable to income tax.....can effectively be deducted*

However, subject to satisfaction of certain conditions (in S37(1) TCGA 1992), which were amended from 9 April 2003 (see below), any amount chargeable to income tax under the chargeable event regime can effectively be deducted from the disposal proceeds in the capital gains tax computation [section 527 ITTOIA 2005 (previously S547(2) ICTA 1988) does not provide relief in cases where the policy gain is subject to CGT].

As mentioned, a new section 210 TCGA 1992 was introduced by Finance Act 2003, which has effect for disposals occurring on or after 9 April 2003, to block a loophole by which it was possible to create an artificial capital gains tax loss due to the interaction of sections 37 and 39 TCGA 1992.

The position now is broadly that the owner of a second hand offshore insurance bond will, on encashment, first be assessed under the chargeable event regime, to determine whether there is an income tax charge and then under the capital gains tax regime to determine any capital gains tax (CGT) liability. Any income tax payable will be deducted from any CGT payable.

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### The fun bit

Still with me? Well done. Let's now apply these rules to give us a planning technique which is really very clever, if the circumstances are right. We are not, in this situation, trying to manufacture artificial capital losses, but instead turn the economic reality of the situation to our advantage. In a nutshell what the rules allow us to do is to turn one man's pain into another man's gain.

Let's look at a simple example. Len Lessor, who is UK resident and domiciled, invested £1m into an investment portfolio within an offshore bond in 2007. It's now worth £650,000 and he needs the funds out to invest in a promising new business venture. Instead of encashing it through the insurance company, he decides to convert the holdings to cash and agrees to sell the bond to his friend Mike Moore. Mike agrees to pay £675,000 to Len for the bond and its underlying portfolio of £650,000, i.e. a premium to its value of £25,000. Mike then has his investment adviser construct and manage a long term investment portfolio, comprising both fixed income and dividend producing equity investments, within the bond structure.

*.... what the rules allow us to do is to turn one man's pain into another man's gain...*

Len is happy that he has clawed back £25,000 of his £350,000 loss and can pursue his business investment. Len has no tax liability as the proceeds he received from selling the bond to Mike are assessed under the chargeable events regime and are £325,000 less than he invested.

Mike is happy because he has now paid £675,000 to invest £650,000 into a structure which will allow him to receive tax-deferred growth which is almost certainly going to incur a tax charge of lower than the 50% on gains arising in a new bond, if he remains a UK resident when he encashes.. Mike is also free to withdraw £100,000 immediately and up to £50,000 in each subsequent policy year without immediate charge to income tax, under the cumulative 5% annual bond withdrawal allowance based on the original premium paid by Len.

When Mike comes to encash the bond, and assuming he is UK resident, if the surrender value (plus any previous withdrawals) is less than the **original premium** paid by Len i.e. £1,000,000, then there will be no income tax charge. To the extent that the value exceeds the original premium this will be taxed at Mike's highest marginal rate, which we will assume will be 50% (from April 2010). In both scenarios a second calculation will be carried out to determine any capital gains tax liability. This will be calculated by deducting the market value of the bond (£650,000) as at the date Mike purchased it, plus the cost of acquisition (£25,000), from the encashment value. The difference will be taxed at CGT rates, which are currently 18%, less any income tax liability due under the chargeable event regime.

Let's take an optimistic scenario that the bond grows to £1,400,000 and Mike remains a UK resident when he encashes, income tax rates are 50%, CGT rates have risen to, say, 25% by then and Mike has used his CGT annual allowance elsewhere. The calculation would be as follows: £1.4M (surrender value) - £1M (original premium) = £400,000 (gain). Income tax would therefore be due of £200,000 (£400,000 x 50%). The capital gains tax calculation would be: £1.4M (surrender value) - £675,000 (market value plus acquisition costs) = £725,000. The CGT bill would therefore be £181,250 (£725,000 x 25%), but as Mike has already paid £200,000 of income tax, the residual CGT liability would be nil.



So in the above scenario Mike would have paid £225,000 (£200,000 + £25,000) of tax and costs on a gain of £725,000 (equivalent to 31%) compared to 50% had he used a new bond or about 43% overall tax if held in his own name (assuming 50% of the return arises from interest, 30% from dividends and 20% from capital growth). Of course Mike could always become non-UK resident when he chooses to encash and he'd avoid both taxes completely but that's another story!

### The constructive remittance 'trap'

If you are a non-UK domiciled person who has capital in an offshore trust which is managed by a UK-based investment manager, you might be inadvertently causing a needless tax liability.

If an offshore trustee remits non-UK income to the UK, or generates UK-source income, whether remitted or not, they will be taxed on that remittance or income at their highest rate i.e. 40%. This will rise to 50% from next April, so avoiding such taxable remittances is vital.

*.... what this means.....  
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It is very common for non-UK domiciled individuals with a long association with the UK, to wish to appoint UK-based investment managers to manage some or all of the capital held in the family offshore trust. However, without specific exempting provisions, the payment of management and custody fees to a UK investment manager by offshore trustees or an underlying offshore company would be treated as a 'constructive remittance', under provisions within the Finance Act 2008. This is because the payment would

come within the definitions in the main constructive remittance section which, paraphrasing, involves the provision within the UK of a service for the benefit of a 'relevant person' (defined to include the trustees).

There is an argument that the settlement of such management fees to an offshore bank account would get around this, but we don't think that this is correct because two rules: 'relevant debt' and 'connected operations' would catch that too. However there was a late amendment to the Finance Bill 2008 which inserted a new s.809W into ITA 2007.

Section 809W states that where there would otherwise be a constructive remittance in the circumstances previously described, it is exempted provided that:

- (a) the service in question relates wholly or mainly to **property situated outside the UK**, and
- (b) the entire consideration for the service is paid into **bank accounts outside the UK** held by or on behalf of the service provider.

So what this means in practical terms for offshore trusts is that UK-based investment assets are best avoided completely and the fees relating to the management thereof by UK-based managers need to be paid into an offshore bank account held by the investment manager. The UK investment manager would then be free to remit those funds to a UK bank account.

There are many offshore funds which are sterling denominated and which provide exposure to UK asset classes, so this need not mean less investment freedom. Dublin funds are now treated as being outside the UK for tax purposes and most fund management groups offer Dublin funds in addition to or instead of UK funds. Exchange traded funds, which are increasingly popular with investors and managers, are also frequently Dublin-based, so they would be suitable.

If your trustees, tax advisers or investment managers haven't mentioned this issue yet, then you most certainly should. Otherwise you might get an unexpected, but totally avoidable, tax bill at the end of the tax year.

### Offshore fund tax changes

The last budget introduced changes that aligned the tax treatment of dividend-paying offshore funds with that of UK funds in relation to the extent to which the fund is invested in equities and debt (interest producing) investments.

Previously all distributions from offshore funds were received and taxed as dividends; the 'UK' concept of an 'interest distribution' does not exist for offshore funds. Since 6 April 2008, individual shareholders with shareholdings of less than 10 per cent in non-UK resident companies are entitled to a non-payable dividend tax credit. This tax credit resulted in tax freedom for non- and basic rate taxpayers on such 'interest-fuelled' dividends and a 22.5% rate for higher rate taxpayers (32.5% - 10%).

*.... extend....eligibility for the non-payable tax credit to individuals in receipt of dividends from non-UK resident companies.....*

However, the tax credit was subsequently withdrawn for offshore funds as some collective investment schemes were seeking to exploit the extension by locating their cash or bond fund ranges offshore, with the intention of securing tax advantages by paying dividends funded by non-taxed interest which carried a 10% tax credit. Before the latest amendments, distributions made as dividends from offshore funds received by individual UK-resident shareholders were taxed at rates of 10% for basic rate and 32.5% for higher rate taxpayers regardless of the

nature of the investments underlying the fund. Where the distributions are from non-corporate offshore funds they may be taxable at different rates depending on the type of fund and (in some cases) the nature of the fund income.

Legislation in Finance Bill 2009 will amend section 397A of the Income Tax (Trading and Other Income) Act 2005 to extend further eligibility for the non-payable tax credit to individuals in receipt of dividends from non-UK resident companies **including offshore funds that are companies**.

However, where the offshore fund holds more than 60% of its assets in interest-bearing form, any distribution will be treated in the hands of the UK individual investor as a payment of yearly interest. This will mean that no tax credit will be available and the tax rates applying will be those applying to interest. This mirrors the current treatment of UK corporate investors with holdings in similar funds (in the UK or offshore) and also means that UK individuals will pay tax on interest-like distributions at the same rate as tax is borne by individual investors on interest distributions received from UK authorised funds. This change will not affect the taxation of UK investors in offshore funds which are transparent for the purposes of tax on income as in such cases the investor is taxed on their share of the underlying fund income according to the type of income received and not on the distribution made.



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With the new higher rate income tax rate of 50% on interest from April 2010, holding such funds within an offshore bond or a roll up version looks even more attractive. Even if you remain UK-resident, the gross roll up of interest and control over when one pays tax looks a better bet than surrendering 50% of interest returns each year. Although current interest rates are low, they are unlikely to stay that way for long and careful tax planning will pay dividends (or rather interest!).

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