Hello and welcome to this short video entitled “The Taxation of Investment Bonds, understanding the five main chargeable event triggers.”

I’ll explain these triggers and highlight any tax planning opportunities.
The chargeable event regime applies to individuals, personal representatives and trustees. Company owned Bonds are taxed under different rules and are covered in a separate video.

The video is based on our understanding, as at the date you can see, in the important information section on the screen.

I’m Graeme Robb, and I’m a Senior Technical Manager. I’ll take you through this short video.

When it comes to the taxation of Investment bonds, clients could be forgiven for scratching their heads. They learn that bonds don't produce income... but are subject to income tax, meanwhile bond gains are rarely subject to capital gains tax.

The explanation is provided by tax law.

The rules for taxing individuals, personal representatives and trustees (but not companies) are contained in the Income Tax, Trading and Other Income Act 2005. This makes it clear that gains are subject to income tax and only in certain specific, and unusual circumstances, will a Capital Gains Tax charge arise. ITTOIA 2005, sets out what's known as the Chargeable Event legislation.

There are five main 'triggers' giving rise to a chargeable event.

I'll consider these next, but don't forget that bonds are, non-income producing investments and therefore potentially useful for those looking to turn off the income 'tap'.

In broad terms, the chargeable event regime is logical.

- Wait for a chargeable event
- Calculate the gain arising
- Attribute that gain to a chargeable person

Regarding that third bullet point, we have a separate video explaining who is liable for the tax when a bond is held in trust.

So, here are the five main chargeable event triggers

Death giving rise to benefits

Assignment for money or money’s worth

Maturity if appropriate

Excess surrenders and part assignments for money or money’s worth

Surrender of all the rights

I’ve listed the chargeable events in the above order as many of you will be familiar with the acronym **DAMES** which is a helpful reminder.

However, it’s logical to re-jig the order and start off with ‘Excess surrenders and part assignments for money or money’s worth’. In fact, part assignments for money or money's worth are very uncommon, so let’s ignore and instead simply start with excess surrenders.

The reason for starting with excess surrenders is that the client continues to have an interest in the bond since there has only been a part surrender, but contrastingly the remaining four events trigger a finality, where for different reasons the client's interest in the bond ceases. Also, part surrenders which may or may not trigger an excess have a knock-on impact when calculating gains on those other subsequent ('final') chargeable events.

So, let's consider part surrenders.

I'm only briefly considering part surrenders because my colleague, Barrie Dawson has already posted a video on Pru Adviser devoted entirely to part surrenders and the 5% tax deferred allowance.

Part surrenders are very popular with individuals and trustees and are therefore very common. An excess gain may or may not arise from a part surrender. If a part surrender occurs then a calculation needs done at the end of the insurance year to determine whether total part surrender proceeds exceed the 5% withdrawal allowance. If so, that excess will constitute a gain.

The withdrawal allowance is equal to 5% of premium(s) paid in an insurance year and the next 19 insurance years. Any allowance not used can be carried forward for later use. An investor can therefore withdraw 5% of a single premium investment each insurance year for 20 years without incurring a chargeable event (or 4% for 25 years, or even 2% for 50 years!).

In his video, Barrie considers this in some detail, but I would like to cover off a particular question before moving on.

How do part surrenders impact on the other four subsequent chargeable event gain calculations?

It’s simple really.

Part surrenders within 5% limits are tax deferred rather than tax free so in that later gain calculation, you need to add back the earlier part surrender proceeds and then, to avoid double tax, you deduct any excess gains arising on those part surrenders.

So, for example, if it’s a pay-out on death then the calculation is

Surrender value immediately before death

Plus Any previous part surrender proceeds

Less Total premiums paid

Less Any previous excess gains

If it was a full surrender, the calculation would be similar, but the starting point clearly would just be the sum payable rather than surrender value immediately before death.

Where part surrender exceed cumulative 5% allowances, be aware that the resultant gain bears no correlation to the economic performance of the bond. A significant part surrender can inadvertently create a significant chargeable event gain.

When a part surrender is contemplated and it's clear the 5% allowance will be breached, then a comparison should be made between a part surrender across all segments, versus the full surrender of individual segments (perhaps combined with a part surrender across the remaining segments). Segment surrender will often produce a smaller gain although each case must be judged on its own merits.

A word of warning – for some, the smaller gain is not always desirable. For example, a low taxpayer with a UK bond gain might prefer to crystallise a larger gain if it gives rise to no tax liability. This is where your top slicing relief knowledge will come into effect. Top slicing relief is also covered in a separate video.

Next, I'll consider a second chargeable event trigger which is death giving rise to benefits.

Firstly, if death doesn’t trigger a payout then death isn’t a chargeable event.

If though you’re dealing with a simple case where the client is the owner and sole life assured then death of the client will trigger a payout and therefore a chargeable event arises. In this case if a gain occurs, it will be taxable on the deceased client and not the personal representatives.

With a life assurance bond, the person whose life is insured may though be different from the policyholder.

So what planning opportunities arise from these facts?

Should a client’s bond always be set up with extra (probably younger) lives assured so that the client’s death doesn’t automatically give rise to a chargeable event? Not necessarily. Remember firstly that insurable interest is a key element. For some applicants, there might simply be no suitable additional life assured to add to the Bond.

Also, from a taxation perspective there may be sound reasons for the bond paying out on the client’s death. Perhaps the client is likely to be a nil or low taxpayer for the rest of their life? Whereas beneficiaries are maybe higher rate.

If the client dies but the bond continues thanks to a surviving life assured, then the personal representatives might surrender or they might assign the bond or segments to beneficiaries of the estate.

These choices are explored in another short video on Pru Adviser.

Next up, I’ll consider Assignments for money or money’s worth.

The phrase ‘Money or money’s worth’ typically involves cash, but in truth the meaning is wider. For instance, if a client transferred ownership of a bond to someone else in return for a valuable asset, then that would be an assignment for money’s worth. Also, an assignment for money’s worth can arise in a loan trust scenario if the trustees assign segments to the settlor to repay the outstanding loan.

Rather than dwelling on uncommon examples of assignments for money or money’s worth, let’s focus on assignments by way of gift which don’t create a chargeable event. These provide tax planning opportunities as later chargeable event gains are then assessed on the assignee (i.e. the new owner). This planning is often used by individuals where the assignor is higher rate and the recipient is basic rate or lower. The assignment should be outright and unconditional.

Also, the trustees of a discretionary trust might assign segments, perhaps in an offshore bond to beneficiaries with low income such as students who can later encash and utilise their own tax position, or perhaps trustees might be the recipients of an existing bond being gifted into trust by an individual as part of an IHT planning strategy.

Next, I’ll consider Maturity.

Life assurance bond maturities are uncommon. If not fully surrendered, most life assurance bonds pay out on death of the (last) life assured.

Other than life assurance bonds, it's possible for clients to purchase an offshore capital redemption bond with no lives assured. The bond will have a fixed term, for example 99 years although it can be encashed at any time. If it is continued for the full term, it will pay a guaranteed minimum amount at maturity.

From a chargeable event perspective, 'death giving rise to benefits' isn't applicable for a capital redemption bond and instead maturity is the potential trigger. Other than this, an offshore life assurance bond is taxed identically to an offshore capital redemption bond.

A capital redemption bond might appeal to an investor who wishes, but is unable to, add extra lives assured to their bond due to a lack of insurable interest. Also, in the case of a trustee application, it may be attractive for the trustees (perhaps even cosmetically) to simply have the trustees as owners but with no lives assured named. This ensures the trustees can choose when to cash it in or instead to keep it going through successive generations.

Next, I'll consider the fifth and final chargeable event, namely the full surrender of a bond.

A full surrender is self-explanatory and easy to understand. Any chargeable event gain will arise at that time and fall into the tax year in question.

Earlier, I explained how a part surrender exceeding 5% limits creates a gain bearing no correlation to the economic performance of the bond, and therefore a significant part surrender can inadvertently create a significant chargeable event gain.

It may be possible for the client to get HMRC agreement to recalculate the gain on a just and reasonable basis – but that is far from certain. Alternatively, it may be possible to rescue the situation with some planning.

Where a part surrender gain arising on the last day of the insurance year is followed by a full surrender in the same tax year, the part surrender gain is then ignored and instead the proceeds are brought into the final surrender gain calculation.

Your account manager can discuss this specific planning with you, but in broad terms, it serves as a reminder that tax wise, bond surrenders should generally be timed if possible, to fall into the most suitable tax year to minimise the impact of taxation. Don't forget that a personal pension contribution extends the client's basic rate band by the gross contribution. Accordingly, a contribution made in the same tax year that a chargeable event gain arises could prevent a top sliced gain from breaching the basic rate threshold.

That’s us at the end of this short video and I hope its been of use.

If you wish to discuss matters further then please contact your Prudential Account Manager.

You can also access our Knowledge Library within Pru Adviser for further information. In particular, these resources may be useful.

Thanks very much for your time.