Hello and welcome to this short video entitled “Top Slicing Relief”. I'll consider why it exists, how it works and explain changes announced in the March 11 2020 Budget.

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.

Insurance Bonds are non-income producing, typically not subject to Capital Gains Tax and so don’t sit squarely within the normal rhythm of the tax system. Instead they're taxed under special rules known as the chargeable event regime.

Tax will only occur when a gain is calculated on a chargeable event.

This can be appealing to many clients. For example those who are currently Higher or Additional Rate taxpayers looking to turn off the income tap & defer crystallising gains until a time when they are subject to lower rates.

But, investors could be disadvantaged by being taxed in a single year on gains accrued over a period of time. Top Slicing Relief therefore delivers a spreading mechanism for individuals to reduce the effective rate of tax charged on the gain.

To carry out a Top Slicing Relief calculation you need to possess certain knowledge.

You need to know the client's other taxable income and the order of tax rules.

The first slice of a client's income comprises earnings, pensions, trading profits etc. The next slice is savings income and then dividends. Bond gains are tricky because offshore gains come before dividends but onshore gains come after dividends.

These rules apply when working out a tax liability before TSR but in the 5 step TSR calculation both onshore and offshore gains and slices are treated as the top part of total income. This is called the highest part assumption.

Bond gains are savings income and therefore in your sums you need to consider the £5,000 0% Starting Rate for Savings and the Personal Savings Allowance known as the PSA. The PSA be £1,000, £500 or zero depending on the client's adjusted net income. Total bond gains rather than top sliced gains are included in adjusted net income. Remember that The personal allowance is restricted where adjusted net income exceeds £100,000. I'll come back to this shortly as it was a matter addressed in the Budget of 11 March 2020.

The key to a top slicing calculation is to divide the gain by the number of complete years. For a full surrender the number of top slicing years equals the number of years since inception. Full details though are contained in our top slicing facts article on Pru Adviser.

Right, let's have a look at a simple case study.

Pease pause the video where appropriate to absorb the tax calculations.

We have a client Anne, resident in England, who has a salary of £48,670 and a £24,000 gain on the full surrender of an offshore bond held for 8 complete years.

This basic information reveals a lot. We know that...

Her salary falls within personal allowance then 20% basic rate.

Her personal allowance is not restricted because her adjusted net income is just £72,670.

She will not be entitled to the £5,000 0% Starting Rate for Savings because the first £5,000 of her taxable income is earned income and not savings.

She will be entitled to a £500 PSA so that the first £500 of bond gain will be taxed at zero.

And her salary falls £1,600 below the £50,270 higher rate meaning that only £22,400 of her bond gain falls in higher rate tax.

So, let's calculate Anne's tax liability before TSR.

Anne’s salary of £48,670 is taxed at zero within personal allowance and 20% basic rate on the £36,100 balance.

Regarding the bond gain she has £1,600 before the higher rate threshold.

The first £500 of that £1,600 is taxed at zero within her PSA.

The next £1,100 is taxed at 20% with the balance of £22,400 then taxed at 40%.

Her tax liability before top slicing is £16,400.

Let's now work through the 5 step top slicing calculation.

STEP ONE

The gain is treated as the highest part of income and is added onto other income to establish how much tax is due in total.

STEP TWO

Review that calculation and identify how much of that tax is due solely to the bond. To arrive at the ***individual's liability***, deduct a basic rate credit for both onshore & offshore. This ensures that top slicing relief is identical between onshore and offshore bond gains.

STEP THREE

Divide the gain by 'N' which is the number of years to work out the slice.

STEP FOUR

Remember that STEP TWO taxed the **gain** on top of other income. This time we tax just the slice on top of other income. We then deduct the basic rate credit on the slice and multiply the answer up by 'N' to arrive at the ***individual's relieved liability .***

STEP FIVE

Top Slicing Relief can then be calculated by deducting STEP FOUR from STEP TWO.

Let's now apply these steps to our case study.

We’ve seen this one before.

When we calculated Anne's liability before top slicing relief we used the order of tax rules which comprised salary first and then bond gain. This time the gain is treated as the highest part of income. It so happens that Anne's affairs are simple so both methods are identical but that wouldn’t always be the case. Remember that under order of tax rules, an offshore bond gain comes before dividends but under the highest part assumption used in step one it comes after dividends.

Calculating the “individual’s liability” on just the bond gain is quite simple.

Look at the final column, the tax due on the bond gain is £220 + £8,960 = £9,180.

Despite it being offshore , we knock off the 20% basic rate credit and this provides a figure of £4,380 for the **individual’s liability**

Now let’s consider steps three to five.

Step three. The gain of £24,000 is divided by eight years giving us a slice of £3,000.

In Step 4 we ignore the full bond gain and instead slot in the slice of £3,000 in the tax calculation. Please see the orange circles.

The first £500 is covered by the PSA, the next £1,100 up to the higher rate threshold is taxed at 20% and the balance of £1,400 is taxed at 40%. In total we get a tax bill on the slice of £220 + £560 = £780. See the Step four calculation in the bottom left. Now deduct the £600 tax credit relating to that slice. £600 is just 20% of the £3,000 slice. The balance of £180 is multiplied back up by 8 years to provide a figure of £1,440 representing the **individual's relieved liability.**

In the Budget of 11 March 2020, there was a top slicing change concerning Step 4. This related to the situation of a client losing personal allowance because their bond gain plus other income breached the £100,000 threshold. The Budget announced that the personal allowance can be reinstated in Step 4 where it has been reduced due to the inclusion of a gain in the income for the year. In Step 4, the personal allowance is calculated by reference to the taxpayer's other income and the slice. Previously, where it had been reduced, that reduced figure was used in Step 4. HMRC consider the amount of PSA and Starting Rate for Savings remain set by virtue of the client's adjusted net income, and so, unlike the personal allowance are not adjusted in Step 4 when calculating the notional tax due on the slice.

OK back to the case study figures.

Please see bottom right where we calculate the top slicing relief by deducting the ***individual's relieved liability*** of £1,440 from the ***individual's liability*** of £4,380 to arrive a top slicing relief figure of £2,940

Let's summarise this.

Anne's liability before top slicing relief was £16,400.

Her top slicing relief is £2,940.

Her tax liability after top slicing relief is £13,460.

Anne's bond was offshore. If it had been onshore then top slicing relief is identical but you simply need to deduct the bond basic rate credit of £4,800 so that the tax liability drops to £8,660.

That’s us at the end of this short top slicing webex. In summary

- If the gain straddles basic & higher then top slicing relief applies, and
- If the gain straddles higher and additional rate then again top slicing relief applies

A very quick word on planning.

Since bond gains can result in basic rate clients being pushed into higher rate or a higher rate clients being pushed into additional rate then a personal pension contribution which extends the basic and higher tax bands by the gross contribution can be very tax efficient.

That’s 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 and these articles cover off certain quirks which I’ve not had time to address in the video such as

- Why top slicing relief can apply when the gain falls fully into higher rate
- How to deal with more than one gain in the same tax year, and
- The gift aid quirk where basic and higher rate bands are not extended by gift aid payments for top slicing relief purposes.

Thank you very much for your time.