British Expatriates

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Summary of tax benefits of an offshore investment plan

Under HMRC tax rules for 'foreign' investment bonds and investment-linked life policies have additional tax planning benefits compared with their domestic equivalents. The purpose of this information sheet is to briefly highlight the most important. The content is not intended to be specific tax advice of any kind, and rules can change at any time. Everyone's tax situation is unique and you should consult a qualified tax accountant regarding your own circumstances.

- 5% withdrawal allowance
- Time apportionment reduction
- Top slicing relief
- Clustering & segmentation

Background

Foreign investment-linked life policies, including investment bonds (for lump sum investments) and offshore savings plans (for regular savings), have been used for decades by international investors as a legal way to manage and mitigate certain tax liabilities. These wrappers are generally domiciled in low-tax jurisdictions where no tax is due on investment gains, hence providing 'gross roll-up' - compounded growth year on year with no deductions. Recognised in large number of expat locations, tax liability on gains (which would ordinarily be due for the current tax year) can be deferred to a potential liability for tax at some time in the future (when we might be in a lower tax bracket or a more favourable tax jurisdiction).

Whilst the policyholder is offshore (non UK-resident), the underlying investments can grow in a tax efficient environment throughout the time held. On realising the investment, any potential tax charge is dependent on your country of residence.

For British expatriates, compliant structures have tax planning benefits even when you have returned to the UK. The following information refers to policyholders who are UK resident at the time of withdrawal. The treatment is broadly similar for both investment bonds and regular savings plans, though the calculations are more complicated for regular savings (many providers will supply you or your accountant with the calculations upon request). For ease of explanation we refer only to investment bonds in the text below.

Chargeable events

A key concept to understand is that of the 'chargeable event'. Investment bonds are non-income producing assets for UK tax purposes. Details of the bond do not have to be included in your tax return until a

chargeable event is triggered, and at such time the details must be included in the relevant section of your Self Assessment.

Chargeable events include:

- death of a life assured giving rise to benefits under the bond
- full surrender (cash-in) of the bond
- maturity of the bond
- assignment of the bond for money or money's worth
- partial withdrawals, above a certain level, across all segments
- full surrender of individual segments

What is a chargeable gain?

Prior to working out the benefit of allowances and reliefs, first we identify the chargeable gain.

Death - the gain is the excess of the surrender value immediately before death, plus the total amount of all previous partial withdrawals, if any, minus the total amount of premiums paid, plus the total taxable gains on any previous chargeable events.
Full surrender - same as death but use the actual surrender value.
Maturity - same as death but use the maturity value.
Assignment for money - same as death but use value obtained at point of sale instead of surrender value.
Partial withdrawal - the gain is the amount withdrawn *less the 5% per annum cumulative allowance*.
Full surrender of segments - same as full surrender but applied only to the surrendered segments.

The 5% allowance rule

The 5% rule (periodic calculation rule) applies only to partial withdrawals across all segments. Specifically, partial withdrawals of up to 5% a year of accumulated premiums can be made with any tax charge postponed. The 5% rule becomes an exemption if the policyholder's circumstances have changed so that by the time the deferred tax charge is triggered there's no tax payable.

Every policy year there's an allowance of 5% of the premium paid, up to a maximum 20 years. Any unused allowance can be carried forward until the bond comes to an end. The policyholder can carry forward unused allowances from year to year, so they may have the opportunity to withdraw more than 5% without having to pay tax.

Time apportionment reduction

Time apportionment reduction applies on full surrender of the policy (or segments) if you have been non UK-resident at any time during the term of the policy.

Time apportionment reduction reduces the chargeable gain on full surrender by the proportion of time you were non-resident. The gain after time apportionment reduction will be subject to income tax at your applicable rate (not capital gains tax).

The part of the gain relating to the period of non-residence is not liable for UK tax. The calculation is:

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Amount of reduced chargeable gain liable for tax = Total gain x (Total number of days resident in UK)/(Total days bond has been in force)
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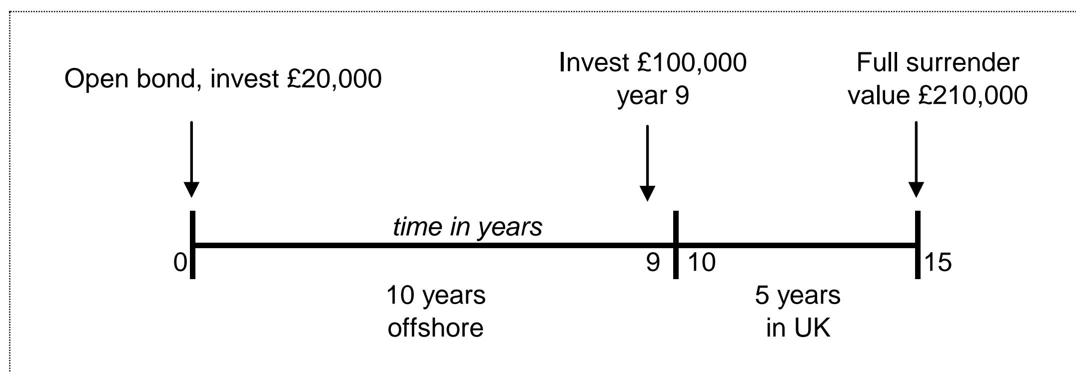
For example, if you have held a bond for ten years prior to full surrender, and for only five of those years you were resident in the UK, the chargeable gain is reduced to 5/10 = one half.

Start the clock as soon as possible

Time apportionment relief starts from the commencement date of the policy, *even for premiums paid into the bond at a later date*.

For example, see the following timeline:



In the scenario above, the chargeable gain is reduced thus: 5yrs/15yrs = one third.

Total gain = £210,000 – (£20,000 + £100,000) = £90,000

therefore chargeable gain = £90,000 x 5/15 = £30,000.

Top slicing relief

Top slicing relief applies only if you are a non-higher rate taxpayer. The relief can't help if you are already taxed at the higher rate before the chargeable event gain is added to your income.

If you are a non-higher rate taxpayer and the gain from a bond causes your total income to fall into the higher rate tax-band then top slicing relief applies. Top slicing determines what fraction of the gain, known as the 'slice', is liable for higher rate tax. The actual calculation of top slice relief requires a number of steps and will depend on the tax rates at the time of withdrawal; your account will be able to perform this calculation for you.

Clustering & segmentation

Many offshore life companies allow their policies - both regular savings and single premium - to be split into a number of 'mini-policies' known as segments or clusters. Each segment is a policy in its own right, which has several advantages for tax-planning purposes in many jurisdictions. The following example is in respect of the UK tax jurisdiction.

Partial surrenders

One of the benefits and a common use of policy segmentation is when a partial surrender is taken from the policy.

As mentioned above, in the UK a withdrawal of up to 5% of the original investment can be taken each year for 20 years without an immediate liability to income tax. If the 5% is not taken in any policy year the unused allowance can be carried forward on a cumulative basis. Any excess over and above the 5% allowance is chargeable excess, which will be liable to tax at the policyholder's marginal rate. The calculation to determine chargeable excesses ignores any growth in the policy.

Here is an example of how surrendering whole policy segments can be more 'tax friendly' than surrendering across all policy segments or from the one policy if segmentation is not chosen or not allowed.

Example: £100,000 single premium investment bond; £30,000 required in year 4 (see table over).

Partial Surrender (of non-segmented plan or across all segments of a segmented plan)		Full Surrender of Segments	
Gain is calculated using the 5% rule, and investment performance is not considered		*Gain is calculated using the actual investment performance*	
Initial Contribution	£100,000	Initial Contribution (100 segments)	£100,000
Current value in year 4	£120,000	Initial value of each segment	£1,000
Surrender in year 4	£30,000	Current value in year 4	£120,000
Cumulative 5% allowance		Current value of each segment yr 4	£1,200
£100,000 x 5% x 4 =	£20,000	Surrender value of 25 segments	£30,000
Chargeable Excess £30,000 - £20,000 =	**£10,000**	**Chargeable Gain** 25 x (£1,200 - £1,000) =	**£5,000**

Actual tax liability (as income in both cases, not capital gains) on these chargeable figures will depend on the policyholder's marginal tax rate and entitlement to time apportionment relief and top-slicing relief.

Whilst it can be seen that in many cases surrendering full segments may have immediate tax benefits, note that the continuing 5% p.a. allowance will be based on the original value of the remaining segments. In the above example, after surrendering 25 segments of 100, the annual allowance would reduce to 5% of £75,000 rather than 5% of £100,000.

Important note: always consult your tax accountant prior to instructing a withdrawal, as the method chosen (5% allowance or segment surrender) cannot be changed retrospectively.

Transfer by assignment

This can be a significant tax planning benefit of an offshore investment bond or life policy, and should not be overlooked at the time of any withdrawal.

Assigning a policy absolutely to a third party is not a chargeable event for tax purposes, as long as the assignment is done by way of a gift. Once the policy has been assigned, the assignee as the legal owner of the policy can surrender the policy, providing of course that the assignee is over 18. If the beneficiary is a non or basic rate tax payer, then this is a simple way of passing on the benefits to the beneficiary in a tax effective manner.

Where the policyholder is a higher rate tax payer, assigning individual segments to a non-tax (or lower rate tax) paying spouse or adult child is a tax effective way of passing capital on between family members.

In addition to the reliefs and allowances detailed above, the potential benefits of policy segmentation are so great, that for British expats likely to return to the UK it is almost always worth considering a clustered policy.