Offshore bonds: unique tax planning vehicles

For UK adviser use only.

Back in the spotlight

Increases to the rate of Capital Gains Tax (CGT) combined with recent cuts to the annual exemption, and dividend allowances mean bonds are back in the spotlight.

Unique tax features

Offshore bonds enjoy unique tax features which means unlike onshore bonds, investment gains can be completely tax free in certain circumstances leaving some clients better off.

While the flexibility of offshore bonds can help to meet a wide range of client needs, they can also be used as one very simple, tax-efficient solution for your clients.

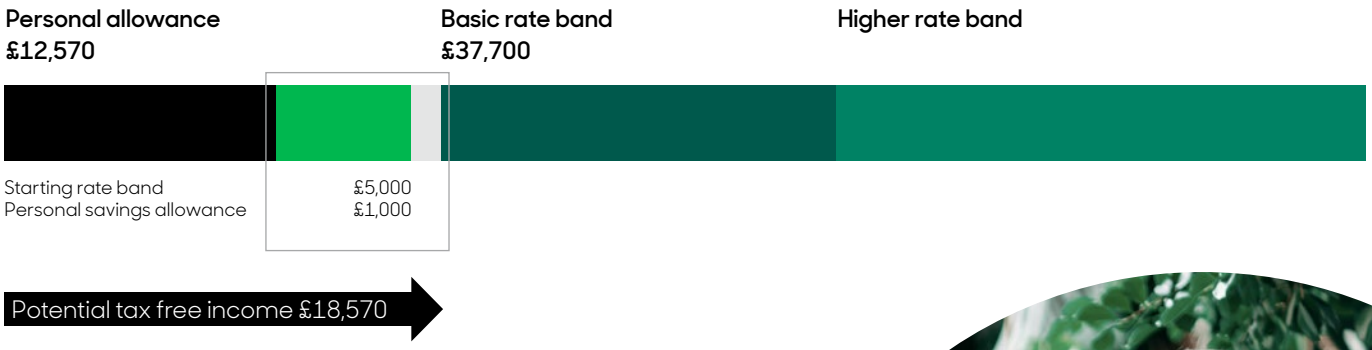
This tax efficiency effectively allows clients to build on their existing ISA allowance to achieve largely the same outcome.

With an offshore bond, gains can be extracted tax free within the allowances, and there's no need for complex top slicing relief calculations.

With good planning, clients can extract gains from an offshore bond, free of tax, through:

1. **Gross roll up:** Unlike onshore bonds there's no UK tax on income and gains within the fund.
2. **Flexibility to time when gains are assessed for tax:** Realising gains in tax years when the client has little, or no income can avoid tax on gains altogether.
3. **Adjusting other income:** To coincide with bond gains so clients can make full use of all the appropriate available tax-free allowances.
4. **Keeping gains within available tax allowances:** Gains of up to £18,570 each year can be taken tax free as offshore bond gains can be offset against the starting rate for savings (£5,000) and personal savings allowance (£1,000), in addition to the personal allowance (£12,570).

   One common use for offshore bonds is for clients in flexible drawdown, retiring before State Pension age. They have the option to switch off pension income for a year. As our diagram below illustrates.





Fund taxation

Within a onshore bond:

Corporation tax:

• Dividends	0% (Franked)
• Interest	20%
• Rent	20%
• Capital growth	20%

(indexation allowance removed from Jan 2018)

Within a offshore bond:

Not liable to UK corporation tax:

- Dividend income received net of with-holding tax
- Tax paid on "net" funds (generally) not reclaimed
- Interest income received gross

Investor taxation

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- Taxed as the top part of income, so after dividend income
- Benefit from a non-reclaimable 20% tax credit, reflecting life fund taxation
- This tax credit satisfies the liability for non and basic rate taxpayers
- Further tax is payable if the gain, when added to all other income, falls in the higher rate band and above

offshore bond

- Taxed as savings income and taxed after earned income but before dividends
- There is no credit available to the bond holder. Gains are taxed 0%, 20%, 40% or 45%
- Gains will be tax free if they are covered by an available allowance:

Personal allowance (£12,570)

Starting rate for savings (£5,000)

Personal savings allowance (£1,000 BRT or £500 HRT)

Offshore bonds: with investment profits extracted tax free, tax planning can be simple

Both onshore and offshore bonds are taxed under the chargeable events legislation, which means that income and gains are only assessed to tax when there's a chargeable event as a result of surrender; withdrawals in excess of cumulative 5% allowance; or death. This allows planners to time when chargeable events occur and control when tax may be payable.

- Offshore bond gains are taxed as savings income. This means chargeable gains which fall within the following are tax free: an investor's personal allowance; starting rate for savings; personal savings allowance.
- Profit from the offshore bond can continue to be taken tax free - for an investor likely to remain a non-taxpayer, by surrendering just enough segments to keep gains with the available allowances in subsequent years.

Offshore bonds can also support your clients savings' needs as, if income is stopped for one year, clients can take gains up to £18,570. See example below.

Current value £371,400 with original investment £185,700 into 100 segments.
Surrendering 10 full segments would realise £37,140, but investment gain would be £18,570.



For a non-taxpayer this could be offset against the personal allowance, starting rate band and personal savings allowance:



Offshore bonds: the planning opportunities for your clients

The number of retirees with DC pensions is rising. So, for clients at retirement, pre state pension and using drawdown, they may be able to turn off their pension income and make themselves a non-taxpayer in a tax year in which bond gains are taken. **Take a look at example 1 right**.

Offshore bonds can also be used as a 'bridging pension'. Clients who may have a fixed retirement income such as a DB pension or state pension may be able to use an offshore bond as a 'bridging pension' between retirement from work and accessing pension benefits. It means clients' pension benefits can remain invested in a tax beneficial environment for longer and may even help with early retirement. **Take a look at example 2 right**.

More ways offshore bonds can support your clients' needs

Can be assigned between spouses without a tax charge ...

Bonds are subject to income tax but this isn't applicable when a bond is assigned by way of gift. The new owner is assessable for all future chargeable gains as if they'd owned the bond from the start. It means gains can be transferred to a non-taxpaying spouse or civil partner, allowing them to use their spouse's tax-free allowances. If both spouses are non-taxpayers, the bond can be assigned into joint names doubling the potential tax-free allowances from £18,570 to £37,140.

... and can support university funding

Gains can be extracted tax-free while adult children are studying at university and not earning. As most students are unlikely to have much income, they'll have unused allowances to offset any chargeable gains. Students with no other income will have the full personal allowance, the starting rate band for savings and the personal savings allowance, giving £18,570 of tax-free allowances. Over a typical three-year university course, that's £55,710 of chargeable gains which can be taken tax-free. With the capital returned too, it should be enough to meet students' tuition fees and living costs.



Example 1

Ian, 63, has a SIPP and he takes drawdown income of £46,858 p.a. which gives him a net spendable income of £40,000 a year. He also has an offshore bond which is currently worth £160,000 and includes a gain of £72,000. He has no other income.

As an alternative, Ian could pause his drawdown income for the current tax year and surrender a quarter of the segments in his offshore bond. This would give him the £40,000 spendable income he needs to replace the drawdown income. There would be a chargeable gain of £18,000 on the 25% of the bond which was surrendered but this would fall within Ian's available allowances and no tax would be payable.

Ian could repeat the exercise over the next three tax years, surrendering the remaining 75% of the bond while not taking any drawdown income. This would save Ian £6,858 a year (over £27,000 over the 4 years) in tax, compared to continuing to take drawdown income and would allow his SIPP to remain fully invested.

Example 2

Karen, 65, has retired from her employer's DB scheme. However, she's deferred taking an income from the scheme and intends using an offshore bond she holds to provide an income until she attains state pension age in two years' time. The offshore bond is currently valued at £100,000 and includes a chargeable gain on surrender of £35,000.

She surrenders half the bond segments in the current tax year creating a chargeable gain of £17,500 which, as she has no other income for the tax year, falls within her available allowances and no tax is payable.

Karen repeats the exercise the following tax year, surrendering the remaining segments and keeping the gain within her tax-free allowances. For each year beyond the normal retirement date her employer's DB scheme is deferred, she will receive an uplift of 6% as a late payment factor. Karen's scheme pension at age 65 was £50,000 but by deferring for two years, it will rise to £56,180.

Onshore bonds and tax under the spotlight

The examples above are not possible with onshore bonds. With onshore bonds, dividend income and gains do not roll up tax free and are subject to corporation tax. An onshore bond holder will receive a 20% tax credit for the income and gains taxed within the fund, but the credit is non-reclaimable leaving non-taxpayers paying tax unnecessarily – and the credit may be greater than the actual tax suffered within the fund. For non-taxpayers who may suffer tax on gains, they could, if invested in an offshore bond, be tax-free.

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