

Insurance bonds and collective investments

A treatise on investment and
tax planning post-budget 2008

Adviser summary



The importance of tax planning in the field of personal investment cannot be underestimated. Simple decisions such as whether to use a collective investment or an insurance bond can have a substantial effect on the client's ultimate return. Tax planning does not compromise the client's choice of investment, it merely ensures that, having made that investment choice, the ultimate return can be maximised.

KEY POINTS TO CONSIDER IN THE TAX WRAPPER ADVICE PROCESS:

- Starting point: asset allocation and fund selection
- ISA remains the first port of call
- Tax wrapper allocation is relevant where chosen assets are available in more than one tax wrapper
- Consider whether withdrawals would allow for more frequent use of the annual CGT allowance
- More than one wrapper may increase overall tax efficiency

KEY POINTS TO CONSIDER IN TAX WRAPPER ANALYSIS:

- Tax wrapper analysis is a guide based on post-budget 2008 tax principles using certain assumptions (for example, investment return and RPI). Legislation may change and actual tax rates may be different from those in the assumptions. Similarly, investment returns and other figures may be different from the assumptions used
- Simple assumptions – for example, that the whole insurance bond or fund will grow at a certain rate – must be avoided. It is necessary to look at the precise type of investment return
- Only by looking at internal and external tax for each type of investment return can a proper analysis be carried out
- As the exact time that tax is paid (internally or externally) affects the outcome, simple reference to rates of tax is insufficient

STEP 1: ASSET ALLOCATION AND INVESTMENT RETURNS

- Chosen underlying assets will give rise to a number of possible types of investment return
 - UK interest
 - UK dividends
 - UK rent
 - Capital growth
 - Foreign interest
 - Foreign dividends
 - Foreign rent
- Some assets may yield only one type of return, others two or more. The precise type of investment return must be examined

STEP 2 AND 3: INTERNAL AND EXTERNAL TAXATION

- Consider two aspects of taxation: first internal taxation (taxation within tax wrapper), secondly external taxation (taxation in the hands of the investor)
- Full picture will emerge only when both facts are combined, but analysis will also depend on other variables used
- Analysis relies to an extent on assumptions used at the outset being equally apposite at the time the investment is cashed-in, but it will never be an exact science
- The source of return is relevant: we need to know how income is taxed, how capital gains are taxed, and whether all the tax is bundled together. We need to know the client's tax position and correlate this with the internal tax
- Analysis is pure mathematics based on given internal and external taxation inputs
- Whether a wrapper fires capital growth into the CGT arena or income tax arena will be relevant
- Whether tax is paid each year (leaving only a lesser net amount to be invested for the following year) or paid in one go on cashing in affects the outcome
- Anomalies in the ways that taxpayers are treated from wrapper to wrapper can create advantages

INTERNAL AND EXTERNAL TAXATION OF ONSHORE BONDS, OFFSHORE BONDS AND UK COLLECTIVE INVESTMENTS

		Onshore bond	Offshore bond	UK collective investments
Internal tax	UK interest	20% annual	0%	20% annual
	UK dividends	0%	0%	0%
	Capital growth	20% on gains after indexation allowance	0%	0%

		Onshore bond	Offshore bond	UK collective investments
External tax – higher-rate taxpayer	UK interest	20% additional on amount paid out	40% on cashing in	20% additional annual liability
	UK dividends	20% on amount paid out	40% on cashing in	25% annual liability
	Capital growth	20% additional on amount paid out	40% on cashing in	18% on cashing in (CGT) subject to annual CGT allowance

		Onshore bond	Offshore bond	UK collective investments
External tax – basic-rate taxpayer	UK interest	0%	20% on cashing in	0%
	UK dividends	0%	20% on cashing in	0%
	Capital growth	0%	20% on cashing in	18% on cashing in (CGT) subject to annual CGT allowance

TOTAL EFFECTIVE OF TAX FOR HIGHER RATE AND BASIC RATE TAXPAYERS INVESTING IN DIFFERENT TAX WRAPPERS

		Onshore bond	Offshore bond	UK collective investments
Higher-rate taxpayer – total effective tax	UK interest	36%	40%	40%
	UK dividends	20%	40%	25%
	Capital growth	Here the effective tax rate is driven by RPI and the actual growth. Assuming RPI at 2.5% 3% growth = 23% 5% growth = 28% 7% growth = 30%	40%	18%* but the effective tax rate will be lower if the annual CGT allowance can be used. Gain of £10,000: 0.7% Gain of £25,000: 10.9% Gain of £50,000: 14.5% Gain of £100,000: 16.3%

		Onshore bond	Offshore bond	UK collective investments
Basic-rate taxpayer – total effective tax	UK interest	20%	20%	20%
	UK dividends	0%	20%	0%
	Capital growth	Here the effective tax rate is driven by RPI and the actual growth. Assuming RPI at 2.5% 3% growth = 3% 5% growth = 10% 7% growth = 13%	20%	18%* but the effective tax rate will be lower if the annual CGT allowance can be used. Gain of £10,000: 0.7% Gain of £25,000: 10.9% Gain of £50,000: 14.5% Gain of £100,000: 16.3%

Of course, it is not as simple as this because the time at which tax is paid affects the dynamics. If there is tax to pay each year within the wrapper or the investor has to pay tax each year, then there is less to roll forward and invest next year. Never base analysis on static figures. Simple statements such as insurance bonds pay 40% tax and collective investments 18% are not true!

TAX WRAPPER MATRICES

The matrices below depict which tax wrappers are likely to prove more tax efficient for specific types of investment return. The analysis assumes the same underlying assets and the efficiency is simply a mathematical product of the tax regime:

- Indicators: **Green**, greater relative tax-efficiency; **red**, less relative tax-efficiency; and **amber**, relative tax-efficiency but not as efficient as green
- Cost neutrality is assumed for all tax wrappers and only one CGT allowance is assumed to be used on cashing in
- Greater use of annual CGT allowances will increase efficiency if there is a capital growth
- Where applicable, the annual CGT allowance will have greater effect the shorter the term and greater effect the lower the investment amount

Higher-rate taxpayers and investment returns

Asset/wrapper	Capital growth	UK interest	UK dividend	UK rent
Collective investment	Green	Red	Amber	Amber
Onshore bond	Red	Green	Green	Green
Offshore bond	Red	Green	Red	Red

Basic-rate taxpayers and investment returns

Asset/wrapper	Capital growth	UK interest	UK dividend	UK rent
Collective investment	Green	Amber	Green	Green
Onshore bond	Amber	Amber	Green	Green
Offshore bond	Red	Green	Red	Red

The output is based on analysis of each wrapper by examining its relative efficiency compared to the other wrappers over investment periods from one to ten years. Annual return assumptions are 7.5% capital growth, 5.5% interest, 4% UK dividends, 6% rental income and RPI at 2.5%. The same fundamental corresponding efficiency will be seen with other assumed rates of positive return, since the rate of return generally affects the quantum of the differential rather than detracting from fundamental tax-efficiency.

UK EQUITY FUNDS AND TAX WRAPPER ALLOCATION

What may be seen from the matrices above is that collective investments provide a more efficient wrapper for capital growth, whereas an onshore insurance bond provides the more tax-efficient wrapper for UK dividends for higher-rate taxpayers. However, the tax-efficiency within a collective investment for growth is generally greater than the tax-efficiency within an onshore bond for UK dividends. The following depicts the relative tax-efficiency assuming given growth and dividend yield assumptions.

UK collective investments v onshore insurance bond – higher-rate taxpayer

		Annual growth							
		1%	2%	3%	4%	5%	6%	7%	8%
Dividend yield	0%	Dark green	Dark green	Dark green	Dark green	Dark green	Dark green	Dark green	Dark green
	1%	Light green	Dark green	Dark green	Dark green	Dark green	Dark green	Dark green	Dark green
	2%	Yellow	Light green	Dark green	Dark green	Dark green	Dark green	Dark green	Dark green
	3%	Yellow	Light green	Light green	Dark green	Dark green	Dark green	Dark green	Dark green
	4%	Yellow	Yellow	Light green	Light green	Light green	Dark green	Dark green	Dark green
	5%	Blue	Yellow	Yellow	Light green	Light green	Light green	Dark green	Dark green
	6%	Blue	Yellow	Yellow	Yellow	Light green	Light green	Light green	Light green

UK collective Investments v onshore insurance bond – basic-rate taxpayer


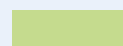
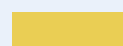
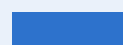
		Annual growth							
		1%	2%	3%	4%	5%	6%	7%	8%
Dividend yield	0%	Yellow	Yellow	Light green	Light green	Light green	Light green	Light green	Light green
	1%	Yellow	Yellow	Yellow	Yellow	Light green	Light green	Light green	Light green
	2%	Yellow	Yellow	Yellow	Yellow	Yellow	Light green	Light green	Light green
	3%	Yellow	Yellow	Yellow	Yellow	Yellow	Yellow	Light green	Light green
	4%	Yellow	Yellow	Yellow	Yellow	Yellow	Yellow	Light green	Light green
	5%	Yellow	Yellow	Yellow	Yellow	Yellow	Yellow	Light green	Light green
	6%	Yellow	Yellow	Yellow	Yellow	Yellow	Yellow	Light green	Light green

KEY

The analysis is based on an assumed investment of £50,000 over a seven-year period with RPI rising at a rate of 2.5%. The following should be noted:

- Only one CGT allowance is assumed to be used on cashing in
- Greater use of annual CGT allowances will increase the tax efficiency of collective investments
- The annual CGT allowance will have greater effect for lower investment amounts
- The annual CGT allowance will have greater effect for shorter investment periods




The analysis compares the tax-efficiency of a collective investment and an onshore insurance bond. The tables then depict the additional return from the collective investment as a percentage of the return from the insurance bond.

-  **Dark green: collective investment outperforms by 10% or more**
-  **Light green: collective investment outperforms by between +3% to +10%**
-  **Yellow: collective investment differential is between +3% and -3%.**
-  **Blue: collective investment underperforms by between -3% and -7%**

SUMMARY MATRIX – TAXPAYERS, ASSET CLASSES AND TAX WRAPPERS

The following matrix indicates the most likely tax efficient wrapper, relative to others, for a range of asset classes. If two wrappers are shown, they offer comparable levels of tax-efficiency.

	Higher-rate taxpayer	Basic-rate taxpayer	Non-UK taxpayer
UK equity growth	UK collective investment		Offshore bond
UK equity income	UK collective investment		Offshore bond
UK fixed interest	Onshore bond	Offshore bond	Offshore bond
UK property fund	Onshore bond	UK collective investment	Offshore bond

 UK collective investment	 Onshore bond	 Offshore bond
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Additional notes to the adopted methodology for all analysis

- Unless otherwise stated only one annual CGT allowance is used on cashing in
- UK dividends are assumed to be paid as dividend distributions from collective investments and interest as interest distributions
- Analysis of onshore insurance bonds assumes a basic unit-linked policy, with capital gains subject to annual taxation after indexation relief. In accordance with common practice the full charge has been levied each year
- Where investor tax is payable each year, this is assumed to be paid each year with only the net amount being carried forward for investment to future years
- The effect of fund manager or insurance company management expenses is ignored in calculations. Certain expenses may be deductible according to the type of wrapper and investment return
- Taxpayers are assumed to maintain the same rate of tax throughout the investment period and no account is taken of top-slicing relief
- Analysis does not include the effect of charges
- Tax rates used are those applicable at 6 April 2008
- Unless otherwise stated RPI is assumed to rise at a rate of 2.5% a year throughout
- Where a 5% annual withdrawal is shown, the analysis depicts total return, meaning final cash-in value plus the sum of the annual withdrawals taken, without any reinvestment of the withdrawn amounts. Units or shares of the collective investments are assumed to be cashed-in only up to the extent required to meet the annual withdrawal. There is no assumption that the total withdrawal comprises of growth alone, simply that each cashed-in unit or share will have an element of growth (where relevant) in accordance with the overall assumptions used



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