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AVIVA

Case study:

Comparing tax efficiency of bonds vs. collective investments

Introduction

To understand the different tax treatments of investment wrappers beyond pensions and ISAs, and to appreciate the impact taxation can have on the outcome for the investor, let's consider an example. Each case depends on its own facts, and what might be right for one investor may not be right for another. Therefore, personalised advice is essential, considering all variables related to the underlying portfolio and the investor's current and likely future taxation position.

Investor profile:

Sam is a 55-year-old divorced individual who recently inherited £250,000 from his aunt. He plans to invest this inheritance with a minimum horizon of 10 years. Sam's current financial plan involves continuing to work until at least age 65, at which point he will decide whether to continue working or start drawing down on his investments.

Assets:

- Sam owns a mortgage-free home
- He maximizes his ISA investments each year
- He has a well-funded pension and holds a general investment account that utilise his dividend allowance and CGT annual exemption.

Investment objectives:

Sam aims to minimise year-on-year taxation and tax administration while securing tax-efficient growth. He also wants the flexibility to draw down on his investment tax-efficiently if needed in 10 years or to leave the investment running in a tax-efficient manner.

His advisor looks to compare investment in an Onshore Bond, an Offshore Bond and a Collective.

Sam is a "balanced" investor. For the purpose of this comparison, his portfolio will consist of 80% UK equities and 20% fixed interest. We will assume that the equity portion of the portfolio will yield 3.5% per annum, with an annual capital growth of 3.5%. The fixed interest portion will yield 4% per annum, with no assumed capital growth. The following key assumptions are also made:

1. **10 year term**
2. **Collective distributions are taxed in Sam's hands whether he reinvests or not.**
3. **All capital taken at the end.**
4. **£250,000 single investment in one collective investing in UK equities and fixed interest**
5. **UK resident additional rate taxpayer**
6. **No dividend allowance or CGT exemption available.**
7. **UK life co-reserving for tax on deemed fund level capital gains at 18%. 20% tax on interest income within fund.**
8. **No account of charges**

And remember, consideration first given to and opportunities maximised in relation to pensions, ISAs, other tax efficient investments, collectives (unit trusts, OEICS with full dividend allowance and CGT exemption available) and DFM.

This example will compare how the selected portfolio performs after tax, both at the fund level and when cashed out. We will look at three scenarios:

If Sam is an additional rate taxpayer at the time of cashing out...

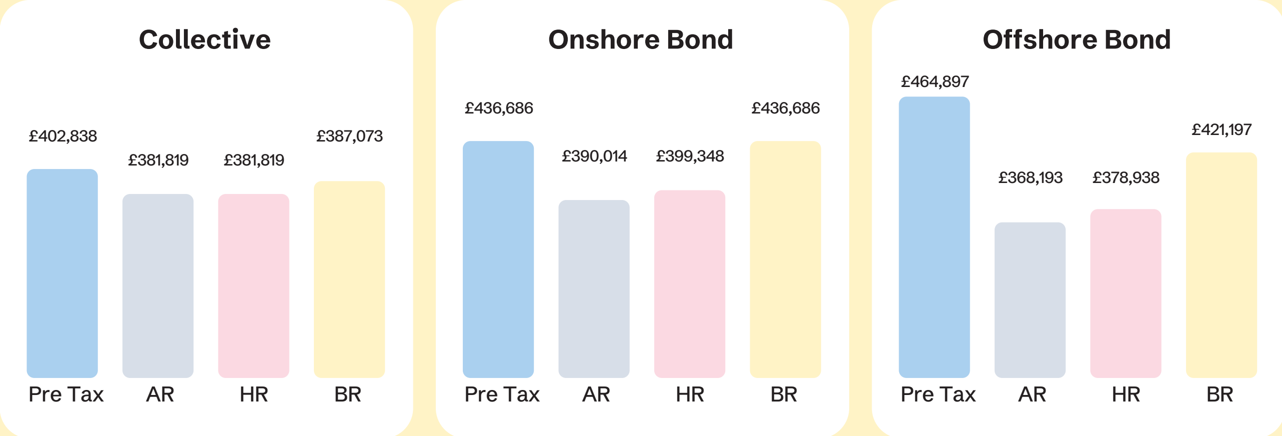
...a higher rate taxpayer at the time of cashing out...

...or a basic rate taxpayer at the time of cashing out.

This comparison doesn't take charges into account.

Comparing Collective, Onshore Bond and Offshore Bond

In this example Sam remains a 45% taxpayer throughout the investment term.



Taxpayer tax rate on encashment = Additional Rate (AR), Higher Rate (HR) or Basic Rate (BR).
For non-taxpayer rate, see the "pre-tax" figures which illustrate the investment's value before any personal tax.

Pre-encashment values

Let's first look at the pre-encashment values of the investment portfolio (light blue bars). The Offshore Bond has the highest value because there is little or no tax suffered within the funds. The Onshore Bond comes next, with the life company paying some taxes on interest and capital gains. The Collective investment has the lowest value due to the high tax Sam would have to pay on dividends at 39.35% before reinvestment (Sam has already used his dividend allowance). In practice, dividends would usually be reinvested in full, and the investor would need to pay the tax on the dividends out of their other income. But when comparing with bonds, where the tax on the fund is wholly covered at the fund level, making this assumption is essential for a fair comparison.

Encashment if Sam is an additional rate (45%) taxpayer

Now, let's consider the tax position on encashment. If Sam is a 45% taxpayer (indicated by the light grey bars), the Onshore Bond would produce the highest net amount of £390,014 as only 25% would be payable on the gain given the basic rate tax credit (due to the taxation within the fund), whereas the Offshore Bond would suffer a full 45% tax rate on the gain, leaving a net £368,193. The Collective gain would be subject to tax at 24%, the new highest rate of capital gains tax, leaving a net £381,819 (as the CGT exemption has been used elsewhere).

Encashment if Sam is a higher rate taxpayer

If Sam is a higher rate taxpayer (indicated by the pink bars), the amount received net of capital gains tax under the Collective investment will be the same as Sam received as an additional rate taxpayer, as the CGT rate on encashment would be the same at 24%, leaving a net £381,819. Under the Offshore Bond, a tax rate of 40% would leave £378,938, whereas under the Onshore Bond, a liability of 20% would be due owing to the basic rate credit. On these assumptions, the Onshore Bond would again produce the highest net of tax amount of £399,348.

Encashment if Sam is a basic rate taxpayer

Finally, let's consider Sam being a basic rate taxpayer on encashment, illustrated by the yellow bars. With the Collective investment, the tax rate on the gain would be 18%, leaving Sam with a net £387,073. Under the Offshore Bond, a rate of 20% would be payable, leaving Sam with a net £421,197. Under the Onshore Bond, however, if Sam were a basic rate taxpayer, then with the basic rate taken into account at the fund level and a full basic rate credit available, Sam would receive the full value of the bond, that is, £436,686.

Top slicing relief

In determining whether any tax was due on the offshore and onshore bond gains (Sam being a basic rate taxpayer), Sam would benefit from the use of top slicing relief so that the gain would be divided by the number of years that the bond had been in force and only that number added to his other income to determine whether and to what extent any of the gain exceeded the basic rate threshold. In our example, we have assumed that the whole of the top-sliced gain fell below the threshold above which higher rate tax is payable, so the Onshore Bond can be surrendered incurring no tax to pay as a result of top slicing relief.

Conclusion

The tax deferment and tax management qualities of the Onshore Bond are best illustrated when a higher or additional rate taxpayer can manage their income to be a basic rate taxpayer on encashment.

There are several variables to consider in determining which investment wrapper will produce the best outcome, and what might be right for one investor may not be right for another. If an investor has the CGT exemption and dividend allowance available, an investment bond may not be the best option for tax deferment. However, the threshold for considering investment bonds for tax deferment and management has lowered (given recent increases in the rates of CGT), making them more attractive. For UK investors, the basic rate credit and 0% tax on dividends at the fund level make onshore bonds very appealing. This is especially true since a wide range of underlying investments on an open architecture basis can be secured.

The information in this leaflet is based on our understanding of current legislation and HM Revenue & Customs' practice. Both of these are likely to change in the future. Tax treatment will depend on personal circumstances.

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