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Investment bonds

How bonds' structure and tax advantages can help you pass on wealth

Investment bonds offer several benefits that some investors may be missing out on, and have become even more beneficial due to recent changes in tax regulations following the Chancellor's decision to reduce the Capital Gains Tax (CGT) Allowance from £12,000 to £6,000 this year and to £3,000 in April 2024.

MINIMISE INHERITANCE TAX

These changes will likely appeal to investors who want to minimise Inheritance Tax (IHT) liabilities when passing on wealth. The IHT nil-rate threshold has remained at £325,000 since 6 April 2009, with no indications of future increases. As a result, more individuals are considering trusts to keep their money outside their estates.

Investors who have already utilised their ISA allowances and other tax-efficient wrappers, or those who have received substantial windfall payments, such as inheritances, could benefit from using investment bonds. Investment bonds primarily fall into two categories: onshore and offshore. The key difference is their tax treatment, which can significantly impact returns.

ONSHORE BONDS

Onshore bonds are subject to UK Corporation Tax. However, this tax is offset by your provider, which means you, as an investor, do not have to worry about it directly. While this may seem like an advantage, it's important to note that the tax could lower your return compared to an offshore bond.

OFFSHORE BONDS

On the other hand, offshore bonds are issued from outside the UK. The returns from these bonds roll up gross of tax in the funds, with the exception of Withholding Tax. This can potentially offer higher returns compared to onshore bonds, depending on your personal tax situation.

UNDERSTANDING OF THE TAX RULES

Despite these advantages, the research reveals that only a minority of investors fully understand investment bonds. However, there is potential interest among certain demographics. For example, 18% (9 million) of non-bond investors would consider investing in bonds. This interest is particularly prevalent among mass affluent consumers, those with children aged between 0 to 10, and individuals with a household income of £100,000 and above.

It is worth noting that only 10% of UK adults claim to have a clear understanding of the tax rules regarding bonds. This lack of knowledge could hinder investors from fully capitalising on the benefits offered.

NOT SUBJECT TO CAPITAL GAINS TAX

One of the key advantages of investment bonds is that they are not subject to CGT. Onshore bonds are treated as having already paid 20% tax on any gains when calculating a chargeable gain. In reality, the actual tax deducted is likely to be less than this amount.

In addition, investment bonds can be beneficial for IHT planning. If held in a trust, they can be exempt from IHT after seven years. However, despite this potential advantage, only a quarter of bondholders have written their bonds in trust, which means the bonds would still be considered part of their estate for IHT purposes.

CHARGEABLE EVENT OCCURRING

Investors can withdraw up to 5% of their initial investment each year without triggering a chargeable event or incurring immediate tax liability.

Furthermore, top-slicing relief is available to reduce tax liability when a chargeable event occurs. This relief can eliminate or significantly reduce any tax liability, which can be advantageous for individuals in the accumulation phase and those preparing for retirement. For example, someone may be a higher rate taxpayer while owning the bond but can become a basic rate taxpayer when encashing it.

MAKE INFORMED INVESTMENT DECISIONS

Investment bonds also offer options for assigning them between spouses. From a tax perspective, the assignment is generally treated as if the new owner had always owned the bond. This can be particularly beneficial if one spouse is a basic rate taxpayer, as they may have no tax to pay upon encashment.

Overall, investment bonds present numerous advantages, including tax benefits, that investors should consider. However, it is crucial for individuals to fully understand these benefits and the tax rules associated with bonds in order to make informed investment decisions. ■

WANT TO LEARN MORE ABOUT UTILISING BONDS AS PART OF YOUR INVESTMENT PLAN?

An investment bond gives you the potential for medium to long-term growth on your money, over five to ten years or more, along with fund management expertise. You also get access to a mixture of funds, which are looked after by professional investment managers. If you'd like to learn more about utilising bonds as part of your investment plan, please get in touch.

Source data:
[1] LV= research – Don't forget the benefit of bonds – published 23 May 2023.

THE VALUE OF YOUR INVESTMENTS CAN GO DOWN AS WELL AS UP, AND YOU MAY GET BACK LESS THAN YOU INVESTED.

THE TAX TREATMENT IS DEPENDENT ON INDIVIDUAL CIRCUMSTANCES AND MAY BE SUBJECT TO CHANGE IN FUTURE.

ESTATE PLANNING IS NOT REGULATED BY THE FINANCIAL CONDUCT AUTHORITY.