

## **THE BENEFITS OF USING AN OFFSHORE BOND AS A WRAPPER**

The following information applies where the investor is UK resident (regardless of their domicile).

### **Taxation of an offshore bond**

#### **Gross Roll-up**

- There is no income tax or capital gains tax deducted from the underlying funds of an offshore bond with the exception of a small amount of non-reclaimable withholding tax on certain income producing funds. The effects of withholding tax can be minimised by investing for capital growth rather than income. This is great for tax payers who would otherwise face a tax hit on their income stream, dependent upon their earnings. Within an offshore bond, investors will continue to benefit from being able to build up the dividend income without a further tax charge.

**See also 'Factors to take into account when considering the use of an onshore bond'.**

Offshore bonds are subject to income tax under the Chargeable Events Legislation. There can only be an income tax liability when a 'Chargeable Event' occurs. A 'Chargeable Event' can only occur in the following circumstances:

- when the sole or last life assured on a policy dies;
- when the bond is surrendered or a segment of the bond is surrendered;
- if the policy is assigned for money or money's worth;
- if more than the cumulative 5% of total premiums paid allowance is withdrawn in any given policy year.

Money can be extracted from an offshore bond by two methods. These are called 'partial encashment' and 'surrender of segments'. There are important tax implications to consider when deciding which method to choose.

#### **Tax efficiency of taking withdrawals as partial encashments:**

With an offshore bond, it is possible to take up to 5% of total premiums paid every year without paying any Income Tax. This does not represent 'tax free' money but is 'tax deferred' because when the policy is ultimately surrendered, any withdrawals are added to the surrender value of the policy in order to calculate the gain. This 5% allowance is cumulative, so it simply rolls over and over.

This feature has numerous advantages:

- It is excellent for higher rate tax payers as it enables them to take a 'tax deferred' income from their bond. When 100% of the capital has been withdrawn, any further partial encashments would be taxed at the individual's highest marginal rate of Income Tax. This facility means the investor can take a tax deferred income but avoid paying income tax upon the eventual proceeds until such time as they may be in a lower rate tax bracket, or have retired abroad, or they have decided to gift the policy to someone else.
- When money in excess of the cumulative allowance is taken, the chargeable event is triggered on the last day of the policy year in question as opposed to the day the withdrawal is made. This therefore means that it is possible for an investor to

withdraw money in one tax year but not have to include it in their tax return until the following tax year.

- Offshore bonds can provide a useful means of supplementing pension provision using the 5% deferred tax rule.
- The 5% cumulative allowance is also useful for individuals in danger of falling into the Age Allowance Trap. This is because offshore policies are non-income producing assets and even if the 5% withdrawal is utilised, this will have no impact on reducing the age allowance unless the cumulative 5% withdrawal allowance is exceeded in any given policy year.

#### **Tax efficiency of taking withdrawals as a surrender of segments:**

- If a client has utilised his or her 5% cumulative allowance for that policy year, then it would mean that any excess withdrawn would be charged to Income Tax even if the policy was showing an overall loss. Therefore, in this scenario it is more tax efficient to surrender individual segments in order to raise the required amount of money. Where the policy has made a loss then no income tax would be payable and where the policy has made a gain, then the investor would be paying money purely on the gain on those individual segments which have been surrendered.
- A client may wish to take a large tax free withdrawal prior to returning to the UK. Because a withdrawal is deemed to occur at the end of the policy year in which it is taken (by which time the client could be resident for tax purpose in the UK) it may be more advantageous to surrender a segment/s as any gain will not be subject to UK income tax if the client is still non-UK resident.

#### **Top Slicing**

Unless an individual is already a higher rate tax payer, it is possible to benefit from the rules of top slicing whereby the gain is divided by the number of complete policy years the contract has been in force and if that 'slice' when added to the individual's other taxable income keeps them within the basic rate tax bracket, they will pay 20% on the whole gain. If it pushes them into being a higher rate tax payer, then top slicing serves to ensure they pay an effective rate of Income Tax between 20% and 40%.

#### **Time Apportionment Relief**

If a holder of an offshore bond decides to move abroad, then on their return to the United Kingdom they could benefit from a relief called 'Time Apportionment Relief'. This effectively reduces the gain on the policy by the amount of time spent as a non-UK resident.

This relief also applies where the policy is held under a trust. In order to ensure that this relief is not jeopardised, you should ensure that any Trustees appointed are always classed as UK residents as even the appointment of one non-UK resident Trustee would jeopardise the claiming of this relief.

Furthermore, if the holder of the offshore bond moved abroad indefinitely or even for a couple of years, it would be possible for them to surrender the offshore bond and not pay any UK Income Tax (although they would need to consider the tax treatment in their country of residence). This compares favourably with a portfolio of say unit trusts, where if you sold them when non-UK resident but returned to the UK within five years, you would still be liable to Capital Gains Tax.

#### **Satisfying an Investor's various Investment Requirements with an Offshore Bond**

Offshore bonds can be used to suit a wide variety of investment requirements for example:

##### **Capital Growth:**

Investing to achieve growth at a higher level than inflation. This objective can be pursued with varying degrees of aggression.

**Capital preservation:**

Preserving the purchasing power of capital. This is usually important during periods of high investment volatility, high inflation, in the run-up to retirement, or when personal circumstances do not dictate that risk is appropriate.

**Income generation:**

Taking payment of a regular sum generated by an investment, such as during retirement or for payment of school fees.

**Investment horizon**

This will help determine how much risk the portfolio should be exposed to. Generally the longer the investment period, the more speculative the investment strategy can be as there should be time to ride out market fluctuations. Conversely, if the time period is relatively short then the fund may have to follow the profile of low volatility, cash-type investments. This is because the volatility sometimes associated with higher-risk investments could result in short-term losses or restrictions on liquidity.

**Client's attitude to risk**

The client's attitude to risk is a key factor in constructing the investment portfolio, because they need to fully understand and be comfortable with the level of risk that is being taken. Generally, higher risk investments will give greater growth potential but expose the client to more extreme short-term price fluctuations. In contrast, safer investments such as cash are unlikely to achieve significant levels of growth over the longer term, and may even lose value in real terms.

**Liquidity**

A liquid investment is one that can easily be realised and converted to cash. Generally, a higher risk investment strategy will give greater growth potential but less liquidity because there may be times when it would be unwise to withdraw from the investment, just after a stock market correction, for example. If a client requires some element of liquidity then it is possible to place a proportion of the portfolio in a cash holding or near-cash investment for easy access whilst the balance is invested in higher risk assets.

**Flexibility**

A portfolio should be able to adapt to meet a client's changing circumstances and requirements. For example, targeting growth at outset and changing to an income requirement in later years. The construction of the portfolio should be able to adapt to this change. Even if an investor does not wish to change his investment objectives, market conditions and asset class behaviour will be constantly moving and the portfolio may need to be adjusted regularly to reflect this.

**Investment Acceptance Guidelines on Offshore Bonds**

Many offshore bonds are open architecture portfolio bonds which allows access to a large and varied range of assets, all of which are subject to strict asset vetting criteria. The reason for vetting is to ensure that the life office as a company complies with the obligations of its licence, regulations and any antimoney laundering regulations. In addition, it is important to ensure that the assets available through the offshore bond satisfy the UK Personal Portfolio Bonds (Tax) Regulations 1999.

### **Suitable for investors who require a broad fund choice.**

Offshore bonds offer access to all the household name fund managers in the UK market, plus many more international and specialist fund managers. This allows the client to access a wider range of asset classes. An important consideration for asset allocation.

The investment choice within offshore bonds cover all the major world regions and sectors and the full risk spectrum from low risk capital guaranteed funds through to hedge funds and higher risk specialist funds.

### **Obtaining Discounts on funds**

Many offshore life offices have negotiated enhanced terms with many leading Fund Management Groups. These terms enable investors to benefit from significant levels of discount, normally only available to institutional clients. In many cases, traditional bid-offer spreads are eliminated completely. Furthermore, rebates on Annual Management Charges, may be passed back to the life office and will be paid back to the policy. The availability and extent of discounts and rebates will be dependent upon the funds selected, however, many offshore life offices regularly review the discounts and rebates they have negotiated, to ensure the best terms available. These advantageous buying and selling terms also increase the flexibility of an investor's bond by enabling them to deal on a cost-effective basis between funds and/or managers.

### **Clients who wish to pursue an active investment strategy**

Clients who have actively managed portfolios will incur 18% Capital Gains Tax on gains realised when making switches within a portfolio of onshore direct equity or unit trust investments. These gains arise in the tax year during which the switches were made. With an offshore bond, you can switch between funds without triggering a Capital Gains Tax liability. The compounding effect of tax free switching in an offshore bond can result in higher gross returns allowing more scope for tax savings on exit.

Offshore bonds therefore provide a more tax efficient structure for active investment management. This has the added benefit of ensuring that the timing of investment decisions is not in any way constrained by tax considerations. It has the added advantage of freeing up the policyholder's Capital Gains Tax allowance, which can then be used in respect of any other investments.

### **Suitability for those investors who will be above the pensions lifetime allowance and want to save more for their retirement**

Since 'A' Day most people are limited to a lifetime allowance of £1.75 million (tax year 2009/2010) and for those who are nearing this amount who want to add to their pension provision, they may be looking around for alternatives. There may be others who want access to capital for various reasons or who do not want all their savings to be tied up in their pension.

Many clients will be internationally mobile or could have plans to retire abroad. Once invested, the bond will grow virtually tax free with no CGT liability. This would undoubtedly seem like an attractive proposition for these clients too. Furthermore, the client will not be restricted in the timing of taking benefits from the bond, unlike a pension arrangement. Clients do not have to wait until they are 50 (55 from 6 April 2010) before taking an income which can make them attractive for funding early retirement.

### **Suitable for those clients considering making gifts**

Offshore policies can be gifted via assignment and this does not trigger an income or capital gains tax charge.

Policy segmentation and assignments are a critical aspect of planning when considering exit strategies from an offshore bond. For example this allows parents to transfer a number of policy segments for no consideration to their children provided they are over 18. If a policy holder is a 40% tax payer who has already established an offshore bond in his name, it is possible to assign the policy to an individual who pays tax at a lower rate than the assignor without giving rise to a chargeable event for income tax purposes. Thus on the eventual happening of the chargeable event any chargeable event gain will be assessed on the new owner at their appropriate rate of income tax. If the child who is over 18 has unused personal allowances the gain on the policy which has grown in a tax advantaged environment could be tax free.

Unlike pensions, offshore bonds can be assigned. Allocating segments to a lower rate tax payer such as a non working spouse can be very tax efficient. This could be helpful in a divorce situation where assets need to be split and it can avoid such contentious issues as pension sharing.

### **Policyholder Protection**

One of the risks faced by an investor in a policy issued by a life assurance company is the risk that a life company is unable to meet its contractual commitments (either in part or in full) to policyholders. Governments have made varying provisions to protect policyholders against such an eventuality.

The responsibility for policyholder protection in the Isle of Man for example has been given to the Insurance and Pensions Authority (IPA). The IPA regulates and monitors the prudent financial management of these companies. Its powers and responsibilities are set out in the Insurance Act 1986 and its subsequent amendments, the most recent of which is the Insurance (Amendment) Act 2004.

The Compensation Scheme in the Isle of Man is called the Isle of Man's Life Assurance (Compensation of Policyholders) Regulations 1991. It ensures that should a life assurance company on the Isle of Man be unable to meet its liabilities to its policyholders, up to 90% of the liability to the protected policyholder would be met no matter where that policyholder was resident. It would be funded by levies on the industry. This scheme is different to that in the UK which only compensates UK resident policyholders.

### **Suitable for clients interested in holding all of their investments under a Wrap:**

A Wrap can save both time and money by providing the client with a single point of entry to an extensive range of products and investments. It is a 'one stop shop' for transactions, cutting down the hassle of dealing with multiple providers and streamlining processes and it offers a single view of the whole portfolio on one statement. Offshore bonds will fit well into this type of investment environment.

### **Benefits of choosing a 'Capital Redemption' version of an Offshore Bond**

Many offshore bonds can be written on a 'capital redemption' or life assured basis. Capital redemption bonds have no lives assured and this distinguishing feature can have valuable advantages for trustees and non-UK resident companies. Under a last survivor single premium life assurance bond, the death of the last surviving life assured would mean that the bond would come to an end and the policy proceeds would become payable. This would constitute a chargeable event which may give rise to a chargeable gain. The result may be an unexpected income tax charge payable by the Settlor, trustees or company. By choosing a capital redemption bond as an alternative investment, the problems associated with lives

assured simply do not exist. The trustees/company can manage any tax liability by deciding when to exercise their options.

### **Reducing the administrative burden for both individuals, trustees and beneficiaries**

As the underlying funds are held within an offshore bond wrapper, this will remove the hassle of the administrative burden associated with directly holding a portfolio of unit trusts. Quarterly valuations can be issued to the investor thus providing regular portfolio updates. The ease of administration impacts not only upon individual trustees but also trustees if the policy is held in trust.

Offshore bonds are more self-assessment friendly than a portfolio of collective investment schemes. An offshore bond is classed as a non-income producing asset and therefore makes an excellent asset for a trust as it removes the need for the Trustees to distribute income to the beneficiary and complete annual tax returns. This is in contrast to investments like Unit Trusts, OEICs and Investment Trusts which may produce an income which would need to be distributed to the beneficiary. Furthermore, if the trust fund produces income, this is generally taxed on the Settlor of the trust if UK resident.

Where a bond is held under a bare trust and when the beneficiary reaches the age of 18, they will become the taxable entity for the offshore bond. The offshore bond will remove the need to be entered on that individual's tax return every year until a Chargeable Event occurs. This is in contrast to the potentially complicated requirements for reporting a portfolio of OEICs/Unit Trusts.

### **Ability to appoint an adviser/discretionary manager**

Offshore bonds can provide an investor with a range of advisory options to assist with the investment selection process depending upon the level of personal involvement the client would like. Although an Independent Financial Adviser may also be qualified to provide a client with advice relating to investment selection, this may not be possible where a client's investment profile is more complex. In these circumstances, it may be beneficial for the client to appoint an investment adviser or discretionary manager. The appointment of an Investment Adviser means that the offshore bond provider will retain custody and dealing responsibilities for the investments held within the offshore bond.

On the other hand, discretionary management is becoming increasingly popular, especially for clients looking for professional investment advice but without the requirement to be involved in the day to day management. The discretionary manager will make investment decisions on the client's behalf in accordance with an agreed strategy. Discretionary management allows an individual's portfolio manager to move quickly and take advantage of arising opportunities or corporate events such as takeovers or rights issues when timescales can be demanding. All this means a greater potential for investment gains.

### **Suitable for clients who wish to move abroad for a couple of years and may need access to further money during this time.**

If you surrender an offshore policy in a tax year when you are non-UK resident, any gains will be free of UK income tax. This contrasts with investments such as unit trusts/OEICs, where if you remain non-UK resident for less than five years, you will be hit with a Capital Gains Tax liability on your return to the UK.

### **Suitable for clients who wish to undertake effective Inheritance Tax planning**

Offshore bonds make excellent assets for trusts, particularly the Discounted Gift Trust and the Loan Trust where the Settlor either carves out an 'income' or is entitled to repayment of his or her loan. Because of the 5% cumulative allowance, this means that the Settlor has no ongoing income tax liability. Also, with the offshore bond being a non-income producing asset, there is less administration for the trustees to consider.

### **Suitable for those clients who are making provision for their long term care**

Individuals who are provided with residential accommodation are means tested to determine to what extent they must contribute towards the cost. A resident with assets in excess of £22,250 will (apart from a few Government exemptions) be liable to pay the full standard rate for accommodation if in a local authority home, or the full amount of the fee if in an independent home.

The National Assistance (Assessment of Resources) Regulations 1992 sets out which assets, for the purpose of the means test, are to be disregarded. The regulations confirm that one of the assets to be disregarded is "the surrender value of any policy of life assurance".

Despite this early definition, many local authorities have included the value of investment bonds as part of the means test to determine an individual's total assets.

A revised version of Charging for Residential Accommodation Guide (CRAG) was published in October 2003. This publication sets out more detailed guidelines for local authority assessors to determine which capital assets should be included in the means test and those assets which should not. The publication puts it beyond any doubt that investment bonds with lives assured (so does not include redemption bonds) should not be included (subject to certain qualifications) as a capital asset for the purpose of financial assessment. The following paragraphs contain the relevant statements:

6.002A states - The treatment of investment bonds in the financial assessment for residential accommodation is complex because, in part, of the differing products that are on offer. For this reason councils should seek the advice of their legal departments when they arise. However, it is possible to offer some general advice and councils are referred to the Social Security Commissioners decision R (IS) 7/98.

6.002B states - Councils are advised that if an investment bond is written as one or more life insurance policies that contain cashing-in rights by way of options for total or partial surrender, then the value of those rights has to be disregarded as a capital asset in the financial assessment for residential accommodation (see paragraph 15, schedule 10 of the Income Support (General) Regulations 1987. In contrast, the surrender value of a bond without life assurance is taken into account.

However, clients need to be careful and prove there are genuine financial reasons for taking out a bond as otherwise the sudden switching for example from ISAs into investment bonds could be seen by the authorities as deliberate deprivation and therefore challenged.

### **FACTORS TO TAKE INTO ACCOUNT WHEN CONSIDERING THE USE OF AN ONSHORE BOND**

- Non or starting rate tax payers will not be able to claim the tax which is deducted at source from an onshore bond.
- Offshore bonds may be more suitable for clients who are considering becoming an expatriate as the underlying investments in an onshore bond would continue to be subject to UK taxation whilst they were abroad.
- Offshore bonds may be more suitable for a client who intends to surrender the policy whilst living abroad. If an individual surrenders an offshore bond whilst non-UK resident, they could still face a tax charge in their new country of residence. However with an offshore bond there is no danger of an individual being exposed to double taxation as would be the case with an onshore bond. This is because, unlike the UK, the individual's new country of residence may not give them a 20% tax credit in respect of the tax to which the underlying funds on the onshore bond have already been subjected.

- Offshore bonds may be more suitable for clients who not only plan to work abroad but also plan to return to live in the UK, since Time Apportionment relief will reduce the gain which is liable to income tax on their return to the UK. For example if an individual has held an offshore bond for 10 years and spent 5 of those years resident abroad and 5 as a UK resident, then when a gain is realised, only 50% of the gain would be subject to UK income tax. Onshore bonds do not benefit from Time Apportionment relief.
- Offshore bonds may be suitable for clients who wish to top-up their existing pension arrangements because offshore bonds suffer no internal taxation apart from non reclaimable withholding tax on some assets.
- Offshore bonds may be more suitable for investors who require a greater fund choice. Within an onshore bond, fund choices are more limited whereas an offshore bond provides access to a broad range of investment funds, including institutional cash funds. The wider investment choice aids effective asset allocation and portfolio diversification.
- Offshore providers may be more suitable for those investors wishing to establish a capital redemption bond. Many offshore providers offer both life assurance and capital redemption versions of their single premium products. Few onshore providers offer the facility for the bond to be written on a capital redemption basis. The reason for this is that the maturity value of a capital redemption bond has to be guaranteed and most jurisdictions require the life office to reserve a percentage of the initial premium for this event. In the UK this percentage is prohibitively high and capital redemption bonds are therefore very rare. Whilst some Dublin based companies offer this option on their products, an additional charge is sometimes made to help offset the reserving costs. It is mainly those companies based in the Isle of Man which has more favourable reserving requirements who provide capital redemption bonds and are generally able to do this for the same cost as a life assurance bond

## **FACTORS ONLY RELEVANT TO UK RESIDENT BUT NON UK DOMICILED CLIENTS**

### **Remittance basis of taxation**

Unremitted Foreign Income and/or Gains' is a term which relates to any foreign income (and foreign gains if the individual is not domiciled in the UK) that arises (or accrues) during the tax year and which are not remitted to the UK but remain abroad. For example, if an individual had £50,000 of foreign income and gains in the tax year and they remitted £40,000 to the UK, their 'unremitted' foreign income and gains for the tax year would be £10,000.

If an individual has less than £2,000 unremitted foreign income and/or gains which arise or accrue in the relevant tax year it is possible to use the Remittance Basis of taxation without making a claim or paying a charge, regardless of the length of time that person has been resident in the UK.

If an individual has £2,000 or more unremitted foreign income and/or gains arising or accruing in the relevant tax year and want to use the remittance basis, then they must make a claim for that year and pay the Remittance Basis Charge (RBC) of £30,000.

Whether or not an individual has to pay a Remittance Basis Charge (RBC) depends upon their age and the length of time they have been a UK resident. It will be necessary for an individual to pay the charge if they are eighteen or over, they have been UK resident for at least seven out of the previous nine tax years and they wish to continue using the remittance basis of taxation.

Offshore Bonds can be a useful planning tool for those individuals who have been advised not to pay the RBC and opt to be taxed on an arising basis. Offshore bonds offer the ability to extract 5% of total premiums paid every policy year as capital without having to declare it via

Self Assessment. However, benefits such as these are only available where the bond is funded by 'clean capital'. 'Clean Capital' means that the premium paid would not include any previously unremitted offshore income and/or gains. Failure to do this could result in any withdrawal from the bond being taxable in the UK.

Offshore bonds were never subject to the remittance basis of taxation in any event and the gain was taxable whether or not the individual remitted the money to the UK or abroad. Some UK foreign nationals may be better off now with an offshore bond so as not to have recurrent income, thereby avoiding the need to pay the £30k charge. The 5% tax deferred withdrawals for foreign nationals is still a way of circumventing the remittance basis form of taxation.

### **Avoiding Inheritance Tax in the event of becoming UK deemed domiciled**

A non UK domiciled individual living in the UK is deemed to be UK domiciled for Inheritance Tax purposes once they have been resident 17 out of the last 20 tax years in the UK.

Offshore bonds may be more suitable for a non-UK domiciled client who wishes to place the bond under an Excluded Property Trust. An offshore bond is located outside of the UK and so it is not a UK cited asset. A person who is domiciled in the UK is liable to Inheritance Tax (IHT) (currently 40% in excess of £325,000 for the 2009/2010 tax year) on their worldwide assets. A UK foreign national is liable to IHT on UK cited assets only, and on world-wide assets if the person becomes "deemed domiciled". IHTA 1984 s.48 states "Where property comprised in a settlement is situated outside the UK, the property is excluded property unless the Settlor was domiciled in the UK at the time the settlement was made". This means that assets held in a settlement (trust) are exempt from IHT providing the Settlor was not UK domiciled at the time the trust was established and the assets are situated outside the UK. Providing these two conditions are satisfied when the trust is established, then full exemption from UK IHT will be available on those assets held in trust, even if the Settlor of the trust subsequently becomes UK domiciled. In particular, the beneficiaries of the trust, which can include the Settlor, his/her spouse and children, can receive payments from the trust without any liability to IHT

### **OFFSHORE BOND WRAPPER VERSUS DIRECT HOLDINGS OF COLLECTIVES**

Before deciding on a client's asset allocation or choice of tax wrapper and therefore tax consequences, it is first important to understand how each underlying asset is taxed.

#### **Portfolio Options**

Cash	Income Tax due yearly	0%, 20% or 40%
Gilts	Income Tax due yearly	0%, 20% or 40%
Corporate Bonds	Income Tax on interest yearly	0%, 20% or 40%
Property funds	CGT on sale	18%
	Income Tax on yield yearly	0%, 20% or 40%
Equities	CGT on sale	18%
	Income Tax on dividend yearly	10% or 32.5%
Investment Trusts, Unit Trusts and OEICs	CGT on sale	18%
	Income Tax on dividends/income/interest yearly	10%, 20% or 32.5%
Non Distributor funds	Income Tax on sale	0%, 20% or 40%

In view of the flat rate of tax of 18% on capital gains, some may wonder why an offshore bond is still an attractive proposition to UK clients. It should be noted that the proposed 18% is not simply the highest rate at which an individual would pay Capital Gains Tax, it is a flat rate and as such it is not a simple comparison of tax rates which is required for a fair comparison of the impact of the new tax rates. In the life time of an investment, capital gains may well be paid

on several occasions, when funds are switched for instance, however, with offshore bonds, tax is only charged and paid when there is realisation via encashment at the end of the bond's life.

Furthermore, an authorised fund will not produce 100% of its return in the form of capital gains. A sizeable proportion of its return will be in the form of dividends, which in the hands of a higher rate taxpayer creates an ongoing tax liability of 22.5%. If the fund in question is an income fund (e.g. a deposit or fixed interest fund), then little or none of the return will be in the form of capital gains. If the fund is an offshore non distributor fund (most hedge funds will fall into this category), then the gain will be charged at income tax rates without the benefit of top slicing relief.

### **Trust Issues**

Since the Finance Act 2006, there are two main ways in which a trust is taxed depending upon whether it is a Bare Trust or a Flexible (Discretionary) Trust. Bare trusts are recommended generally where fixed beneficiaries are in mind. Whilst it is true that a discretionary trust provides more flexibility in terms of when the trust fund monies have to be distributed, there is a hefty price for this in the way of charges.

Where a discretionary trust is established, any amount over your available nil rate band and your available annual exemptions of £3,000 for the current and previous tax year, will be subject to IHT at a lifetime rate of 20%. When establishing a discretionary trust, if available, you can offset any of your available nil rate band (£325,000 in tax year 2009/2010) and it is also possible to use this and last year's annual exemptions of £3000 each to reduce the amount of the chargeable transfer.

Establishing the trusts on a Bare Trust basis would avoid this immediate IHT charge because each gift would be treated as a Potentially Exempt Transfer. A Potentially Exempt Transfer means that there is no IHT to pay if you survive the creation of the trusts by seven years. If you were to die within the seven year period, your executors would need to include the value of your gifts with the remainder of your estate and IHT would be due on any amounts over and above your available nil rate band at the time. If you die between years 3 and 7, there is an element of relief by way of taper relief which serves to reduce the rate at which tax is charged and it progressively reduces the rate of tax the longer you survive. No taper relief is provided if death occurs within the first three years. In addition to this, any growth on the initial investment is also outside of the estate from day one.

Bare Trusts do not allow for beneficiaries to be changed once they are named. Furthermore, establishing the trusts on a Bare Trust basis removes the need for the onerous reporting requirements and IHT charges which are associated with the establishment of discretionary trusts, on initial set-up, on every ten year anniversary and whenever money leaves the trust fund.

The terms of a normal Bare Trust do mean that upon reaching the age of 18, the beneficiary can demand that the policy is either surrendered or assigned to them.

If a bare trust beneficiary dies, then the trust fund would pass to his or her estate. It is also important to note that the death of a beneficiary would trigger an IHT charge on that beneficiary's estate. This is because the whole value of the trust fund (i.e. the surrender value of the policy) as of the date of death, would form part of their estate for IHT purposes.

Offshore policies are non-income producing assets so there is no requirement to distribute income to beneficiaries as and when it arises. This also means that there are no complicated tax returns to complete every year.

Where a bond is placed under trust it is important that the bond is written using the maximum permissible number of segments (999) to give flexibility in terms of assigning segments to other beneficiaries.

Where an offshore bond is held under a Bare Trust, it is the Settlor who is the taxable entity if he or she is UK resident and the named beneficiary is under the age of 18. Any income tax liability would be levied at the Settlor's highest marginal rate of income tax. If the Settlor became non-UK resident, and assuming the beneficiary is still a minor, the income tax liability would fall on any UK resident Trustees at a special Trustee rate of 40%. Once a beneficiary is aged 18 or over, any income tax liability would fall on them assuming they were UK resident, at their highest marginal rate of Income Tax.

Offshore bonds can be easily placed under trusts. Using a trust would avoid the making of any outright gifts and would provide an element of control in relation to the investment of the underlying funds. Furthermore, placing the policies in trust enables the Settlor to be involved in decisions regarding as and when the trust fund monies are distributed.

OFFSHORE LIFE ASSURANCE BOND	UK OEIC
<b>Income Taxation within the Fund</b>	
No tax on income within the fund (apart from non-reclaimable withholding tax on some assets).  Annual management expenses cannot receive tax relief as the fund is not taxed.	20% Corporation Tax on all income except UK dividends. 10% tax credit on UK dividends satisfies the fund manager's liability. Annual management expenses may be offset against income, other than UK equity income (provided there is sufficient income), before Corporation Tax.
<b>Capital Gains Taxation within the Fund</b>	
Capital gains within the fund are free of tax.	No Corporation Tax liability within the fund when the manager disposes of assets.
<b>Income tax on investor</b>	
Withdrawals of up to 5% of the original premium per policy year (for a maximum of 20 years) may be taken without a chargeable event arising. This is usually known as the 'tax deferred' allowance. Any unused allowance can be rolled forward indefinitely until the amount of the original premium has been withdrawn. When a chargeable gain occurs, tax is payable at 10%, 20% and 40%. A non-tax payer can set their personal allowance against the gain. A basic rate taxpayer will pay tax at 40%. A higher rate tax payer will pay tax at 40%. As the proceeds are paid gross tax will normally be collected through self assessment. If the gain takes a basic rate tax payer into the higher rate band, top slicing relief can be used but only to reduce tax at the higher rate.  <u>Top Slicing</u>  Top Slicing can reduce the amount of tax paid on the gain. It can only be used where the gain takes a basic rate taxpayer into the higher rate tax bracket.	Income tax is deducted before income is paid to the shareholder or reinvested.  <u>Dividend distributions.</u>  The tax credit is not reclaimable by non-taxpayers. Paid with an attaching 10% tax credit. Satisfies the liability of starting and basic rate taxpayers. Higher rate taxpayers have a further 22.5% of the gross distribution due, paid through their self assessment tax return.  <u>Interest distributions</u>  These are paid with an attaching 20% tax credit. This satisfies the liability of starting and basic rate taxpayers. Starting rate taxpayers can reclaim the balance between starting rate (currently 10% and the 20% deducted).  Non taxpayers can reclaim the whole 20% deducted.

<p>It cannot be used to reduce the tax paid on a gain that takes a non-taxpayer into the starting or lower rate bracket or where a starting rate taxpayer moves to the lower rate.</p> <p>On full or partial surrender on an offshore bond the gain is divided by the complete number of years since the bond started. This is always the case (subject to time apportionment relief below). This is always the case even if further investments were made into the bond at a later date.</p> <p><u>Time Apportionment Relief</u></p> <p>Available to individuals who have been resident outside the UK for some of the time that they have owned the bond. The gain can be reduced proportionately, in line with the time the individual has spent outside the UK.</p>	<p>Higher rate taxpayers will have a further liability of 20% of the gross distribution due via their self assessment tax return.</p>
<b>Age Allowance</b>	
<p>The full gain (not the top sliced amount) that arises as a result of a chargeable event will be added to the tax payer's total income to determine if their age allowance is reduced.</p>	<p>The 'gross' income, either accumulated or distributed under the OEIC will be added to the taxpayer's total income to determine if their age allowance is reduced.</p>
<b>Capital Gains Tax</b>	
<p>The individual has no liability to Capital Gains tax under the bond, unless it is no longer in the hands of the original beneficial owner AND it was acquired for consideration.</p>	<p>When an individual disposes of their shares in an OEIC this may result in a liability to Capital Gains Tax.</p> <p>Every individual has an annual Capital Gains Tax allowance (£10,100 in the 2009/2010 tax year) that can be offset against the gain.</p>
<b>Switching</b>	
<p>Switching between the available funds within a bond will not give rise to a chargeable event.</p> <p>An offshore bond can offer a wide range of available funds.</p>	<p>Switching between funds will always involve a disposal for Capital Gains Tax purposes.</p>

**OFFSHORE BONDS V. ONSHORE BONDS**

**FOR INTERNAL USE ONLY**

OFFSHORE BOND	ONSHORE BOND
<b>Income Tax within the fund</b>	
No tax on income within the fund (apart from non-reclaimable withholding tax on some assets). Annual Management expenses cannot receive tax relief as the fund is not taxed.	The rate of Corporation Tax applicable to the fund is 20% on interest, overseas dividend income and rental income. Dividends from shares in UK companies are effectively received net of tax and no further tax is paid on these dividends. The 10% tax credit on these satisfies the fund manager's liability. Annual Management expenses may be offset against income, other than UK equity income (provided there is sufficient income) before Corporation Tax.
<b>Capital Gains Tax within the fund</b>	
Capital gains within the fund are free of tax.	Corporation tax is paid on the capital gains of the funds at a rate of 20%. However the life assurance office will not necessarily have to sell assets in the fund when an investor cashes in a bond. When calculating a gain for taxation purposes the purchase price is indexed to allow for inflation from the date of purchase to the date of sale of an asset.
<b>Taxation for non tax payer</b>	
Income tax is payable on the chargeable gain at applicable rate(s) only if the gain takes the investor into or beyond the starting rate tax band.	No further tax liability on any gains (unless chargeable gains push income into the higher rate band). Tax deducted at source on the underlying fund cannot be reclaimed.
<b>Taxation for starting rate tax payer</b>	
Income tax is payable on the chargeable gain at rate(s) applicable to the investor.	No further tax liability on any gains (unless chargeable gains push income into the higher rate tax band).
<b>Taxation for basic rate tax payer</b>	
Income tax is payable on the chargeable gain at rate(s) applicable to the investor.	No further tax liability on any gains (unless chargeable gains push income into the higher rate tax band).
<b>Taxation for higher rate tax payer</b>	
Chargeable gain taxed at higher rate.	Any chargeable gain will be subject to the difference between basic rate and higher rate income tax.

<b>Top Slicing</b>	
The gain is always top sliced back to the start of the bond. Potentially this will mean the gain will be divided by a greater number of years leading to a smaller slice.	The gain is top sliced back to the last chargeable event, except on final surrender when the gain is top sliced back to the start of the bond.
<b>Investors who become resident outside the UK</b>	
Underlying investments can grow in a tax efficient environment throughout the time held. The only tax to which the fund will be liable is a withholding tax that is deducted from dividend income and interest. On realising the investment any potential tax charge is dependent on your country of residence.	Underlying investments continue to be subject to UK taxation. On realising the investment, any potential tax charge is dependent on the country of residence (only if UK resident at this time would there be no risk of double taxation).
<b>Investors who return to the UK after living abroad</b>	
Time apportionment relief may reduce tax liability on any gains, for example, if an investor lived outside the UK for 5 years of a 10 year investment, only half the gain is taxable.	Onshore investments are still subject to UK taxation rules.

### **QUALIFYING RECOGNISED OVERSEAS PENSION SCHEME**

An offshore bond can make an excellent underlying investment for those who may wish to transfer their UK pension to a Qualifying Recognised Overseas Pension Scheme (QROPS).

In order to transfer UK pension rights to a QROPS, **the member must have left or intend to leave the UK for tax purposes**. A UK pension can then be transferred outside of the UK into QROPS in the same way as pensions can be transferred in the UK. When benefits are transferred to a QROPS they do not suffer a UK tax charge unless they are over the lifetime limit.

Qualifying Recognised Overseas Pension Schemes (QROPS) were introduced and allowed by HMRC as a direct result of the 2006 pension simplification rules bringing them inline with European directives.

A UK pension may be transferred into QROPS either before the owner starts to take the benefits or after they have come into payment. This includes most types of pension including income drawdown and protected rights, which are pensions which have accrued as a result of UK national insurance rebates.

However it is not possible to transfer an entitlement to the basic UK state pension into QROPS, or to make a transfer after an annuity has been purchased or Final Salary Schemes are in payment.

To become a QROPS, the provider must meet a number of rules and regulations that fit the HMRCs criteria. Crucially, reporting the member's benefits for five complete tax years after leaving the UK. Not all overseas pension schemes qualify as QROPS and therefore attempting to transfer into un-authorized schemes is not recommended.

By moving UK pension benefits to a QROPS, assets are effectively removed from the UK tax net and introduced to a new tax environment depending on the member's new residence. For many expatriates the avoidance of UK taxes on pension income and the dangers of additional pension tax levies are an important planning consideration.

Many QROPS impose some restrictions, to the extent that an individual must be resident in the country into which they are transferring their pension benefits, for instance Australia. However, certain QROPS do not have this restriction and so there is no link between where the member lives and the geographical location of a QROPS. In this case the member is able to choose tax friendly jurisdictions that have more flexible rules for how benefits can be taken.

A significant benefit for those who are not UK resident at the time they start drawing their pension benefits is that payments from QROPS will not suffer any UK tax. Their location of tax residence may have impact in terms of local taxes but with careful planning and specialist advice this can be minimized or even removed.

This could be important because once a UK resident pension comes into payment; the UK tax authorities will automatically tax the pension in the UK until the member establishes a new tax residency or moves the benefits offshore. For fiscal nomads, i.e. those who have left the UK but are not established in a non-UK tax system, QROPS are very attractive.

Once someone has been resident outside of the UK for five or more complete tax years and has transferred their pension rights to a QROPS, the reporting requirements to HMRC cease, more flexible ways of taking the pension can then be introduced.

Whilst many schemes have claimed to be able to move a UK based pension offshore, until now it has not been possible to do this legally and with the permission of the UK tax authorities. This has been primarily because, in return for the tax-relief an individual receives on their pension contributions, the Revenue is expecting to tax the income they receive when the compulsory annuity is purchased; and then take any residual value on their death!.

A transfer to a QROPS is not subject to IHT and therefore not a chargeable event doesn't suffer periodic or exit charges.