Quilter

Technical insights – Quick reference guide 2

***Taxation of investment bonds** – partial withdrawals (the 5% tax deferred allowance)*

This guide will provide you with an understanding of excess gains caused by partial withdrawals from onshore or offshore investment bonds. This guide is not suitable for investment bonds held by companies.

The 5% tax deferred allowance applies to partial withdrawals.

The allowance is used when a partial withdrawal is made. Partial withdrawals are those where the surrender is taken equally across all the individual policies which make up the bond. Adviser fees, as introduced by the retail distribution review (RDR) in January 2013, are also partial withdrawals.

Withdrawals within the 5% tax deferred allowance are not immediately taxable.

Each policy year, the bond holder may withdraw up to 5% of the premiums paid to their bond. The maximum which can be withdrawn this way is 100% of the premiums paid.

The withdrawals are referred to as 'tax deferred' as they will be added to the surrender value of the bond when calculating the gain on a full surrender or maturity.

A policy year begins on the day the bond is established.

Example: Start date 2 January 2022, the first policy year begins on this day and ends 1 January 2023.

The policy year does not change if additional premiums are made. The 5% allowance is available to be used from the first day of each policy year.

The 5% tax deferred allowance increases when additional premiums are paid.

The increased allowance is available in the same policy year the premium is added and the years which follow. It does not apply to previous years.

Any unused allowance rolls forward.

Rolled up allowance is used against partial withdrawals in future policy years. Surrenders in excess of the 5% tax deferred allowance available do not 'eat' into the allowance in future years.

Surrendering individual policies will reduce the 5% tax deferred allowance.

A bond is made up of a number of identical policies. Each policy holds a fraction of the total premiums paid into the bond. Therefore, each policy has a fraction of the overall 5% tax deferred allowance for the premiums paid to it. After an individual policy has been surrendered, any 5% tax deferred allowance for that policy (including unused allowance rolled forward) no longer exists.

Withdrawals in excess of the 5% tax deferred allowance are taxed as 'income'.

Only the amount in excess of the allowance is taxable.

Excess gains are calculated at the end of the policy year.

The excess gain calculation checks whether withdrawals in that year were in excess of the available allowance. It will take into account additional allowance from premiums paid during the year. The gain is assessable in the tax year in which the policy year ends.

Consider an alternative method.

Withdrawals in excess of the available 5% tax deferred allowance can result in gains which are disproportionate to the actual growth of the bond. The full surrender of individual policies is an alternative method which will provide a different result. A comparison should be made between these methods to ensure the method with the best outcome is used. See quick reference guide 3.

Calculating the available 5% tax deferred allowance — an example.

To calculate the available 5% tax deferred allowance, step through each year recording the partial surrenders taken and compare these to the allowance available at the time. Then, carry forward any unused allowance to the next year. The example below demonstrates the process.

Policy year	*Total premiums to date*	*Available allowance (including carry forward)*	*Surrenders in this policy year*	*Allowance to carry forward*	*Excess gain*
1	£100,000	£5,000	£0	£5,000	£0
2	£100,000	£10,000	£2,500	£7,500	£0
3	£100,000	£12,500	£15,500	£0	£3,000
4	£100,000	£5,000	£0	£5,000	£0
5	£110,000	£10,500	£0	£10,500	£0

The example shows an initial premium of £100,000 and then another £10,000 in year 5.

Year 1 – The allowance is £5,000 (5% of the total premium to date).

Year 2 – Carry forward from year 1 is added to this year's allowance. A withdrawal of £2,500 is made with no immediate tax charge. The carry forward to year 3 is reduced.

Year 3 – There is surrender of £15,500, which is £3,000 over the allowance available. £3,000 is taxable as income.

Year 4 – No allowance has been carried forward from year 3. Only this year's allowance of £5,000 is available.

Year 5 – £10,000 additional premium has been added. The allowance for the year includes £5,000 carried forward from year 4 and this year's allowance of £5,500 (5% of the total premium paid to date).

The information provided in this article is not intended to offer advice.

It is based on Quilter's interpretation of the relevant law and is correct at the date shown. While we believe this interpretation to be correct, we cannot guarantee it. Quilter cannot accept any responsibility for any action taken or refrained from being taken as a result of the information contained in this article.

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