DIXON WILSON
CHARTERED ACCOUNTANTS

Offshore Life Insurance Bonds

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INTRODUCTION

Offshore life insurance bonds are a popular investment wrapper, usually involving the payment of a single premium which is used to fund an investment portfolio. They are particularly popular among French expats (they are known as "assurance vie") as they offer tax advantages and more flexible inheritance rules in France.

CHARGEABLE EVENTS

An income tax charge arises in relation to a foreign life insurance policy if a 'chargeable event' occurs while the policyholder is UK resident, and that chargeable event gives rise to a gain.

The following are considered to be chargeable events:

- A complete or partial surrender of the policy;
- An assignment of all rights under the policy for consideration; and
- The receipt of a payment on the maturity of the policy.

The key point is that a chargeable event can occur if you withdraw or receive cash (or other benefits) on a full surrender, partial surrender or maturity of the policy.

Where the policyholder is a trust, any chargeable event gain arising on a policy is fully assessed on the 'creator' of the trust provided they are UK resident in the tax year of the chargeable event.

TAXATION OF CHARGEABLE EVENTS

Chargeable event gains are subject to income tax rather than capital gains tax. Income tax rates are progressive in the UK (20%, 40% and 45%) and chargeable event gains are deemed to form the 'top slice' of an individual's income so they are subject to their highest marginal rate of income tax.

It is possible to withdraw up to 5% of the premium paid per insurance year without triggering a chargeable event gain. The insurance year (sometimes called a 'policy year') is normally the 12-month period beginning on the anniversary of the date the policy was taken out. If no withdrawals are made in an insurance year, the 'unused' 5% allowance is carried forward and can be used in future insurance years.

PARTIAL SURRENDER

The chargeable event gain arising on a partial surrender is calculated annually and arises at the end of each insurance year. Although chargeable events are only subject to UK tax if the policyholder is UK resident, it is possible for an individual to be taxed on a withdrawal made whilst non-resident if they subsequently become UK resident by the end of the insurance year.

The gain for an insurance year when there has been a partial surrender is computed as the difference between the value of the parts surrendered and the unused 5% allowances for current and previous years. In essence, the gain will be the excess amount withdrawn over the unused 5% allowance(s).

Any gain would need to be converted into sterling at the prevailing exchange rate at the date of the chargeable event.

Any gain is charged on the individual on a partial surrender irrespective of the performance of the policy. This can lead to disproportionate tax charges.

FULL SURRENDER

The gain arising on a full surrender is taxed in the tax year in which the surrender takes place and is calculated in a different manner to the gain arising on a partial surrender.

The gain or loss is the difference between the value of the policy surrendered plus withdrawals made less the premium paid and any previous gains on partial surrenders.

Where the policy is surrendered for an overall loss, this loss cannot be set against capital gains or income to save tax at marginal rates.

There is limited relief available in the guise of 'deficiency relief', when a partial surrender of a policy has been previously made, which allows for an extension of the basic rate band resulting in a saving of higher rate tax. However, this relief is only available on a full surrender of the policy and is limited to the gain made on the previous partial surrender.

Where a chargeable event gain accrues to an individual who has previously been non-UK resident, the gain will be reduced by 'time apportionment relief'. In effect, the relief ensures that the element of the gain accruing prior to an individual becoming UK resident is exempt from UK taxation. Broadly, the gain is reduced by the fraction 'A / B' where A is the period in which the current policyholder has been non-UK resident,

including periods of non-UK residence in a split year, and B is the full period for which the policy has been held.

In addition to the above reliefs, top-slicing relief is available for policyholders who are either basic rate or higher rate taxpayers. Generally, the relief works by comparing the average annual gain of the policy with the rates of tax that the policyholder pays and reduces the liability to the rate of tax that would have been paid had the gains been assessed annually rather than in one tax year.

In order to prevent excessive relief, the number of complete years by which a gain on a foreign policy is divided under the top-slicing relief provisions, is also reduced if the policyholder was not UK resident throughout the policy period.

PERSONAL PORTFOLIO BONDS ('PPB')

There are special anti-avoidance rules that apply to life insurance policies classed as Personal Portfolio Bonds ('PPB'). A PPB exists where the policyholder has the ability to select the property that determine the benefit under the policy. Notably it is the ability of the policyholder to select the investments that brings a policy within the PPB regime. A policy is potentially caught even if the policyholder does not actually exercise his ability to select investments.

Self-selection of investments is permitted (without invoking the PPB rules) if the investments fall within any of the following categories:

- Authorised unit trust;
- Investment trusts;
- Open-ended investment companies;
- Foreign collective investment schemes; and
- Cash.

In addition, investments must be available to all policyholders of the life insurance company or, if availability is limited to a class of policyholders, the terms of membership of the class must be published by the company and the class must not be limited to connected persons.

The effect of the anti-avoidance rules is that a chargeable event gain is treated as accruing in each insurance year even if no withdrawals are made. The deemed gain in the first insurance year is 15% of the premium paid. In the second year, the deemed gain from the first year is added to the premium paid and a deemed gain of 15% is applied to the total amount (i.e. the charge in the second year is 17.25% of the premium paid). The deemed gain increases in the same manner for each subsequent year.

The status of a policy is considered on a year-by-year basis to determine whether it is a PPB for a particular insurance year. A policy is caught if it is within the definition at the end of the policy year.

The PPB rules are extremely penal and, since the deemed gains bear no relation to the performance of the underlying investments, can result in annual tax charges on capital of at least 15%.

REMITTANCE BASIS

Chargeable event gains are specifically excluded from the remittance basis for non-UK domiciled policyholders. This means that it is not possible to shelter chargeable event gains on offshore policies from UK tax; even if the remittance basis for the tax year in which the gain arises is claimed and the proceeds are kept outside the UK.

Where a non-UK domiciliary has been taxed on the remittance basis it is important to analyse the source of the funds used to acquire the policy. If the source is foreign income or gains which have previously been taxed on the remittance basis, remitting the proceeds from the surrender of the policy to the UK leads to a remittance of the foreign income and gains used to acquire the policy potentially resulting in an additional tax charge on the policyholder.

CHANGE AFOOT?

An HMRC consultation in 2016 followed the much publicised tribunal of Joost Lobler v HMRC [2015] regarding the tax consequences of the partial surrender of his policies. However, all proposals within the consultation were subsequently dropped and the basic rules currently remain unchanged.

Included in the draft Finance Act 2017 was a clause which would allow taxpayers to request HMRC to recalculate any gain on a 'just and reasonable basis' where the gain is 'wholly disproportionate' to the economic gain of the policy.

There was, however, no definition of 'wholly disproportionate' and the legislation was expected to have limited application.

These amendments were dropped from the final 2017 Finance Act following the announcement of the snap General Election. There is, however, an expectation that the proposals included in the draft Act will be enacted.

COMMON REPORTING STANDARD ('CRS')

The Common Reporting Standard ('CRS') was introduced in an effort to improve tax transparency between jurisdictions and tackle worldwide t a x evasion through increased exchange

of information between financial institutions and HM Revenue & Customs.

CRS requires the identification of holders of insurance policies to be reported to HM Revenue & Customs if the policies have a "cash value" to the policyholder, i.e. if the policyholder can withdraw funds from the policy or pledge it as collateral.

WHAT NEXT

We strongly suggest that advice is sought by UK residents (or those contemplating becoming UK resident) prior to any surrender or purchase of a life insurance policy or assurance vie.

Dixon Wilson can assist with a review of the tax consequences of investments held by individuals planning to come to the UK or looking to invest in insurance policies so that the policyholder is fully aware of their options and any ongoing UK tax implications.

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The services described in this document may include investment services of this kind.

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