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Watch those withdrawals

Sep 8 2011, by Gerry Brown , Manager Tax & Trusts , Prudential plc

The structure and taxation of life assurance bonds are, arguably, well-known.

A tax charge arises when a chargeable event occurs. The main, but not only, chargeable events are:

- The death of a life assured, giving rise to benefits under the terms of the bond
- The surrender of all of the policyholder's rights under the bond
- The assignment of all of the policyholder's rights under the bond for money or money's worth
- Part-surrenders during an insurance year yielding an amount in excess of 5% of the premium

While most people have heard of the 5% rule, it is not clear whether its impact is fully understood.

In each 'insurance year', the policyholder can withdraw up to 5% of the premium paid without triggering a chargeable event. Any unused portion of this 5% 'annual allowance' is carried forward. Once the 5% allowances have been fully used, all further withdrawals are fully taxable.

The 5% annual limit is not a tax-free amount. All amounts withdrawn have to be taken into account in the calculation of any gain made when the bond finally ends.

During the 'life' of the bond, there is no correlation between the investment profit and the amount which is subject to tax.

Two cases on this legislation have recently been heard by the Tax Tribunal.

On 22 March 2006, Chandraprakash Shanthiratnam paid £150,000 as a single premium for an offshore bond. Within twelve months, for commercial reasons, Shanthiratnam executed a part-surrender withdrawing £50,000.

This clearly triggered a chargeable event. As a result of the artificial rules applying to the calculation of chargeable event gains, on the occasion of partial surrenders, 85% of the amount received (i.e. £42,500 out of the £50,000) was treated as his taxable income.

The chargeable event gain was calculated as follows:

Premium £150,000; annual 5% allowance	£ 7,500
Surrender Proceeds	£50,000
Allowance	£ 7,500
Chargeable event gain	£42,500

Shanthiratnam appealed. One of the grounds was that "the calculation had to be wrong, not least because the total value of the policies was about £10,000 less on the occasion of the partial surrenders than the premium paid."

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The Tax Tribunal, although sympathetic, dismissed the appeal: “We admit that we are at something of a loss to understand what tax advice was given to the Appellant prior to effecting the 2007 transaction, and whether it was made clear to the Appellant that the immediate tax liability would be considerably influenced by the precise form that the surrender transaction took.

“We add finally that we consider that the Appellant has been most unfortunate to have fallen into a trap, occasioned by what can perhaps be described as rather “broad-brush” legislation that does not always (at least until the final surrender) occasion very fair results, and we extend our sympathy to the Appellant.”

In 2002, Captain Steven Cleghorn took out an offshore investment bond with a premium of £66,000 of the proceeds of the sale of his home. At the time of the investment, he did not intend to take any immediate withdrawals from the bond. However, soon after the investment was made, he commenced training as a commercial airline pilot. Due to his change in circumstances he needed to draw from the bond. Initially, this was at the rate of £1,000 per month, commencing in May 2002. Additional capital withdrawals were required from time to time to meet the costs of his training. On 21 May 2002, the insurance company wrote to him and while confirming his instruction to make a withdrawal, informed him that there was a 5% withdrawal allowance for tax purposes.

In the tax year ending 5 April 2003, he withdrew £24,300. This was more than the 5% allowance of £3,200 and so there was a chargeable gain of £21,100.

Similarly, gains of £30,800 and £6,800 arose for the years ended 5 April 2004 and 5 April 2005 respectively.

Captain Cleghorn appealed against inclusion of these amounts in his tax assessment. He could not understand why he had a tax liability when he had made no profit on the investment and simply withdrew money to pay for his expenses while training. His sole intention, when making the investment, was to finance his training and he had been led to believe that he would only pay tax on any amount received over and above the amount invested.

The Tax Tribunal came to the inevitable conclusion that the assessments were properly made and dismissed the appeals.

Shanthiratnam’s and Cleghorn’s problems were exacerbated by the fact that they had invested in offshore bonds, where, unlike bonds issued by a UK insurer, no basic rate credit was available.

However, their tax liabilities could have been completely avoided had full surrenders, rather than part surrenders, been executed. Alternatively, a strategy involving surrenders of complete segments, rather than surrenders across segments, would have had the same impact.

An analysis of all of the options should be made before any part surrender is executed.

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