COLUMBIA THREADNEEDLE INVESTMENTS

Adviser Edge

Should you top up an existing bond? We explore

CATEGORY: INVESTMENT AND TAX

Key Takeaways

- **Learn how to compare the 5% tax deferred withdrawal allowances as they apply to separate investment bonds and to a single policy that has been topped up (incremented)**
- **Compare how top-slicing relief applies to separate bonds and a single policy that has been incremented**

We explore some of the key tax-planning issues associated with the decision to either increment an existing investment bond with an additional premium or establish a new policy.

Case study

Albert Smith has had a particularly good year, providing body piercing services to rock stars. He decides to invest some of his profits. He takes out an investment bond with ABC Life, for a premium of £50,000.

Five years later, Albert's mother dies, and his share of the inheritance is £200,000. He wants to invest this money for his retirement. He has enjoyed the simplicity of the investment bond: tax deferral, no tax reporting, ease of administration and being able to switch funds and re-balance his portfolio without tax considerations. So, he decides to invest the £200,000 into an investment bond.

Should Albert take out a new investment bond or top up his existing bond? Let's compare the two scenarios.

Scenario 1. New bond

5% tax deferred withdrawals:

- Each policy will have its own 5% tax deferred allowance
- 5% of initial premium into each policy
- The cumulative entitlement based upon policy years of each policy

Top-slicing relief:

- On surrender, Albert may benefit from top-slicing relief
- The relief will be calculated separately for gains from the separate bonds
- The top-slice divisor will be the full number of years each policy has been in force (or it may be the number of years since the previous chargeable event gain in respect of part surrenders)

Case study continued

Scenario 2. Top up the existing bond

5% tax deferred withdrawals:

- Each increment will have its own 5% tax deferred allowance
- 5% of each premium/increment
- Cumulative entitlement based upon policy years of each premium/ increment

Top-slicing relief:

- The top-slicing relief calculation will be based upon one policy
- The top-slice divisor will be the full number of years the policy has been in force (or it may be the number of years since the previous chargeable event gain in respect of part surrenders)
- There is no separate top-slice divisor for each premium/increment

Just over 10 years after Albert invested the £200,000 (and fifteen years since he invested the initial £50,000), he retires and wants to supplement his retirement income with withdrawals from his investments. The investment bond is now in its sixteenth policy year.

Assuming growth at around 6% pa

£50,000 initial premium value	£120,000
£200,000 additional investment current value	£360,000
Total	**£480,000**

Albert's cumulative 5% tax deferred allowances

£50,000 x 5%x 16 years	£40,000
£200,000 x 5% x 11 years	£110,000
Total	**£150,000**

The cumulative allowance is the same. regardless of whether Albert has two policies or if he has one policy which he has incremented. But what about top-slicing relief should he wish to surrender the policies?

Let's assume Albert fully surrenders the polices:
Top-slicing relief:

Separate policies

Policy 1	
£120,000 – £50,000	£70,000 gain
Divided by 15 years top-sliced gain	**£4,667**
Policy 2	
£360,000 – £200,000	£160,000 gain
Divided by 10 years top-sliced gain	£16,000
Total combined top-sliced gain	**£20,667**

One policy

£480,000 – £250,000	£230,000 gain
Divided by 15 years top-sliced gain	**£15,333**

The top-sliced gain on the single policy is **£5,334 less** than the total combined top-sliced gains from two policies.
It is likely to be advantageous to increment an existing policy due to the way the top-sliced gain is calculated on full surrender.

Of course, there may be reasons to establish separate policies. These might include:

- The existing policy having highly restricted investment options
- The existing policy provider being closed to new business and not allowing increments
- In relation to a settlement into trust, if the tax issues associated with incrementing existing trusts outweigh the top-slice advantages discussed above

For more information refer to our article on "Should you choose a new trust or top up?

Note: the top-slice divisor in respect of offshore bond gains from part surrenders will depend upon whether the policy was taken out pre or post 6 April 2013, or was taken out pre 6 April 2013 but has since been varied. Essentially, for pre 6 April policies that have not been varied, the top slice divisor is the number of complete years the policy has been in force. For post 6 April policies or pre 6 April 2013 policies that have been varied since 6 April 2013, the top slice divisor for part surrenders is the number of complete years since the previous chargeable event.

Summary

Pensions and ISAs are highly tax-efficient but ironically, their tax-efficiency may lead to them being drawn down upon only after other tax wrappers in the decumulation stage.

Pension funds are generally exempt from inheritance tax (IHT). For those with a potential IHT liability and money invested elsewhere, this may be a disincentive to access pensions when other funds are available.

ISAs provide tax-exempt income and capital withdrawals. For those with other tax wrappers, the ISA may be held in reserve until other wrappers have been depleted using a tax-efficient strategy.

Another reason some investors may choose to access ISAs after other investments, is that they can be encashed in full without tax liability, whereas other tax wrappers are likely to give rise to a tax liability if the withdrawals are not phased over multiple tax years.

This ability to raise funds quickly without tax consequences makes ISAs a useful pot of money for future IHT planning which involves substantial gifts, and/or the use of trusts.

Unwrapped portfolios may provide income in the decumulation phase, perhaps by conversion from accumulation shares to income shares, or by taking the income from income shares, rather than re-investing it. While this income is taxable, it will only be taxed to the extent that it exceeds the relevant allowances and nil rate bands (e.g. personal allowance, starting rate band for savings, the personal savings allowance and the dividend allowance).

Of course, income can be supplemented with capital withdrawals. Additionally, even where the funds have increased in value over time, the capital withdrawals can still be free of tax, as long as gains realised are within the CGT annual exemption. Drawing down on the capital in an unwrapped portfolio reduces the remaining capital, and therefore the taxable income that it produces. This reduces future income tax labilities.

Investment bond chargeable event gains are taxed as savings income. Withdrawals from investment bonds that give rise to chargeable event gains may be free of tax if there are allowances and nil rate bands (e.g. personal allowance, starting rate band and personal savings allowance) available.

There is a tax planning argument for not drawing pension income in the early stages of decumulation to preserve the personal allowance. This way, it can be set against other income such as savings income, dividend income and chargeable event gains.

Even where the personal allowance and nil rate bands have been used, top-slice relief and the basic rate tax credit can provide scope to realise very substantial gains from onshore bonds without further liability to tax. This is especially relevant where the investment bond has been in force for many years.

For many, multiple tax wrappers will be unnecessary as the pension and ISA allowances will be generous enough. However, for those who have the scope, having multiple tax wrappers presents tax planning opportunities.

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WF2049366 (01/25). UK