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Friends Provident International

Exercising care when withdrawing money from an offshore bond

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Introduction

There are two ways to withdraw money from a Friends Provident International offshore bond:

1 By partial surrender, taken equally across all individual policies within the offshore bond wrapper.

2 By fully surrendering some, or all, individual policies within the offshore bond wrapper.

This factsheet will explain the differing tax treatment of both options, and why it is important for UK residents to fully consider the method they use to withdraw money from their bond.

Partial surrenders

One advantage of offshore bonds is the ability for policyholders to withdraw 5% of the policy premium each policy year tax-deferred. No further allowance accrues after 20 years if the maximum 5% withdrawals are taken each year.

Withdrawals taken within this limit represent a return of the policy premium and are not immediately subject to UK income tax.

This allowance is cumulative, which means that if it is not used in a particular policy year, it can be carried forward to future years.

Please note that taking money out of the bond in this way is tax-deferred, and not necessarily tax free. All partial withdrawals taken in this way are added to the proceeds on policy surrender and may become subject to income tax at that point.

Example one

Bond premium = £100,000

5% allowance means that £5,000 can be taken on a tax-deferred basis each year as a regular withdrawal if required. **(£100,000 x 5% = £5,000)**

Therefore, if no previous withdrawals have been taken £50,000 could be taken on a tax-deferred basis in year 10. **(£100,000 x 5% = £5,000) x 10 years = £50,000**

Taxation

Whereas partial surrenders within the cumulative 5% withdrawal allowance are tax-deferred, any partial surrender taken in excess of the cumulative allowance will create a chargeable event. The amount by which the withdrawal exceeds the 5% allowance is a chargeable excess.

The chargeable excess is subject to income tax in the tax year in which the end of the policy year falls. Example two illustrates this:

Example two

Bond premium = **£100,000**

In the second policy year, the policyholder wishes to take £25,000 from the bond. The cumulative 5% withdrawal allowance in the second policy year is **£5,000 x 2 years = £10,000**.

If the remaining £15,000 required is taken as a partial surrender, this will create a chargeable excess of £15,000. This would be subject to income tax at the policyholder's marginal rate of tax.

Therefore, if the policyholder is a higher rate (40%) taxpayer, they would have to pay income tax of £6,000 (£15,000 x 40%) on this chargeable excess.

This is regardless of whether any investment gains have been made on the bond.

Segmentation

Another feature of an offshore bond is the ability to split the bond into a number of individual policies, or "segments" as they are often referred to.

Policyholders can surrender individual segments, which can be more tax efficient than taking large partial surrenders.

Taxation

By surrendering individual segments, the unfavourable tax situation created by the large chargeable excess outlined in Example two can be avoided. When taking money from the bond by surrendering individual segments, only the investment gain is taxable, as illustrated in Example three:

Example three

Using the same figures as Example two:

Bond premium = **£100,000** split equally into 100 segments.

The current bond value is **£110,000** which means each individual segment is worth **£1,100**.

In the second policy year, the policyholder wishes to take £25,000 from the bond. The cumulative 5% tax-deferred allowance in the second policy year is:

5% of premium = £5,000 therefore:

2 years x £5,000 = £10,000.

In order to avoid creating a large chargeable excess, a policyholder has the option of taking a combination of the two methods.

20 segments can be fully surrendered to raise £22,000.

The calculation to determine the gain on surrender is:

(surrender proceeds + previous withdrawals) – (premium + previous chargeable excesses)

For the surrender of 20 segments, the following figures would be used:

(£22,000 + 0) – (£20,000 + 0)

meaning a gain of **£2,000**.

The gain is the amount that would potentially be subject to tax.

A withdrawal of £3,000 can then be taken from the remaining 5% allowance.

The remaining total invested premium would be £80,000. Therefore the 5% allowance in year two is **£8,000**.

As the £3,000 part surrender is within the allowance there would be no further tax liability at that time. The total gain is therefore £2,000. This compares to the £15,000 excess gain in Example two

Additional segment surrender points

- When individual segments within the offshore bond wrapper are surrendered, in future policy years, the 5% withdrawal allowance will be based on the premium paid in respect of the remaining segments only.
- There may be early surrender penalties applied when policy segments are surrendered. The impact of this must be considered when deciding the most appropriate method of releasing funds.

Conclusion

When considering taking money out of an offshore bond, it is important to fully consider whether it is best done by partial surrender, surrendering individual segments or by using a combination of the two methods, as set out in Example 3.

We recommend that policyholders take professional advice, particularly where large amounts in excess of the 5% cumulative allowance are required.

Important information

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