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How single-premium investment bonds can help with IHT planning

The tax regime for domestic life insurance companies can often seem very different to that which applies to the rest of us. Life companies have not been slow to exploit this over the years.

At the turn of the century products called "single-premium investment bonds" proved particularly popular. They offered modest life cover but sufficient to enable the providers – and their customers – to take advantage of this strange tax regime. Some companies still issue them today.

These products, sold heavily at the time, did have their attractions. Buyers invested a lump sum – say, for example, £100,000 – and were then allowed to take out 5% of this initial sum every year tax deferred. The insurance company invested the money, with an expectation of it growing. Often bonds were issued on joint lives so they passed to the survivor on the first death and provided continuity. You can see the appeal.

Many were issued in the wake of the 2000 tech crash, when equity prices were relatively low, and so have done well.

Often the policyholders have not made any withdrawals – it was optional, and unused withdrawals rolled up. That means many are sitting on products fat with gain. Cashing in the policy will trigger what is known as "a chargeable event". So what to do with them?

The way these bonds work is that any chargeable event is assessed to the policyholders – generally the lives assured. The tax liability is deemed to be net of basic-rate income tax and Capital Gains Tax (CGT). Under the regime for life companies this is deemed to have been paid within the fund. So for higher-rate taxpayers there is a potential additional charge of 20% of the gain – the difference between the basic rate and higher rate of tax. For additional-rate taxpayers the extra charge is 25%.

The gains are the difference between your initial investment and the proceeds. If you have taken withdrawals, these are added back. If you have not made any withdrawals over the years then you will be charged on the proceeds less your initial investment. "Top-slicing relief" allows these gains to be divided by the complete number of policy years since commencement. This slice is then added to your income in the tax year of surrender to calculate the additional tax rate. These calculations can be complex, and this is something worth discussing with an adviser.

It is possible to assign a bond to someone else as an outright gift without triggering a chargeable event. Assign the policy to someone who is a basic-rate taxpayer

after the tax calculation and they will pay no tax on surrender. As a result, this transfer opportunity is often used between spouses or civil partners where the original policyholder is a higher-rate taxpayer and their partner a basic-rate taxpayer.

People are increasingly assigning policies to other loved ones. The same benefits apply.

A valuable benefit

This is an unusual perk. You could not, for instance, hand your daughter shares you have held for 20 years without triggering a potential CGT charge.

I now have a lot of elderly clients who are assigning these policies to lower-earning children and grandchildren. They see this as way of unbundling policies. The assignee – the new owner – must be over 18 years old, so it is often a great way of helping a loved one pay off debts or climb the housing ladder.

Often bonds are issued in multiple policy segments. Each segment can be assigned separately. This allows gifting to multiple beneficiaries. It also allows the assignee to surrender over multiple tax years and manage their own tax position.

These policies count in your estate for Inheritance Tax (IHT), so giving them away to a non-spouse or civil partner – if you can afford the luxury – represents a sensible bit of estate planning, too. There might be an IHT liability if you die within seven years, so I encourage my clients for whom this is appropriate to move quickly and hang on in there.

I am not sure that beating the tax man is the best incentive for living a long life, but it can help!

Mission possible: Your assignment if you choose to donate it

Edith is 80. She has a single-premium insurance bond that she bought for £100,000 in 2001. She has taken no income over the past 20 years. The policy is worth £220,000. She and her husband, who are both higher-rate taxpayers, are comfortable. They do not need the money and are worrying about IHT on their estate.

Their 23-year-old grandson is a basic-rate taxpayer and sees no prospect of getting on the housing ladder. They want to help him.

If Edith surrendered the policy she would pay 20% tax on the gain of £120,000 – £24,000. This would leave her £196,000 to give her grandson.

As the assignee, Edith's grandson can encash the policy and enjoy the whole £220,000 benefit. If Edith survives seven years there is no IHT either.

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