The case for bonds after the budget.

For professional intermediaries only.

Adviser guide

Contents.

Introduction.	3
Changes to the CGT regime for collectives.	4-5
How are bonds taxed.	6
Collectives vs investment bonds.	7
Investing for income with a bond.	8-9
Other reasons for recommending a bond.	10-12
The Hartford Gold advantage.	13
Key considerations.	14

Introduction.

A key announcement in Alistair Darling's Budget speech was that the rules regarding Capital Gains Tax (CGT) will change from April 2008.

This document looks at the change to the CGT taxation regime, and how investment bonds will continue to play an important role in your clients' investment strategies.

Changes to the CGT regime for collectives.

Before 6 April 2008.

A higher rate tax payer holding a collective investment would pay tax at 40% on any realised gains over the annual exemption.

However, they could benefit from 'taper relief', depending on how long they had held the asset. This ranged from a 0% reduction for less than three years to a 40% reduction for ten or more years.

This meant that higher rate tax payers holding their investment for ten years or more would only have to pay an effective tax rate of 24%. Basic rate tax payers would only have to pay an effective rate of 12%.

Clearly there was a certain level of complexity in this regime, which is why the Chancellor stated that simplification was one of the key drivers in his decision to abolish both taper relief and indexation relief.

After 6 April 2008.

Following the recent budget, 'taper and indexation relief' have been removed and replaced with a flat rate of 18% after the annual exemption.

The removal of 'taper relief' from collective investments will benefit higher rate tax payers. This is because instead of having to pay an effective rate of 24% tax on an asset held for ten years, they will now only pay 18% on realised gains above the annual exemption.

In contrast, basic rate tax payers who keep their investment for a period of time may be worse off. That's because previously, had they held their investment for ten years or more, they would have paid an effective rate of 12%. The new flat rate of 18% could mean a 50% increase!

Additional 'income' tax for higher rate tax payers.

It's important to remember that investments such as Unit Trusts and OEICS (collectives) suffer additional income tax on 'income' each year.

All income (whether distributed or accumulated) will be paid from the collective net of basic rate tax.

However, higher rate tax payers are liable for additional tax on these assets at 32.5% of the gross dividend, with a 10% tax credit that reduces the effective rate of tax to 25% (see table on page 7).

For example, an £800 net dividend to a higher rate tax payer will benefit the investor by £600 (£800 – 25%).

How bonds are taxed.

After an allowance for indexation, life companies pay corporation tax inside their funds at a rate of 20%. The gain and corresponding tax liability is spread over seven years.

This has the effect of reducing the amount of tax paid by the life company within the fund. Although this varies from year to year, it is not unusual for it to be in the region of 18% each year.

Life companies have no further tax liability on UK dividends, along with any net savings income received after deduction of tax at source, and 20% on other income.

Additional income tax for higher rate tax payers.

In addition to tax already being paid within the fund by the life company, higher rate tax payers are liable for tax on any profits made when they encash, either partially or in full.

However, the investor can defer tax if withdrawals are within the 5% per annum cumulative allowance (see 'other reason for recommending a bond' on page 10).

This tax charge is calculated at 40%, with a 20% tax credit for tax paid in the fund. This tax credit is applied at 20%, regardless of the tax actually reserved for in the fund.

Collectives vs investment bonds.

Under the new regime it would appear at first glance that higher rate tax payers would be better off holding collective investments.

However, the issue depends on whether the client is investing for capital gains or income and whether they are investing for the long or short term.

- Where growth is driven wholly or largely by capital gain (growth equities), then a collective investment is likely to look attractive from a tax perspective.

- Where growth is driven wholly or largely by net dividend (income equities), interest (fixed interest) and rent (property), then an investment bond is likely to look attractive from a tax perspective.

	Investment bond	Collective investment
UK dividends	0%	25%
Offshore dividends	20%	25%
Interest	20%	25%
Rent	20%	25%

(For higher rate tax payers).

This is because UK dividend income, which is reinvested in the life assurance fund, suffers no further tax. Yet when encashing the policy, the tax payer receives a 20% tax credit on the chargeable event gains.

Investing for income with a bond.

Bonds have always been used by financial advisers as an effective tax planning tool for their clients, and they will continue to be so. As you can see in Figure 1, the assets within the bond perform well against the same assets in a collective.

Even when investing for five years in Figure 2. bonds may still be suitable, especially when you consider the other beneficial features of investing in a bond (See page 10-12 for more information).

Figure 1. Higher rate tax payers.

Term: ten years.

• Investment of £100,000.	
• Net dividend.	3.5%
• Growth.	2.0%
• Interest.	0.0%
• Collective after ten years.	£154,911
• UK bond after ten years.	£156,652
Difference in favour of a **bond.**	£1,741

Summary.

As the investor maintains their investment over a longer period, the effect of the preferential tax treatment of the net dividend means that the UK investment bond produces a higher return.

Figure. 2 Higher rate tax payers.

Term: five years.

• Investment of £100,000.	
• Net dividend.	3.5%
• Growth.	2.0%
• Interest.	0.0%
• Collective after five years.	£125,317
• UK bond after five years.	£124,557
Difference in favour of a **collective.**	£760

Summary.

As can be seen in this example, the effect of the preferential tax treatment of the net dividend, over a relatively short period of time, means that the collective is producing only a slightly higher return.

Therefore the other benefits of a bond may make this a more suitable investment.

For clients who will not be a higher rate tax payer on encashment, the advantages of bonds are even clearer.

Non or basic rate tax payer on encashment.

Term: ten years.

• Investment of £100,000.	
• Net dividend.	3.5%
• Growth.	2.0%
• Interest.	0.0%
• Collective after ten years.	£154,911
• UK bond after ten years.	£170,815
Difference in favour of a **bond.**	£15,904

Summary.

In this example, because the investor is not subject to marginal rate tax upon final encashment, they receive a significantly higher return from an investment bond.

Furthermore the application of top-slicing relief would make this a very tax-efficient outcome.

Assumptions.

- All figures quoted are after all charges and are the same regardless of the investment wrapper.
- All life funds are invested in collectives.
- Indexation (relevant to the taxation of gains in UK life funds) is at 2.5% p.a., reflecting inflation.
- The tax rate applicable to gains each year within a UK life bond is 18%. While 20% is the rate that applies to life company gains, for life company holdings in mutual funds, the liability is on a deemed annual realisation that is spread over seven years, so the effective tax rate is lower. It is thought that 18% is a fair way of allowing for that.
- Collectives are assumed to be constituted entirely by accumulation units / shares.
- For collectives, where applicable the 2007/08 annual exemption of £9,200 has been applied.
- The annual CGT exemption is increased at the rate of 2.5% p.a., rounded to the higher £100.
- For higher rate tax paying investors, tax at an effective rate of 25% on the net dividend has been assumed to have been deducted from the net dividend at the end of each year before reinvestment.

Other reasons for recommending a bond.

Taxation is an important consideration for an adviser when determining the appropriate tax wrapper for their client's needs. The way in which different assets are taxed in bonds and collectives will assist the adviser in making a recommendation.

But taxation is not the only consideration. Investment bonds have a number of features that are not available with a collective.

Feature	Explanation	Potential benefit
5% tax-deferred withdrawals per annum.	Investors may take up to 5% of the original investment each year as a tax-deferred withdrawal. This is cumulative, which means that if an investor does not take the full amount available in any policy year, the unused amount rolls forward to the next year, and so on.	This may be of particular interest to an investor wishing to supplement their annual income in a tax-efficient manner. There is a particular benefit for those who draw income as a higher rate tax payer but expect to be a basic rate tax payer when they encash the bond.
The availability of 'top slicing relief'.	This is available to basic rate and non-tax payers who become higher rate tax payers as a result of profits from their bond. Essentially, the gain is divided by the number of complete years the bond has been in force and the top sliced gain added to current income. If the new level of income enables the investor to remain a basic rate tax payer, then there is no more tax to pay. Any gain within the higher rate bracket is taxed at 20%. This tax amount is then multiplied back up by the number of complete years the bond has been in force, to calculate the total top sliced tax amount due.	Top slicing relief is often of benefit to basic rate tax paying investors and those paying higher rate tax who assign all or part of their bond to a basic rate or non-tax paying spouse. This can significantly reduce tax, or even avoid it altogether. With a collective investment, the maximum tax that can ever be saved in any one year by assigning the collective to a basic rate or non-tax paying spouse is 18% of the annual exemption (2008/09) i.e. £1,728 (£9,600 x 18%).

Feature	Explanation	Potential benefit
Good fit with trusts.	The fact that bonds are non-income producing assets make them ideal for trust arrangements. Again, this is due to the ease of administration. Collective investments can be placed in trust, but this would give rise to additional work for the trustees as a result of annual taxation reporting, any fund switch or a partial withdrawal.	By utilising an investment bond, a trustee can administer the trust asset with a minimum of time and complexity.
Positive for age allowance.	As withdrawals of up to 5% per annum do not need to be reported to HMRC, they are not included in the means test and do not affect some state benefits, including age allowance.	This is a key benefit for those in receipt of age allowance. For those aged between 65 and 74, the personal allowance increases to £9,030 and rises to £9,180 for those aged 75 and over (2008/09). Any withdrawal, other than 5% tax-deferred income, above £21,800 reduces this allowance by £1 for every £2 in excess. The minimum personal allowance will always be £5,435 (2008/09).
Potential sheltering for long term care costs.	According to the CRAG report, bond assets are not included by local authorities in the means test for long term care costs. Caution must be exercised however, as the local authority can access bond assets if they can prove that the investment was placed with the intention of avoiding long term care costs i.e. deliberate deprivation.	Due to increasing longevity and medical advancements, more and more people need long term care. Although the investment must not be made in an attempt to avoid long term care costs, it may be comforting for investors to know that their assets will remain invested and could potentially be part of a legacy for their family.

Other reasons for recommending a bond.

Feature	Explanation	Potential benefit
Tax-free 'fund switching'.	With most investment bonds, a specified number of fund switches are permitted free of charge each year. These are administered within the mutual funds of the life company and do not necessitate a report to HMRC or any tax liability. This is in contrast to collective investments where investment is direct. This means that any fund switch is classed as a sale of one asset (which involves subsequent reporting and potential tax payment to HMRC) and a purchase of a new asset.	This is of particular benefit to those investors who want the flexibility to switch funds over the medium to long term, due to performance, consolidating gains or to reflect a change in personal attitude to risk.
Ease of administration.	As bonds are a non-income producing asset, this means that there's no requirement for HMRC reporting each year. Therefore, bonds are easy to administer when compared with other investments.	Reporting for investment bonds is only ever on full encashment, or on partial encashment in excess of 5% cumulative per annum. This makes reporting more manageable from an investor's perspective.

The Hartford Gold advantage.

At The Hartford, we welcome the simplified regime and the opportunities it presents. We believe that investment bonds will continue to play a very important role in financial planning.

Our flexible investment bond, Hartford Gold, offers a number of benefits that could make it a more suitable investment for your clients. When you select one of our unique optional guarantees, Hartford SafetyNet or Hartford SafetyNet for Life, you can provide your clients with an number of additional benefits.

- Guaranteed income: For clients seeking an income from their investment, the 5% tax-deferred annual withdrawals continue to be attractive. By adding one of our unique optional guarantees, Hartford SafetyNet or Hartford SafetyNet for Life, clients can guarantee their level of income for 20 years or for life, even if markets go down. What's more, clients can lock in up to a maximum of 10% of investment growth (up to age 75), which can increase income.

- Inheritance tax (IHT) planning: Using one of The Hartford's sophisticated trust arrangements alongside a Hartford Gold investment bond can be an efficient way of investing a lump sum to reduce your clients' beneficiaries' future IHT liability.

- Guaranteed death benefit: By choosing one of our unique guarantees, you can not only pass on the full amount of your original investment, but also any locked-in gains, less any withdrawals taken.

- Leading fund management: Investors can benefit from expert fund selection and a five-star support service. What's more, up to 12 tax-free switches are permitted free of charge each year.

Key considerations.

- A detailed understanding of a client's attitude to risk.
- Selecting an appropriate asset allocation.
- Selecting appropriate funds in conjunction with the attitude to risk and asset allocation.
- Understanding the taxation of the selected funds in each tax wrapper.
- Determining whether each fund produces:
  - A capital gain
  - A UK dividend
  - An offshore dividend
  - Interest
  - Rent
- Considering any features of a bond that may be important to the investor.
- Selecting the most appropriate tax wrapper.

Next steps.

- Now is an opportunity to review the circumstances of your existing investor book and their portfolio of funds from a tax perspective.
- Consider those clients that are investing for income, either currently or in the future. Do those clients require a guaranteed income?
- The Hartford has produced a client facing standard letter to help you contact your clients and arrange for a review meeting.
- You may need to update your suitability letter process.
- Financial Advisers may need to inform and train their paraplanners and sales support staff. The Hartford has effective training and technical departments which can support this.
- If you require any assistance or if you want to obtain a copy of our standard letter or guidance on your suitability process, please call your local Hartford Consultant or our Sales Support Team on 0800 028 6767.

Notes.

Sales Support for advisers.

0800 028 6767

sales.support@thehartford.co.uk

www.thehartford.co.uk

Telephone calls may be recorded and monitored for training and quality purposes.

Caring for our future.

In wanting to help you prepare for the future, we believe we should first help to protect it. This includes caring for the environment. That's why this brochure is printed on paper derived from sustainable forests and aims to minimise the use of toxins, raw materials and energy that go into its production.

The Hartford does not offer taxation, legal or investment advice. This is based upon our current understanding of HM Revenue & Customs practice and regulation, both of which may change in the future.

This is not a consumer advertisement. It is intended for Professional Financial Advisers only and should not be relied upon by private investors. 'The Hartford' refers to The Hartford Financial Services Group, Inc., the parent company of the family of Hartford companies, and its affiliates, offering financial services products in selected jurisdictions, including Hartford Life Limited (no. 242197) incorporated in the Republic of Ireland with limited liability. Registered and Head Office: Swords Business Campus, Swords, Co. Dublin. Hartford Life Limited authorised by the Irish Financial Regulator and regulated by the Financial Services Authority for the conduct of UK business. UK Branch: Level 29, One Canada Square, Canary Wharf, London E14 5AA. Registered in England and Wales with registered number (Co No. FC25647; Branch No. BR007928). HLLHG/166114/0308.