

Investment wrappers

The use of wrappers, such as unit trusts, or life assurance bonds that hold underlying investments in the most tax efficient manner, has increased as the choice of available structures has expanded. However, the proposed changes to personal taxation announced in the Chancellor's Pre-Budget Report (PBR) in October 2007 will affect the relative merits of the different wrappers being used from the 2008/09 tax year. In this article, Phillip Wood considers what the impact might be.



The most obvious change to be considered is the proposed move to a flat rate of capital gains tax (CGT) of 18% from 6 April 2008. For investors, this means that the rate of tax could be reduced by more than half from 40% in the current tax year (07/08) to the new rate of 18% from 6 April 2008. In addition, the proposal is that there will no longer be the complications of the current CGT regime such as taper relief and indexation meaning that calculating the tax due on investment assets should be far simpler.

The proposed change in the CGT rate will create a large gulf between those assets that are subject to income tax at 40% and those that are taxed at the new CGT rate of 18%. This means that many UK higher rate tax paying investors may start looking for investments that generate returns which are subject to CGT rather than income tax. This is something that has not been witnessed on a significant scale since the 1980s, which was when the rate of CGT was last dislocated from income tax rates.

As a result, investment wrappers such as unit trusts, open-ended investment companies and investment trusts, the capital gains realised from which are chargeable to CGT, are likely to be favoured as investment holding vehicles over single premium insurance bonds, where the investment returns made are all subject to income tax. For many investors, these will probably be the vehicle of choice going forward from April 2008.

Single premium insurance bonds, also known as investment bonds, have traditionally been favoured as investment wrappers by some financial advisers. Historically, the charging structure of certain bond wrappers has been extremely high, which often reflects the level of commission paid to the adviser. In recent times, as the popularity of insurance bonds has risen, they have become far more competitive in their upfront costs. However, they will become a comparatively tax inefficient way of holding assets that are aimed at generating capital growth from April 2008 onwards, particularly for higher rate taxpayers.

UK based insurance bonds are subject to tax on the insurance funds held within them, which is treated by HM Revenue & Customs (HMRC) as having discharged the savings rate of tax payable on the returns. Consequently, when a chargeable event such as encashment of the bond arises, higher rate taxpayers are subject to an additional 20% levied on the net gain.

Where an offshore-based insurance bond wrapper is used instead, the underlying insurance funds are not subject to UK tax, so higher rate taxpayers will incur a 40% income tax charge on the returns made when a chargeable event arises.

Insurance bonds will be less tax effective when compared to investments that will be subject to a CGT rate of 18% on capital gains realised after 5 April 2008.

This tax rate differential is something of a side effect of the PBR CGT changes and one which has caused the insurance industry considerable concern. They have held extensive discussions with the Treasury and HMRC and the Chancellor, when announcing the entrepreneurs' relief, confirmed that such discussions were ongoing without saying whether any changes would be made.

Such wrappers could, however, remain a reasonably effective way of holding income yielding assets, particularly where the ability to defer the crystallisation of a higher rate income tax liability to a future point is an important consideration. There are other scenarios that could also make the use of an investment bond as a wrapper to hold investments attractive. For example, this could include investors who may be outside the scope of the UK tax net when the bond is realised.

Undoubtedly, a number of advisers will cling to the use of single premium insurance bonds, possibly citing their use as an inheritance tax (IHT) planning tool, through so called gift and loan arrangements and discounted gift trusts. However, these structures can be both costly and complex and are subject to a change in legislation by HMRC, so alternative methods of IHT planning could prove to be more effective, less complex and less costly.

Although single premium insurance bonds may still be effective to hold income generating assets, there is likely to be an increase in the number of investment vehicles that are designed to mirror income-type returns in a form that is subject to CGT, rather than income tax. These wrappers are commonly referred to as structured products.

Structured products generally seek to provide investors with a cash plus return, with a reasonable degree of security. Structured products are not new, although only a small minority of those made available to date have been capital gains taxable. In order to structure them as investment vehicles that are subject to

CGT, the returns will be linked to an increase in one or more stock markets over a pre-determined period, with an element of capital protection, but not a capital guarantee. Commonly, they will have a tie-in period of five to six years, although they may have early release clauses if the targeted stockmarket increases are achieved at an earlier point. Where the proceeds are structured so that the return is subject to CGT, rather than to income tax, they start to look very attractive as an alternative to conventional term deposits or cash-based insurance bonds.

For wealthy investors, bespoke notes that are subject to CGT can be obtained from city institutions. These can be tailored to the investor's requirements in terms of length of investment and credit risk. Doubtless over the next few months further products will be brought to the marketplace that are designed to generate competitive low risk returns that are subject to CGT.

Another set of investment wrappers that may be facing changes are offshore funds. An HMRC consultation document has suggested a number of changes to the UK taxation of offshore funds, which may result in more of them being subject to CGT in the UK, rather than their returns being treated as offshore income gains that are subject to UK income tax. In particular, this might increase the availability of hedge fund investments that are taxed to CGT which, at the new rate being introduced in 2008/09, would make them more attractive to UK tax resident investors. Further information on the proposals will be forthcoming once the consultation period has ended and the responses are considered.

The world of investment wrappers is changing. This will affect those who have existing investments as well as those that are looking to invest in the future. We all know that the tax tail shouldn't wag the 'investment dog', but increasing the after tax return by careful structuring can make a big difference to the net proceeds. With the proposed rate coming into effect from April 2008, making the right choice of investment wrapper in the future will become even more important.

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