

Deficiency relief on insurance bonds

(Lecture P1202 – 15.11 minutes)

Losses on insurance bonds

If the bond is eventually surrendered for an overall loss, this loss cannot be set against capital gains or income to save tax at marginal rates. Indeed, if two investment bonds are surrendered, one showing a profit (i.e. chargeable event gain) and the other a loss, they cannot be matched off.

There is a very limited form of loss relief, known as corresponding deficiency relief ('deficiency relief'), under ITTOIA 2003 s.539. This is only available where there has been an earlier chargeable event gain on the same bond. As most investors try to avoid making partial encashments that might trigger chargeable event gains, this relief will not be encountered too often in practice.

Advisors should be aware of it (and its limitations) though, as for some taxpayers it may produce a sizable tax saving on eventual surrender of the bond, should the investment perform poorly.

Example – Ricky

Ricky invested £50,000 into a UK investment bond on 3 October 2011. On 16 March 2013 he withdrew £20,000 from the policy by part surrender. On 5 December 2019 he surrendered the policy for £32,500.

His only taxable income (after personal allowance) in 2019/20 is employment income of £42,800 and the higher rate threshold for 2019/20 was taxable income of £37,500.

Solution

In policy year 2 (ending on 2 October 2013) there was a withdrawal of £20,000. This part surrender gave rise to a chargeable event gain on 2 October 2013 of £15,000, being $£20,000 - [£50,000 @ 5\% \times 2]$.

Note that as it is a part surrender, any tax charge on this gain would have arisen on Ricky in tax year 2013/14 (i.e. the tax year in which the policy year ends).

When the final surrender happens in December 2019, the gain calculation on the surrender compares the total benefits received with the total amounts invested, and then gives a further deduction for chargeable event gains that have arisen in earlier years (to avoid double counting).

For Ricky, these amounts are:

Total benefits: $£20,000 + £32,500 = £52,500$.

Total invested: £50,000

Previous gains: £15,000

The gain calculation is $£52,500 - £50,000 - £15,000 = -£12,500$.

This deficiency is less than the amount of earlier gains, so the amount of deficiency available for relief is £12,500 and will be used against Ricky's 2019/20 total taxable income as follows:

- Ricky has taxable income in the higher rate tax band of £5,300 (42,800 – 37,500);
- This higher rate liability is relieved by deficiency relief of £5,300;
- Effectively, the basic rate band is extended by £5,300, so that Ricky doesn't suffer any higher rate tax;
- The balance of the deficiency relief (£12,500-5,300 = £7,200) is lost, as there is no form of carry back or carry forward.

Note that, if the total benefits in the above calculation are less than the sum of the total invested plus the previous gains, any deficiency relief is restricted to the level of the previous gains.

For example, if the final surrender amount had been £27,500 rather than £32,500, the deficiency would have been £17,500 (20,000 + 27,500 – 50,000 – 15,000), but any deficiency relief would have been limited to a maximum of £15,000.

Contributed by Kevin Read