

Chargeable event gains (Lecture P1243 – 24.51 minutes)

Chargeable event gains will typically arise in relation to single premium insurance bonds. This is a product which pays out on the death of the 'insured' but which is an investment product designed to give growth in value in a tax effective way. It is a wrapper for investments rather than insurance. Cash can be withdrawn by the bond holder at any time (subject to any restrictions imposed by the insurance company) and there is no limit on the amount which can be invested. There are tax implications of withdrawing money in some cases.

For reasons which are explained below, it is often the case that even where a single premium is paid, the bond is split into units. Most policies are 'non-qualifying policies'. A qualifying policy is one that is designed to last 10 years or more, with premiums being paid yearly or more frequently. So the kind of products not within this regime include term assurance (which pays out only on death with no investment aspect), insurance for destruction or damage to assets and medical insurance.

It is important to understand the terminology. The policyholder is the legal owner of the policy; the life or lives insured are the people whose death triggers a payout and the insurance year is the year commencing on the date policy is issued.

What is the tax treatment of contributions on the assumption that these are paid in a single contribution in cash?

- There is no deduction or relief for income tax purposes;
- There is no capital gains tax impact as it is a cash transaction;
- If the payer is the beneficiary, then there is no inheritance tax impact as there is no transfer of value. If the initial cash or policy is gifted to someone else or to a trust then it would be a potentially exempt transfer or chargeable lifetime transfer depending on the recipient.

If we are considering the tax treatment of encashment of the bond, the first thing to ascertain is whether this is an onshore or an offshore bond. An onshore bond will be held by a UK insurance company which is paying corporation tax on its profits. There is a tax credit of 20% on any withdrawals. Offshore bonds are held by persons in places such as IOM, Dublin, Luxembourg or the Channel Islands and is not normally subject to UK corporation tax. There is no tax credit on withdrawals.

A tax charge arises when a chargeable event occurs. This is not subject to capital gains tax but instead falls within the chargeable event gain provisions. This is a mechanistic calculation which means that it may not be relevant if the policy is actually standing at a gain.

There are three stages:

1. Identify that a chargeable event has taken place;
2. Calculate any gain using rules in legislation;
3. Determine who is taxed on the gain.

Chargeable event gains are taxed as the highest slice of income.

The typical chargeable events that we see are:

- Assignment of rights for consideration;
- Death;
- Full surrender of rights;
- Partial surrender or assignment.

Assignment

Assignment of a policy for no consideration is not a chargeable event and transfers between spouses or civil partners are disregarded even where this is done for consideration. This can be used for planning purposes.

Death and surrender of rights

A surrender of a policy is where it is fully encashed. However, it is important to note that HMRC consider that some changes in policy terms also represent a full surrender (for example, a change in the first death/last survivor on a joint policy; adding or removing critical illness cover) so most policies restrict this.

Even though chargeable events include death of the insured, if no death benefits arise, then there is no chargeable event (for example, the first death where joint lives are assured).

The calculation of the gain on death, full assignment and surrender is basically the same. It is calculated as:

Total Benefit Value of the Policy

LESS Premiums Paid and Chargeable Event Gains already charged

The total benefit value is the sum payable on termination of the policy plus any capital sums previously paid (such as on partial surrenders, see below). On death, the total benefit value is the surrender value of the policy before death plus any previous capital withdrawals. On assignment, it is the surrender value plus any previous capital withdrawals.

The chargeable event gain arises at the point of the chargeable event.

Examples

An individual pays £20,000 into an insurance bond and makes no withdrawals before encashing it when its value is £35,000. The chargeable event gain is £15,000 as it is simply the difference between these two figures.

An individual pays £20,000 into an insurance bond. She withdraws £3,000 which gives rise to a chargeable event gain of £1,000 before encashing the bond and receiving £35,000. Total benefit value is £35,000 plus £3,000 but the premium paid is £20,000 and the gains charged previously are £1,000. So the chargeable event gain is £17,000.

An individual pays £20,000 into an insurance bond and makes no withdrawals before assigning it for £30,000 when its surrender value is £32,000. The chargeable event gain is the difference between the surrender value and the original premium, being £12,000. The consideration received is of no relevance.

An individual pays £20,000 into an insurance bond and makes no withdrawals. The insured dies when the surrender value is £37,000 but the estate eventually received £38,500 when the bond is encashed. The chargeable event gain is the difference between the surrender value at the date of death (£37,000) and the original premium (£20,000) so is £17,000.

Partial surrender

Part surrenders are chargeable events but there is an annual 5% allowance each year (cumulative) and if the surrender is within the available allowance, then there is no chargeable event gain at the time. It is important to remember that these apparently 'non-chargeable' events are taken into account on subsequent events as they are included in the total benefit value of the policy (see above). A surrender in excess of the allowance will crystallise a chargeable event. The quantum of this is the excess withdrawal regardless of whether the bond is standing at a gain. If further premiums are added to the policy, then you also get 5% of those going forward.

The partial surrender is deemed to occur at the end of the relevant insurance year in which it arises which may be in a different tax year to the date the actual partial surrender took place.

Examples

George contributes £200,000 to an onshore policy in year 1. He withdraws £45,000 in year 4. The chargeable event gain is £5,000. He has four years' worth of 5% withdrawals allowances (£10,000 p.a.) so it is only the excess of this that is chargeable.

Marjory pays £10,000 into an insurance bond, and then makes a supplementary contribution of £5,000 in year 3. She withdraws £3,000 in year 5. The cumulative total of withdrawals that can be made before a chargeable event gain arises is $(£10,000 \times 5\% \times 5) + (£5,000 \times 5\% \times 3) = £3,250$. So the withdrawal is within those limits and no gain arises.

The position is more complicated when there are successive part disposals as you need to know what you take into account and what you don't. The answer depends on whether or not there have been any 'excess events'.

If there have been no previous partial surrenders which have generated a chargeable event gain, then you simply add up all the partial surrenders and compare that to the cumulative 5% allowances to see if a chargeable event gain arises in the current insurance year. If you have previous excess events that have generated a chargeable event gain, you have to disregard any amounts of the cumulative 5% allowances which have already been utilised and any other partial surrenders that have already been taken into account in calculating the previous gain.

Examples

An individual invests £10,000 in an insurance bond, withdrawing £500 in year 2 and £4,000 in year 5. The 5% income allowance each year amounts to £500. The partial surrender in year 2 is covered by this so no chargeable event gain arises. When we come to year 5, we have £2,500 of cumulative allowances and £4,500 of withdrawals. So the chargeable event gain is £2,000.

A further withdrawal is made in year 7 of £2,000. The cumulative 5% allowances for 7 years equals £3,500 but we have already taken into account £2,500 in calculating the partial surrender gain in year 5 so we only have £1,000 to consider. No previous partial surrenders have been exempt so they are also ignored. So the chargeable event gain here is the withdrawal less £1,000 which is itself £1,000

We then need to consider if it is better to surrender full units rather than partial units. This explains why it is common to see large single premium bonds split into numerous smaller bonds.

An individual invests £500,000 in a bond with 1,000 units. In year 2 it is worth £530,000. She wants to withdraw £132,500 to fund cashflow issues in her company.

If she partially surrenders the whole amount from a number of units, the chargeable event gain would be £82,500 as she can only offset £25,000 x 2 being the 5% allowances available. Each individual unit is worth £530 so she could surrender 250 units to get the relevant figure. The gain on each would be £30 so the total chargeable event gain would be £7,500.

Top slicing relief

Top slicing relief is available because chargeable event gains are made in a single year whereas the growth in value will (typically) have arisen over the life of a bond. This can cause the income tax to be artificially high on some surrenders, exacerbated by the chargeable event gain being treated as the top slice of income.

The steps to calculate this are as follows:

1. Divide the gain by the number of complete years the policy has been in place (this is the 'slice');
2. Work out how much of the 'slice' falls into the higher rate or additional rate band and what the tax rate is on this (the 'extra tax');
3. Multiple the extra tax by the number of complete years
4. Deduct this from the individual's tax liability on the chargeable event gain. The difference is the top slicing relief.

Example

An individual has a salary of £130,000 and then makes a chargeable event gain of £45,000 which was taken out 5 years before. It is an onshore bond and top slicing relief is claimed.

No personal allowance is available so the tax on chargeable event gain without top slicing relief would be £20,000 x 40% plus £25,000 x 45% less the basic rate tax credit of £45,000 x 20%. This is £10,250.

The sliced gain is £9,000. The income does not exceed the additional rate threshold so there is £500 personal savings allowance available and so tax due is £8,500 x 40% x 5 = £17,000 less basic rate tax credit of £9,000. So top slicing relief of £2,250 can be claimed.

This calculation has caused problems historically because of the question about loss of personal allowance.

Let us take an example. An individual has income of £40,000 and then makes a chargeable event gain of £90,000 on a policy held for 10 years. Total income without top slicing relief is £130,000 causing complete loss of the personal allowance. However, the 'sliced' gain is only £9,000 which is well below the threshold at which the personal allowance start to reduce.

It has always been HMRC's view that you do not get the personal allowance back in the top slicing calculation but this was disproved in the FTT HMRC v Marina Silver decision (TC07013). The legislation was then amended for chargeable events occurring on or after 11 March 2020 although for cases arising on earlier dates, the principle in the Silver case could be argued.

In the above example, no further tax would be due on the gain as the whole of the sliced gain falls within the basic rate band and is covered by the basic rate credit assuming that this is an onshore bond.

Deficiency relief

Deficiency relief is designed to mitigate some of the effects of having partial surrenders taxed on a figure which does not reflect the underlying gain on the bond.

It is not effective as it only applies on full surrender of a bond and only assists someone who is a higher rate taxpayer.

If the total allowable deductions are greater than the total benefit value, then the gains which have arisen on previous chargeable events arise as a deficiency.

If the total benefit value exceeds the total allowable deductions, then the deficiency is equal to the total of the previous gains, less the excess.

Total allowable deductions are the total premiums paid under the policy. The total benefit value are the capital amounts having been withdrawn from the policy at any point, and including the 5% withdrawals which have previously not been taxable

The tax reduction is calculated by matching the amount of the deficiency with that part of the individual's taxable income which is taxed at the dividend upper rate, and, if there is any deficiency remaining, then with the part taxed at the higher rate with the equivalent for Scottish or Welsh taxpayers.

Example

Romi took out a policy with a premium of £20,000

- In year 2 she withdrew £8,000 from the policy by a part surrender;
- In year 5 she surrendered the policy for £13,000.

She was UK resident throughout.

Her taxable income is £52,000. The threshold at which higher rate is paid is £50,000.

Tax treatment

- The part surrender in year 2 produces a gain of £6,000 (£8,000 less $(2 \times £20,000 \times 5\%)$);
- The total allowable deductions are £20,000 being the initial premium;
- The total benefit value on surrender is £13,000 + £8,000 = £21,000;
- The amount of deficiency = £21,000 - £20,000 - £6,000 = -£5,000;
- The relief is given by extending the basic rate band so, in reality, she will only benefit from £2,000 of the deficiency relief. The excess relief cannot be carried back or forward or used in any other year.

Following on from some criticism of the way in which the chargeable event gain legislation operated, HMRC changed the legislation in 2017 so that a policyholder can apply to have a tax charge recalculated where it is disproportionate. The application must be made in writing to HMRC within 4 years of the end of the tax year in which the gain arose and there are various factors HMRC will take into account in deciding whether the gain is disproportionate. No recalculation will be made if the gain is connected with arrangements where the main purpose or one of the main purposes is the avoidance of tax.

Contributed by Ros Martin