Capital Gains Tax Reform and the Life Assurance Industry

Matthew Little takes a look at the impact of the recent changes to the taxation of capital gains

On 24th January 2008 the Chancellor, Alistair Darling, reiterated the changes to Capital Gains Tax (CGT) first announced in the Pre-Budget Report on 9 October 2007. In this article we describe the nature of the CGT changes, look at how the taxation environment differs depending upon the choice of investment vehicle and outline the alternatives that were discussed.

So what's changing?

The stated objective for the changes was simplification. They only affect individuals and trusts; not companies and the main points of significance were:

- There will be a single 18% rate of CGT;
- Taper relief will be withdrawn;
- Indexation allowance, which indexes base cost up to April 1998, will also be withdrawn; and
- The changes being effective from 5th April 2008.

What does this mean for the life assurance industry?

In simple terms, the relative position of a higher rate tax payer investing in a bond provided by a life assurance company is likely to have deteriorated when compared to an investment in a Unit Trust or an Open Ended Investment Company (OEIC). This can make a life bond less attractive to an investor. However, it's worth looking at the impact on the life assurance market, the investment market and the offshore investment market to understand this relative impact.

Life bonds

The income and gains from assets backing a life bond are taken into account in the I-E calculation. The expression I-E refers to the basis of taxation where HM Revenue & Customs (HRMC) taxes life assurance business on investment income and chargeable gains (referred to as 'I') less allowable expenses (referred to as 'E'). The income and gains are then taxed as they roll-up during the life of the investment through this calculation.

Once the investment matures, a chargeable events regime kicks in. This, in effect, converts the excess proceeds over initial investment into income. Like any other form of income, it is subject to income tax at rates ranging up to 40% depending, amongst other things, on an investor's marginal rate of income tax. There is a credit of 20% where the roll-up has been taxed in the I-E calculation. Curiously, for higher rate tax payers, the total effective tax rate is only 36% on life bonds rather than 40%. This is because the chargeable gains tax rate of 20% (40% less the credit of 20%) is applied to the investment gain on the policy rather than the gain grossed up for the I-E tax paid by the life company on behalf of the policyholder.

Under current proposals this will not change. Now let's look at other forms of investing.

Authorised investment vehicles

Alternative investment vehicles which an investor may consider include unit trusts and OEICs. Income on authorised investments is declared annually as a dividend to the investor, and recognised in the Income tax return. Here, the investor will pay tax at the appropriate marginal rate, 40% for higher rate tax payers. However, due to the beneficial effect of tax credit receipts on UK dividends it is likely that the marginal rate of tax will be around 25% for equity investments. The income is thus taxed on roll-up during the life of the investment through an investor's income tax returns.

Once the investment matures, the investor will be subject to CGT on any investment gain. As announced, this will then be taxed at a flat rate of 18% from April 2008. However, the investor will have an annual CGT allowance to negate the full effect of CGT and if used efficiently over a number of years, this allowance can significantly reduce or extinguish the CGT burden.

This is an important consideration as an analysis without this being factored represents an existing layer of over taxation for most policyholders. This is because very few policyholders would be liable to pay CGT on any other investment and therefore rarely use their personal CGT allowance – particularly if they are basic rate tax payers. The personal CGT allowance is not available through the chargeable events regime, and therefore life bonds.

It is also worth considering one other alternative, the offshore bond.

Offshore bonds

An offshore bond is a similar offering to a life bond, except that the investment is managed offshore. This arrangement brings tax benefits and drawbacks. Income, when in the form of dividend or interest may be received net of local withholding tax particularly if the company writing the offshore bond is in a low tax jurisdiction. Other income may be received gross. Tax on gains is then charged when the investor receives the proceeds under the same chargeable events regime as for life bonds. However, there is no credit of 20% since the roll-up has not been taxed in an I-E calculation. The applicable rate of tax is derived as described above for life bonds and related to an investor's marginal rate of income tax.

A key benefit of an offshore bond is that of tax deferral. Tax on income is low, possibly zero, therefore the fund accumulates on preferential terms. However, and a counter to this benefit, offshore bonds do not benefit from a CGT indexation allowance.

There is specific anti-avoidance legislation which applies where investors take funds offshore to avoid tax. This does not currently apply to offshore bonds. The Willoughby[1] case distinguished between tax-avoidance which is acceptable and that which is not. Lord Nolan referred to 'a course of action designed to conflict with evident intention of Parliament'. The conclusion was that the specific tax regime for chargeable events represented the way in which offshore bonds were intended to be taxed, so that the anti-avoidance legislation did not apply.

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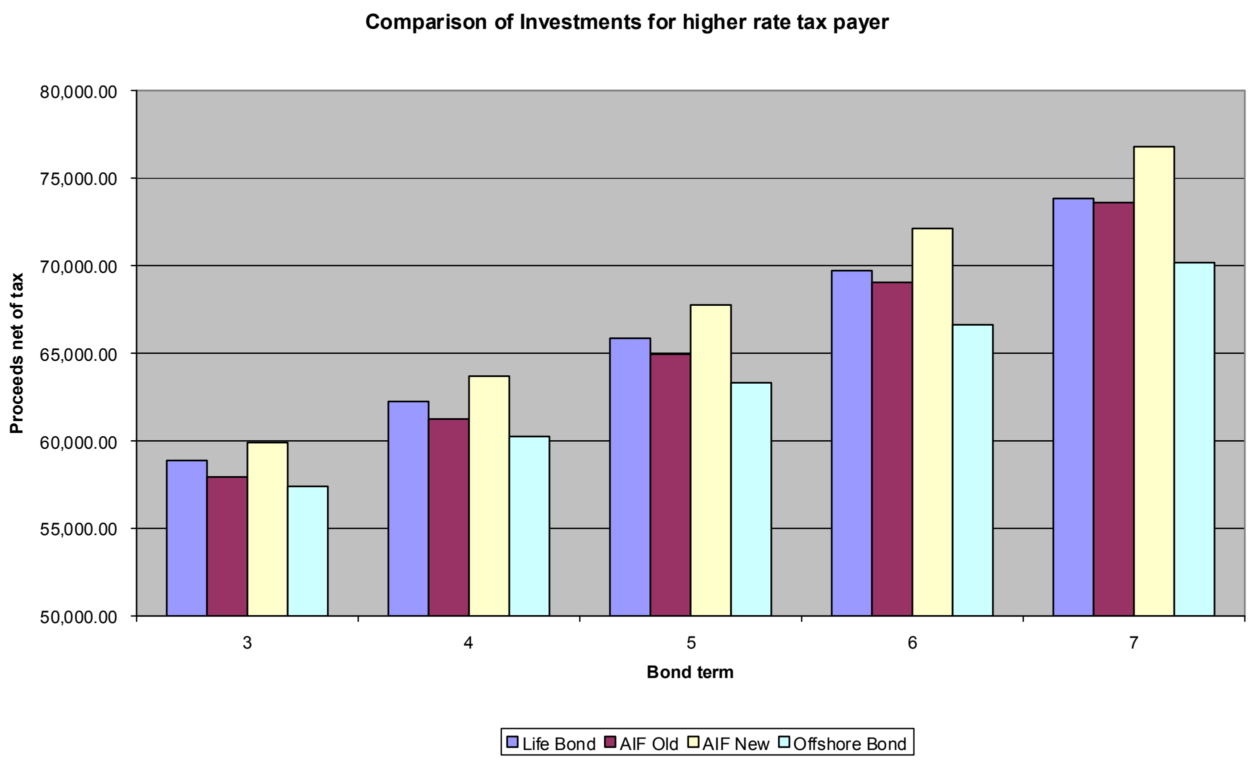
[1] IRC v Willoughby [1997] STC 995

What does this mean for different investors?

The current level of taper relief on direct investment is 0% in the first two years increasing to 40% in year 10 onwards. So in year 10 and beyond any gain was taxable at 24% (60% of 40%) and 12% (60% of 20%) for higher and basic rate taxpayers respectively. So a move to a flat rate of tax of 18% on any gain post April 2008 is:

- much more beneficial for higher rate taxpayers, particularly so in the early years; and
- marginally more beneficial for basic rate taxpayers in the first few years but worse thereafter.

The first chart summarise the relative position of these alternative investments for a higher rate tax payer.

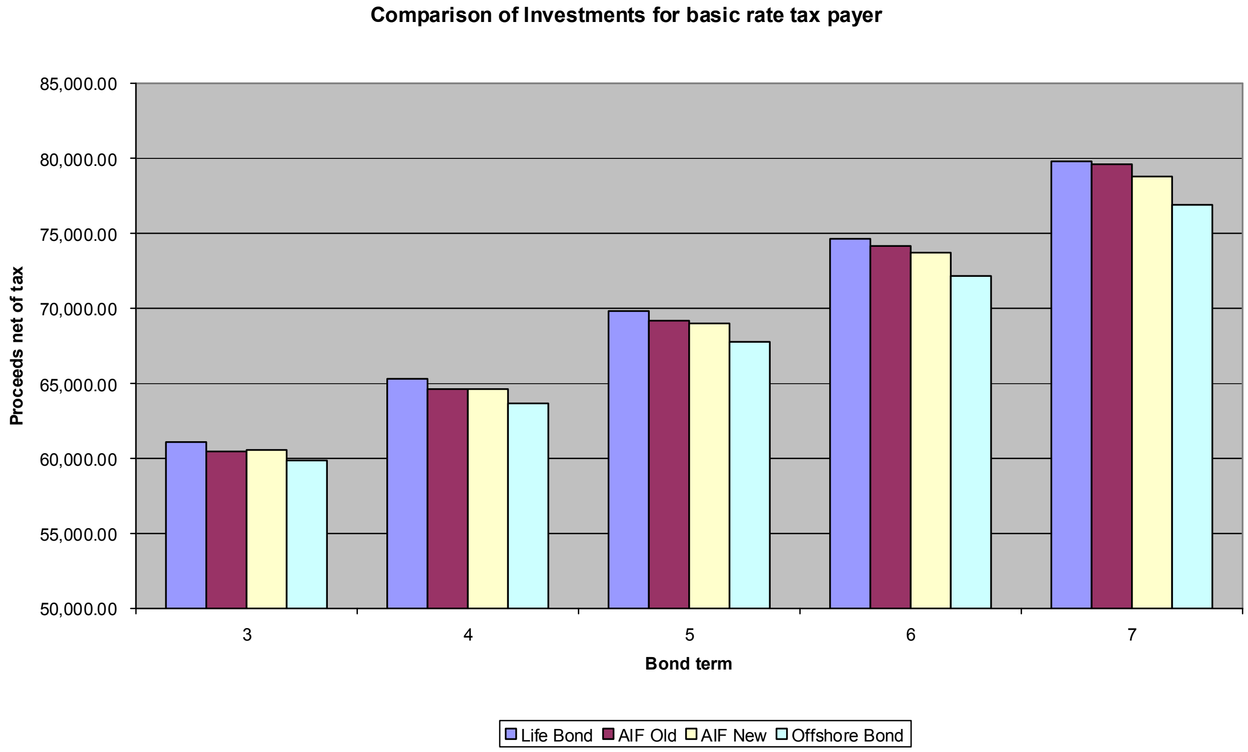


The investments results above assume a £50,000 equity style investment earning a 5.0% real return (plus 2.5% RPI) projected over a 3-7 year period, a 20/80 income/capital split, no relief from the use of the CGT annual allowance (£9,600 in 2008/09) and that the investor is a higher rate tax payer.

Given certain assumptions, it highlights the differential that did exist in the tax regime between authorised investment funds (AIFs) and life bonds. From April 2008, the situation looks very different where the advantage lies firmly with the AIF.

A further thought is the disappointing performance of the offshore bond. Although the offshore bond benefits from the preferential roll-up through tax deferral, it does not benefit from a gains indexation allowance. The CGT indexation allowance is significant within this example.

The second chart summarise the relative position of the alternative investments for a basic rate tax payer.



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Given certain assumptions, it again highlights a differential that did exist in the tax regime between AIFs and life bonds. However, it also highlights the continuing apparent advantage of the life bond.

Please note that any apparent advantage of the life bond can be negated through the management of an investor's annual CGT allowance, when available to be applied to the proceeds of an AIF.

What else has the life industry to offer?

The main concern of the industry is that for a higher rate taxpayer a gain in a life insurance product will be taxed at a cumulative rate of up to 36% while a gain on a direct investment will be taxed at only 18%. However it may be that an investor who is currently a higher rate taxpayer becomes a basic rate taxpayer on exit and will benefit from the change. Such a change in tax status is common in helping to relieve the tax burden of the higher rate tax payer.

There are other specific benefits of investing in a life bond, including:

- They can be written in Trust;
- They are useful for inheritance tax planning, with a benefit provided on death;
- The tax efficiency can be enhanced by taking up to 5% draw-downs each year;
- Switching unit funds is possible without surrendering; other assets classes would necessitate realising gains to switch investments; and
- They can be used as part of a wrapper design;

These additional benefits are now even more important to the future success of the life bond.

What were the alternatives?

Many in the insurance sector voiced concerns about the recently announced CGT changes and the impact on the relative attractiveness of life insurance products compared to other forms of saving, in particular for higher rate taxpayers.

In the above example, it is clear that a large gap now exists when comparing life and investment products for a higher rate taxpayer. A couple of proposals were voiced by the life industry in an attempt to bridge this gap, they were:

- To remove tax on chargeable gains within the life insurer; or
- Change the rate of tax on chargeable events.

The ABI proposed the latter, a reduction to the tax rate on chargeable events to 30% for higher rate tax payers. Thus for life bonds, the effective rate would be 28% rather than 36%. However, the CGT announcements within the budget were a clear signal of events and bring finality to the ABI's recommendation.

This article and previous articles of the Tax Working Party are on our website at www.actuaries.org.uk under life insurance. Our site also has a summary of other events which may affect life company taxation together with links to other relevant websites.

Matthew Little is an Associate at the Financial Services Authority and a member of the Faculty and Institute Tax Working Party. Other members of the working party are Paul Turnbull, Matthew Taylor, Andrew Rendell and Trevor Fannin.