

UNIT TRUSTS v INVESTMENT BONDS

One area of financial planning affected by the Chancellor's decision to introduce a single 18% rate of Capital Gains Tax is that of the main 'tax-wrappers' in which investments can be held, and in particular the respective merits of mutual funds (unit trusts and OEICs) and Investment Bonds.

Both mutual funds and investment bonds provide access to essentially similar equity, fixed interest, property and other funds. However, mutual funds have always had the advantage that dealings by the managers are exempt from Capital Gains Tax. Now, they will have the additional advantage for higher-rate tax-payers that the tax payable on sale in respect of gains which exceed the annual exemption will be reduced from 40% to 18%.

Investment Bonds are technically single premium life policies, and they do not enjoy the CGT exemption on internal dealings but are subject to life company taxation on investment returns. Furthermore, gains made by the policyholder on disposal do not have the benefit of the annual CGT exemption and are potentially subject to higher rate Income Tax rather than Capital Gains Tax – though this can often be avoided by assigning the Bond to a standard rate taxpayer.

Offshore Investment Bonds are rather more complicated, because although there is no local tax on the investment returns, there is equally no relief for the taxes levied at source on the companies in which shares are held, and the charges are higher. In addition, both accrued income and capital gains are subject to Income Tax when the bond is sold, with no reliefs. Hence the appeal of offshore Bonds to people who expect to be non-UK resident when the Bond is encashed.

So, from a tax perspective, the balance has swung in favour of mutual funds, particularly when the underlying investments consist of equity holdings which produce capital gains; and particularly when the investor is a higher rate taxpayer.

There are, however, a number of situations in which Investment Bonds are a particularly suitable vehicle for investment, and these derive from their status as life policies.

One important characteristic of Bonds is the ability of the investor to draw an 'income' of up to 5% of the value of the original investment each year without any immediate tax consequences. These payments take the form of capital rather than income, and so they do not affect eligibility for the Age Allowance enjoyed by the over-65s, nor are they normally taken into account for means testing for residential care funding.

Another situation where the 5% withdrawal facility provides an advantage is that of payments to beneficiaries of Discretionary Trusts. For complicated technical reasons the income tax payable on distributions of dividends income is 20% higher than the normal levels and would amount to 46% for higher-rate taxpayers. But this could be avoided if the investments were wrapped in an Investment Bond from which 5% withdrawals were made.

A third area where Investment Bonds shine is that of Inheritance Tax planning. The fact that a Bond is a life policy means that it can be written in trust for nominated beneficiaries, which makes it a convenient vehicle for making gifts the effect of which will be to reduce Inheritance Tax. Under the so-called discounted gift scheme, the donor retains the right to draw an 'income' from the Bond, and the value of the gift is 'discounted' by reference to the resulting potential reduction in the value of the gift.

However, tax is not the only factor in favour of Bonds. Convenience is also important, in that there is no need to report any transactions to the Revenue until the Bond is sold, and funds can be switched within the Bond without any tax consequences.

So, although mutual funds will usually be the preferred medium for building investment portfolios, particularly in relation to equity holdings, there are some sound reasons for using the Investment Bond wrapper, and existing holdings should not be sold without careful consideration of the pros and cons.



ISA AND PEP

The tax efficiency of ISAs and PEPs from the point of view of income and capital gains tax is well understood, but investors tend to overlook the disadvantage, that these holdings will potentially be subject to 40% inheritance tax on death.

Older investors who have no need of the income from their holdings might sensibly consider using this to make tax-free gifts to their family, perhaps to assist with school fees or pension planning. If contributed to a stakeholder plan, the Government would top-up the payment with basic rate tax relief

THE PENDULUM SWINGS TOO FAR

Investors may be feeling buffeted by volatile investment markets, but it is at times like these that fund managers can prove their worth. Legendary US investor Warren Buffett was reported recently to be excited by the opportunities which are emerging, and New Star's Mark Harris commented that for him a 'buy' signal was when the bad news was broadcast on News at Ten. The pendulum of market sentiment always swings too far, in both directions, as the herd instinct takes over from rational analysis.

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The value of units and the income from them may fall, as well as rise. Investors may not get back the amount originally invested

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