



The Taxation of Life Assurance Bonds and Unit Trusts

A guide for consumers

JULY 2008

This leaflet explains the taxation for individuals who have life assurance bonds and collective investments such as unit trusts and Open Ended Investment Companies (OEICs), and draws out the differences between them.

Whether you already have a life assurance bond or unit trust, or you are thinking about investing in one, this leaflet will help you better understand your investment.

What is...

An Investment Bond?

Investment Bonds are life assurance contracts which give access to a wide range of funds for those wanting income or capital growth over the medium to long term.

A Unit Trust?

An investment which pools together customers' money allowing them to increase the spread of shares they can invest in, therefore potentially reducing the risk.

An Open Ended Investment Company (OEIC)?

The OEIC is an investment company where shares can be created or cancelled to match demand, in a way similar to the units of a unit trust. The principal difference lies in the fact that there is "single pricing".

In this leaflet although for simplicity we refer to Unit Trusts, the same comments will apply to OEICs and Collectives.

This leaflet only applies to bonds issued by UK life assurance companies. If you have bought an "offshore" bond, from a life assurance company based in a foreign location such as the Republic of Ireland or the Channel Islands, then this leaflet will not apply to you and you should talk to your adviser.

If you have invested in a Personal Equity Plan (PEP) or have invested or are considering investing in an Individual Savings Account (ISA), then this leaflet will not apply to you and you should talk to your adviser.

INDEX

[What is...](#)

[How is a Life Assurance Bond taxed?](#)

[How is a Unit Trust taxed?](#)

[Income and Capital Gains](#)

[So where do you fit in?](#)

[The Non Taxpayer](#)

[Basic Rate Taxpayer](#)

[The Higher Rate Taxpayer](#)

[Effect of the different tax treatment of life assurance bonds and unit trusts](#)

[Other factors affecting the choice between life assurance bonds and unit trusts](#)

[Further information](#)

This leaflet provides information only. The ABI cannot give financial advice, and you should always have due regard to your own personal circumstances when thinking about any investment. You may want to take financial advice.

How is a Life Assurance Bond taxed?

The tax that the life assurance company has paid is made up as follows :

On interest that the fund received, it will have paid 20% tax. However this tax is only paid on interest received in excess of the level of expenses incurred by the fund.

On UK share dividends that the fund received, it will have paid no tax as its liability to tax will have been satisfied by the tax credit attached to the dividend.

On capital gains, the fund will have paid 20% tax. However this tax is only paid on capital gains above the level of retail price inflation each year.

Life assurance company funds will have paid some tax on the investments, which means that basic rate taxpayers will have no further tax to pay.

How is a Unit Trust taxed?

The tax that a unit trust has paid on income is made up as follows :

Unit trusts that pay interest distributions (because they are mostly invested in fixed interest securities or short term deposits) will have deducted 20% tax at source and passed this to the Government on the investor's behalf.

Unit trusts that pay dividend distributions (because they are mostly invested in equities) have paid no tax as their liability to tax will have been satisfied by the tax credit attached to the dividend.

A unit trust pays no tax on capital gains.

A unit trust will have paid some tax on the investments, and it is because of this that basic rate taxpayers will have no further tax to pay on their income.

INDEX

[What is...](#)

[How is a Life Assurance Bond taxed?](#)

[How is a Unit Trust taxed?](#)

[Income and Capital Gains](#)

[So where do you fit in?](#)

[The Non Taxpayer](#)

[Basic Rate Taxpayer](#)

[The Higher Rate Taxpayer](#)

[Effect of the different tax treatment of life assurance bonds and unit trusts](#)

[Other factors affecting the choice between life assurance bonds and unit trusts](#)

[Further information](#)

Income and Capital Gains

Just as you pay tax on what you earn, you also have to pay tax on profits that your investments earn for you. In the UK, the Government raise tax from investments in two main forms, income tax and capital gains tax

Income tax is normally paid at either basic rate or higher rate according to your total yearly income. **All figures below relate to the 2008/9 tax year.**

Everyone has a Personal Allowance of £6,035. Income up to this level is tax free. Those over age 65 may also qualify for a higher age related personal allowance.

The first £34,800 of income each year above your Personal Allowance is generally taxed at 20%, the basic rate. Income beyond this is taxed at 40%.

There is a 10% starting rate for savings income only, above the personal limit, with a limit of £2,320. If your taxable non-savings income is above this limit 20% or 40% tax rates will apply to your savings income.

You may also have to pay tax on any capital gains that your investments make.

The first £9,600 of capital gains are exempt from tax. Gains over this figure are taxed at the rate of 18%.

Whether the returns from your investment are taxed as income or as capital gains depends on the product and the way the Government treats that product. In most cases the split is obvious and commonsense, but at the end of the day it is what the legislation says that counts, even if it's not the obvious split!

So where do you fit in?

Firstly, you need to check whether you are a non-taxpayer, a basic rate taxpayer or a higher rate taxpayer. Then you can move to the appropriate section below.

INDEX

[What is...](#)

[How is a Life Assurance Bond taxed?](#)

[How is a Unit Trust taxed?](#)

[Income and Capital Gains](#)

[So where do you fit in?](#)

[The Non Taxpayer](#)

[Basic Rate Taxpayer](#)

[The Higher Rate Taxpayer](#)

[Effect of the different tax treatment of life assurance bonds and unit trusts](#)

[Other factors affecting the choice between life assurance bonds and unit trusts](#)

[Further information](#)

The Non Taxpayer

Life Assurance Bonds

Non-taxpayers who invest in life assurance bonds are treated the same as basic rate taxpayers (you should therefore read the section on basic rate taxpayers). You are not able to reclaim any tax paid by your life assurance company.

Unit Trusts

Non-taxpayers who invest in unit trusts that pay interest distributions (because they are mostly invested in fixed interest securities or short term deposits), can reclaim the 20% tax deducted from their income up to the level of their personal allowance.

Non-taxpayers who invest in unit trusts that pay dividend distributions (because they are mostly invested in equities) are treated the same as basic rate taxpayers. You cannot reclaim any tax credits attached to the distribution.

Non-taxpayers who invest in unit trusts will have to pay capital gains tax on selling their units, in exactly the same way as a basic or higher rate taxpayer does. The first £9,600 of capital gains are exempt from tax. Gains over this figure are taxed at the rate of 18%.

Basic Rate Taxpayer

Life Assurance Bonds

If you are not a higher rate taxpayer, you generally have no further tax to pay on your UK life assurance bond. Regular and one-off payments you receive from the bond and the capital you receive when you cash-in the bond are yours to keep with no further tax due.

As a basic rate taxpayer, you have no further tax to pay on your UK life assurance bond. Regular and one off payments you receive from the bond and the proceeds you receive when you cash-in the bond are yours to keep with no further tax, provided you remain a basic rate taxpayer.

However, there are occasions when you may have an additional liability to income tax. Firstly, you are allowed to take a payment from the bond of up to 5% of the investment each year, until 100% is reached

INDEX

[What is...](#)

[How is a Life Assurance Bond taxed?](#)

[How is a Unit Trust taxed?](#)

[Income and Capital Gains](#)

[So where do you fit in?](#)

[The Non Taxpayer](#)

[Basic Rate Taxpayer](#)

[The Higher Rate Taxpayer](#)

[Effect of the different tax treatment of life assurance bonds and unit trusts](#)

[Other factors affecting the choice between life assurance bonds and unit trusts](#)

[Further information](#)

(20 years) without an immediate liability to income tax. If this allowance is not used in any one year it can be carried forward.

If you take more than this allowance, then there may be a liability if the gain made when taking this payment when added to your income for the year makes you a higher rate taxpayer. For example, if you invested £100,000 and took no withdrawals, and at the end of year 2 you made a withdrawal of £15,000 then the gain would be the withdrawal amount less the allowance. In this instance it would be £15,000 less £10,000, which is £5,000. This £5,000 is divided by the number of complete years you have held the bond, in this case 2 years. If this £2,500 (i.e. £5,000 divided by 2) added to your income makes you a higher rate taxpayer then you would be liable to income tax at 20%, on the portion of the gain which is over the higher rate threshold.

The second occasion is when you cash-in your bond. The profit on your bond (gain) is calculated and is divided by the number of years you have held the bond. If this amount, when added to your income, makes you a higher rate taxpayer then you will have an additional liability to income tax. You will pay income tax at 20% on the portion of the gain which is over the higher rate threshold.

Unit Trusts

If you are not a higher rate taxpayer you generally have no further tax to pay on the income you receive or is automatically reinvested in your unit trust.

When you sell your units you will be liable for capital gains tax on the increase in value of the units while you held them.

Your first £9,600 of such capital gains each tax year are exempt from tax. On gains above this limit, you will pay capital gains tax at 18%. You are responsible for doing this tax calculation yourself, and you must maintain records of your unit trust purchases to enable you to do this when you sell units.

If you do not use all of your annual capital gains tax exemption, you cannot carry it forward to another year.

If you are paying 10% tax on your savings income (see page 3) you will be able to reclaim some of the tax deducted from the income.

INDEX

[What is...](#)

[How is a Life Assurance Bond taxed?](#)

[How is a Unit Trust taxed?](#)

[Income and Capital Gains](#)

[So where do you fit in?](#)

[The Non Taxpayer](#)

[Basic Rate Taxpayer](#)

[The Higher Rate Taxpayer](#)

[Effect of the different tax treatment of life assurance bonds and unit trusts](#)

[Other factors affecting the choice between life assurance bonds and unit trusts](#)

[Further information](#)

The Higher Rate Taxpayer

Life Assurance Bonds

As a higher rate taxpayer, you may have to pay further tax on your life assurance bond.

You can draw an annual payment from the bond, of up to 5% of the initial investment each year for twenty years, without an immediate tax liability. These payments are treated by the Government as a return of your original investment, which is why there is no further tax to pay at the time you take the regular payments.

When you cash-in the bond, you will have to pay income tax of 20% on the profits you have made from the bond. This 20% represents the difference between the higher rate of tax of 40%, and the basic rate of 20%, which has already been deemed paid by the life assurance company.

If you have exceeded your 5% annual payment allowance you will have to pay income tax at 20% on the payments you have received.

The profits you have made from the bond are generally calculated as the cash-in value plus all other payments you have received from the bond over the sum you have invested.

So, if you bought a life assurance bond for £10,000 and have taken £2,000 from it already (£500 a year for 4 years) and now cash-in it for £16,000 your profit will be £8,000 on which you will pay tax of £1,600 (20% x £8,000).

Your life assurance company will calculate your profit for you, and provide the details on a “chargeable event certificate”, along with instructions on how to enter it in your tax return.

Unit Trusts

As a higher rate taxpayer, you will have to pay further tax on the income you receive or is automatically reinvested in your unit trust.

When you receive interest you will pay a further 20% tax on the gross income or 25% on the income you receive. (So if you receive an interest distribution of £80 from which £20 basic rate tax has already been deducted, you will pay a further £20 as higher rate tax).

When you receive dividends you will pay 25% tax on the dividend received. (So if you receive a dividend distribution of £80 from the unit trust, you will pay a further £20 as higher rate tax). In other words, don't spend your entire distribution cheque as you will have to pay tax.

INDEX

[What is...](#)

[How is a Life Assurance Bond taxed?](#)

[How is a Unit Trust taxed?](#)

[Income and Capital Gains](#)

[So where do you fit in?](#)

[The Non Taxpayer](#)

[Basic Rate Taxpayer](#)

[The Higher Rate Taxpayer](#)

[Effect of the different tax treatment of life assurance bonds and unit trusts](#)

[Other factors affecting the choice between life assurance bonds and unit trusts](#)

[Further information](#)

You may have purchased accumulation units on shares, in which case your unit trust will be automatically re-investing your income back into the fund. However your unit trust will send you a tax certificate on each distribution date telling you how much income has been re-invested, and as a higher rate taxpayer you will need to pay the additional higher rate tax as described above.

Your higher rate tax liability, whether your income is actually distributed or accumulated, is collected by means of your annual self assessment tax return, so you must keep a record of all income and declare this on your annual tax return at the end of each year.

The position regarding capital gains tax for a higher rate taxpayer is the same as for a basic rate taxpayer above. The first £9,600 of capital gains are exempt from tax. Gains over this figure are taxed at the rate of 18%.

Effect of the different tax treatment of life assurance bonds and unit trusts

As you will see from the sections above, the rules that determine the amount of income tax and capital gains tax you will pay are different for life assurance bonds and unit trusts. Even when the fund manager holds the same stocks and shares, you may pay different amounts of tax depending upon whether you choose to invest in a life assurance bond or a unit trust.

The exact difference will depend both upon the type of assets that your fund is invested in, and how it performs, on the level of inflation and on the level of future tax allowances and exemptions. But as a general rule for higher rate taxpayers :

If you are looking to maximise the income you receive, then a bond, due to its tax structure, is more likely to provide this.

If you are looking to maximise capital growth, then a collective, due to its tax structure, is more likely to provide this.

This may apply to basic rate taxpayers, but in a far less marked way. For a non taxpayer, the collective is likely to prove more attractive since any tax paid on income can be reclaimed.

INDEX

[What is...](#)

[How is a Life Assurance Bond taxed?](#)

[How is a Unit Trust taxed?](#)

[Income and Capital Gains](#)

[So where do you fit in?](#)

[The Non Taxpayer](#)

[Basic Rate Taxpayer](#)

[The Higher Rate Taxpayer](#)

[Effect of the different tax treatment of life assurance bonds and unit trusts](#)

[Other factors affecting the choice between life assurance bonds and unit trusts](#)

[Further information](#)

Other factors affecting the choice between life assurance bonds and unit trusts

Tax is not the only factor that you should consider when choosing between life assurance bonds and unit trusts.

Further points you may wish to consider are set out in the table below :

	Life Assurance Bond	Unit Trust
Drawing a regular payment	Can pay a fixed regular payment.	Will generally pay income quarterly or half-yearly, that will go up and down with market conditions. In addition capital payments can be made on a regular basis. But you need to be aware of the capital gains tax implications of this.
Age allowance	Regular withdrawals of up to 5% each year do not affect your entitlement to age allowance. However, cashing-in your bond may affect this allowance.	Any income arising is taken into account in looking at your entitlement to age allowance.
Means tested benefits, such as Pension Credit, Housing Benefit and Council Tax Credit	Regular withdrawals up to 5% each year do not affect your entitlement to most means tested benefits. However, cashing-in your bond may affect your entitlement.	Any income arising is taken into account in looking at your entitlement to means tested benefits.
Nursing home fees	You cannot currently be forced to sell your life assurance bond to pay nursing home fees (unless you purchased it specifically to avoid paying nursing home fees).	Your local authority can insist that you sell your unit trust to pay your nursing home fees.
Inheritance tax planning	Life assurance bonds are popular vehicles within inheritance tax planning arrangements, because the trustees will not normally need to produce annual tax returns.	Unit trusts can be used within inheritance tax planning arrangements, but the duties of the trustees will be more complicated.
Fund switching	You can switch investment funds within a life insurance bond easily. In most cases this will happen without incurring entry or exit charges, and without being treated as having sold the fund.	Switching between unit trusts can incur entry and exit charges and is counted as a disposal for capital gains tax purposes.

	Life Assurance Bond	Unit Trust
Annual tax return	Basic rate taxpayers who need to fill in a tax return and higher rate tax payers only have to fill in information about their bond investment when regular annual payments of more than 5% are taken or in the year the bond is cashed-in.	Anyone receiving a self assessment tax return has to fill in the details of income arising in his/her unit trust each year. Anyone with capital gains of more than the annual exemption of £9,600 or total amounts of more than 4 x the annual exemption will need to fill in the capital gains tax pages of their tax return, and to ask for a tax return form if HM Revenue and Customs do not automatically send you one.
Opportunity to defer tax	Higher rate taxpayers investing in a life assurance bond can take regular payments at a level that would allow them to defer the payment of higher rate tax until they cash-in the bond. If at this point they have become basic rate taxpayers, then they may not have any tax to pay.	Higher rate taxpayers investing in a unit trust cannot defer tax and must pay higher rate tax on income or dividends from the unit trust each year, regardless of whether the income or dividends are taken.
Gift transfer	A higher rate taxpayer can gift a bond to a basic rate taxpayer (such as their spouse or adult child) before encashment. This gift will not trigger an income tax charge. The new owner will be responsible for all gains from the start of the product. The tax liability is dependent on the tax position of the new owner at the time the bond is cashed-in.	Unit trusts can be gifted to someone else but that gift is treated as a disposal and could trigger a capital gains tax charge if the gain is more than the annual exemption of £9,600. The new owner will be responsible for the tax on any gains from that point on. Gifts between spouses / civil partners will not trigger a charge to tax and the new owner will effectively be responsible for the tax on all gains from the beginning.
With-profits investment	Bonds offer the opportunity to invest in with-profits funds. The smoothing and guarantees of a with-profits investment help protect investors against the volatility of the markets.	Unit trusts do not offer the opportunity of investing in with-profit funds.

As the table shows, life assurance bonds have rather more flexibility than unit trusts, but in consequence are a bit more complicated. For this reason, life assurance bonds are usually purchased through a professional financial adviser.

Unit trusts are more straightforward to understand, and can be purchased either through a professional financial adviser or direct from a unit trust company without any financial advice.

Further information

You can of course refer any queries to your professional financial adviser if you have one.

Other useful sources of information are :

The Financial Services Authority

<http://www.moneymadeclear.fsa.gov.uk/>

The Association of Independent Financial Advisers

<http://www.aifa.net/consumer-area/>

The Investment Management Association

<http://www.investmentuk.org/investors/default.asp>

The Personal Finance Education Group

<http://www.pfeg.org/>

Directgov

[http://www.direct.gov.uk/en/MoneyTaxAndBenefits/
ManagingMoney/SavingsAndInvestments/index.htm](http://www.direct.gov.uk/en/MoneyTaxAndBenefits/ManagingMoney/SavingsAndInvestments/index.htm)

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