Technical Insights – Quick Reference Guide: Bonds vs Unit Trusts

An overview

Introduction

This guide aims to provide you with a general comparison between the taxation of unit trusts and bonds when held by a UK resident individual. In the context of this guide; unit trusts also refers to OEICs and bonds refers to both life assurance and redemption bonds.

Further reading

This guide assumes a base understanding of income tax, capital gains tax (CGT) and UK life company taxation. You may wish to refer to our guides in these areas:

Income tax bands and allowances ***quilter.com/incomebands***

Chargeable events ***quilter.com/cehub***

UK life company taxation ***quilter.com/lifefundtax***

Capital gains tax ***quilter.com/cgt***

	Unit Trusts	Bond
Reporting	**Income Tax** – Income generated by the unit trust is taxable. This is regardless of whether an accumulation or income fund is used. – Payment is made gross. No UK tax deducted at source. – Income is reported via self-assessment. **Capital Gains Tax (CGT)** – Capital gains in excess of the annual exempt amount must be reported via self-assessment. – Also, Gains must be reported when the proceeds of sale exceeds £50,000 – even if the gain itself is within the annual exemption.	**Income Tax** – Bonds are subject to the 'chargeable event rules'. On the occurrence of a chargeable event, a chargeable gain is calculated. This gain is taxed as income. – Gains are reported via self-assessment.
Treatment of Capital Growth	**Capital Gains Tax (CGT)** – Growth in the unit trust will become taxable when a disposal occurs. This includes, but not limited to; fund switches, rebalancing, payment of adviser fees, product charges. – The nature of a capital growth funds makes it likely that a gain will arise. Particularly on an actively managed portfolio. – Losses in the same tax year offset any gains. Unused losses can be reported to HMRC and used against gains in future years. – When making a disposal, the tax payer will need to be mindful of how much of their annual exemption to CGT is available as well as their income.	**Bond owner taxation:** – The owner's tax position is unaffected by the nature of the portfolio. – Switches/rebalancing/deduction of product charges do not result in a tax liability to the bond owner. **Inside the onshore bond:** – UK corporation tax is payable on gains made on the funds within the bond. Though the bond owner has no direct liability. – See 'further reading' for details. **Inside the offshore bond:** – No corporation tax (0% rate in Isle of Man / exempt in Ireland) on gains.

For financial advisers only

	Unit Trusts	Bond

Treatment of income from the unit trust.	**Income tax**
	– Income generated by the unit trust can be either;
	  – Accumulated within the fund.
	  – Paid and automatically reinvested as additional units.
	  – Paid directly to the owner.
	– Regardless of how the income is managed it is still taxable at the owner's marginal rate.
	– Unit trusts with an equity content of 40% or more will pay a dividend. Any less than this, the fund pays interest.
		Bond owner taxation:
		– The owner's tax position is unaffected by the nature of the portfolio.
		– Income generated by the portfolio does not cause the bond owner a tax liability.
		Inside the onshore bond:
		– Dividend income is not subject to corporation tax.
		– All other income is subject to corporation tax at 20%.
		– See general tax summary for details.
		Inside the offshore bond:
		– No corporation tax (0% rate in Isle of Man / exempt in Ireland) on income received within the bond. Some non-reclaimable withholding tax might apply.

Taking an income/ withdrawals	**Natural income** – 'Income' funds can be used to generate an income in the form of interest or dividends. – Payment of income in this way does not cause a CGT liability. – Amounts of income cannot be guaranteed but can be estimated based on past performance. **Capital disposals** – Alternatively, capital disposals can be made if a fixed amount of money is required. – Any gain arising from a disposal may be subject to CGT.	**5% tax deferred withdrawals (partial surrender)** – Bond holder can take up to 5% of the premiums paid to the bond, each policy year-tax deferred. – There will be no tax immediate tax charge on the surrender. – A chargeable event is triggered for exceeding the allowance. **Policy (segment) surrenders** – Individual polices within a bond can be fully surrendered to provide a lump sum payment. – A chargeable event is triggered on the surrender. The gain is calculated based on the economic growth in the policy. – See 'further reading' for details. **Onshore bond** – Any gains triggered will be treated as having already paid basic rate of tax (20%). – This tax credit is used against the bond owner's tax liability. – This means basic and non-tax payers may have no further liability **Offshore bond** – No UK corporation tax paid, therefore no tax credit to use on the gain. – Gain is treated as savings income and so the personal allowance, personal savings allowance and 0% starting rate band can be used. **Generally** – Top slicing relief can be used to reduce the liability to higher and additional rates of tax. – The relief if calculated by averaging the gain out over a number of years. – See 'further reading' for details.

Gifting the asset	– Transferring ownership of the unit trust will be a disposal for CGT – the same as surrendering the asset.
	– The new owner is treated as acquiring the asset at the market price on the day of the transfer.
	– Transfers to and from a relevant property trust (such as a discretionary trust) can make use of 'holdover' relief. Where the existing base cost is passed onward to the new owner. Deferring the gain until later.
	– The only exemption is a gift between spouses/civil partners.
	  – The transfer is made on a 'no loss, no gain' basis.
	  – The spouse/civil partner acquire the existing base cost for the unit trust.
		Onshore and Offshore
		– The bond or individual policies can be assigned.
		– Assignment, as a gift, is not a chargeable event and will not trigger an income tax charge.
		– The bond is not rebased. The new owner will use the full 'history' of the bond (premiums, withdrawals etc.) to calculate any future gains.
		– As a result, top slicing relief can be used by the new owner.

	Unit Trusts	Bond

Death of the owner	– Any capital gain built up is wiped out on death – with no charge to CGT.
	– The cost price of the unit trust is rebased to the market value on the date of death.
	– Executors take control of the unit trusts
	    – Executors have a single exempt amount for the administration period . The amount of the exemption depends on the tax year in which the individual died.
	    – Gains in excess of their exemption are taxed at 24%.
	    – If the asset is transferred to a beneficiary, no disposal takes place. They are deemed to have received it at the market cost of death - deferring the gain until later.
		– The death of the owner does not always trigger a chargeable event.
		– A chargeable event will arise when the last life assured dies.
		1. Owner was the last life assured:
		– Bond matures, triggering a chargeable event. Same gain calculation as a full surrender.
		– The deceased is taxable. The executors of the estate report the gain in the deceased's final income tax return for the year of death.
		– The proceeds of the bond are delivered to the estate.
		2. Where there are lives assured which survive the owner:
		– The bond remains open. No chargeable even arises.
		– The executors take control of the bond.
		– The bond can be assigned to beneficiaries of the estate to encash at their marginal rate. As with gifting, the beneficiary can utilise top slicing relief.
		– Alternatively, the executors can surrender the bond themselves.
		    – Executors pay a flat rate of 20% on any gain.
		    – On distribution, the beneficiaries must report the gain again as 'estate income' and pay their marginal rate of tax. Though they get a tax credit for tax paid by the executors.
		    – No top slicing applies for the executors or beneficiary when surrendered in this way.
		3. Redemption bonds.
		– No life assured.
		– Matures at the end of a fixed 99 year term.
		– Taxation and surrender options on death of the owner, the same as '2' above.

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