Technical Insights - Quick Reference Guide 8

Taxation of Investment Bonds: Deficiency relief

This guide will provide you with an understanding of how deficiency relief can be used to claim an income tax reduction when a final event generates a loss.

Bonds can generate losses on final events.

When calculating the gain on a final event (this includes full surrender, individual policy surrender and maturity) the calculation may give you a loss. The loss cannot be offset against any other gains. However, it might be possible to claim an Income Tax reduction known as deficiency relief.

Deficiency relief is available for individuals who are UK resident (under the UK statutory residency test).

It cannot be used by trustees, companies, executors or legal personal representatives.

Deficiency relief is available where;

- The chargeable event gain calculation for a final event shows a loss (i.e. the outcome is negative).

AND

- There have been previous excess gains (gains triggered by going over the 5% tax deferred allowance) on the bond/ policies which were subject to UK income tax*.

* *Subject to UK income tax usually means that the policy holder was UK resident at the time of the excess gain. It does not require any tax to have been paid. E.g. The excess gain was within the policy holder's personal allowance and no tax charge applied.*

Amount entitled to deficiency relief is the lower of;

- the final event loss or
- the cumulative total excess gains.

This is the 'deficiency entitlement'

The deficiency relief is given by reducing the rate of income tax

The reduced rate is applied to the first income to enter the higher rate band, up to the total value of the deficiency entitlement. The rate reduces from the higher 40% (33.75% dividends) to 20% (8.75% dividends). Deficiency relief cannot be applied to income which falls into the additional rate tax band.

The deficiency relief available may be limited.

The bond holder can only claim the relief if they will pay higher rate tax in the tax year of the final chargeable event. This means that the amount of relief may be restricted or unavailable if the individual does not have a sufficient tax liability.

Example:

If the deficiency entitlement is calculated as £5,000 but the individual has an income which exceeds the basic rate band by only £3,000. Then the deficiency entitlement is restricted to £3,000.

The relief is claimed through self-assessment.

Life assurance providers will only issue a chargeable event certificate where the gain is £1 and above. Therefore, policyholders will need to calculate the loss on their policy themselves. Details on calculating the gain for full surrender or policy surrender can be found in guides 2 & 3 in this series.

For financial advisers only

Example

A bond is surrendered, and the gain is calculated as follows:

A = Surrender value: £85,000

B = Previous partial withdrawals: £20,000

C = Previous excess gains: £10,000

D = Premiums paid: £100,000

(A + B) – (C + D) = -£5,000 loss

Calculate the entitlement to deficiency relief

The deficiency entitlement in this example is the lower of £5,000 loss on surrender and £10,000 previous excess.

The policy holder has income totalling £60,000 (drawn from a UK Pension) in the 2023/24 tax year, which exceeds the basic rate band by £9,730. This means the individual has enough income in the higher rate band to use the full deficiency entitlement of £5,000.

Calculate the deficiency relief

Tax before the relief:

Band	Amount In Band	Tax Rate	Tax
Personal Allowance	£12,570	0%	£0
Basic rate	£37,700	20%	£7,540
Higher rate	£9,730	40%	£3,892
			Total £11,432

Tax after applying the reduced rate:

Band	Amount In Band	Tax Rate	Tax
Personal Allowance	£12,570	0%	£0
Basic rate	£37,700	20%	£7,540
Higher rate (reduced by deficiency relief)	£5,000	20%	£1,000
Higher rate	£4,730	40%	£1,892
			Total £10,432

The impact of deficiency relief in this example is a £1,000 Income Tax saving.

The information provided in this article is not intended to offer advice.

It is based on Quilter's interpretation of the relevant law and is correct at March 2024. While we believe this interpretation to be correct, we cannot guarantee it. Quilter cannot accept any responsibility for any action taken or refrained from being taken as a result of the information contained in this article.

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QIP 21041/107/6317/April 2024