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/49b26d/siteassets/documents/platform/technical-articles/21492_uk_tax rates_allowances_individuals.pdf*

Chargeable events *quilter.com/cehub*

UK life company taxation *quilter.com/siteassets/documents/platform/support/7910-taxation-for-quilter-life-funds.pdf*

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.

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<tr><th></th><th>Unit Trusts</th><th>Bond</th></tr>
<tr><td>Death of the owner</td><td>

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.

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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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It is based on Quilter's interpretation of the relevant law and is correct at the time of writing. 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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