

Proposed CGT Changes - Good or Bad news for Insurance Bond Holders? By Mike Joslin of the IFAC.

The recent Pre Budget Report proposed changes to the Capital Gains Tax regime (CGT). From 6th April 2008, the rate of tax on capital gains for individuals, trustees and personal representatives will be 18%, with taper relief and indexation relief withdrawn.

Great that the system is being simplified but it makes the choice between having Bond investments (profits and withdrawals taxed as income) or mutual funds (dividends taxed as income and profits taxed as a capital gain) more complex.

However, the good news for bond investors who are basic rate taxpayers now or when profits are realised is that the tax comparison is fairly neutral.

When a **basic rate** taxpayer surrenders the bond, he or she is not normally liable for additional tax on any gains achieved. Without boring you with all the details, the effective rate of tax is likely to be broadly similar to the proposed flat 18% CGT payable on realised gains from a mutual fund.

When a **higher rate** taxpayer surrenders the bond, he or she is liable for an additional 20% tax on any gains achieved. Overall, the effective rate of tax on investment bonds for higher rate taxpayers is typically in the region of 34%. On the face of it, this doesn't compare well with the proposed 18% flat rate of CGT that would be payable on realised gains from an investment in a mutual fund.

The current rate of tax on gains within a mutual fund for a higher rate tax payer varies between 40% and 24%, depending on how long the investor has held the investment. This is the impact of taper relief.

Should these changes to CGT take effect, in practice for a basic-rate taxpayer little changes and insurance bonds will remain an option to consider. Even for higher-rate taxpayers there are circumstances where an insurance bond route could still be an appropriate investment choice.

For example, whilst it is not possible to cover all the points, the 5% annual withdrawal allowance can be taken without any immediate tax liability, this is the equivalent to 8.33% gross interest to a higher rate taxpayer.

Higher rate taxpayers can defer surrender of a bond until they're basic rate taxpayers (top slicing relief is then available).

Bonds are non-income producing assets. This offers an advantage over mutual funds where income arising from the underlying investments is taxable as actual income in the hands of the investor regardless of whether it's actually taken or left to accumulate.

Bonds currently can be an effective means of sheltering assets from assessment for residential care charges (CRAG), subject to the rules on deliberate deprivation.

To summarise, the changes as proposed are not detrimental for basic rate taxpayers but it would make sense for higher rate taxpayers to seek in depth advice from a qualified adviser before making any investment decisions on new or old money.