Financial protection

R05: 2019–20 edition

Web update 1: 8 January 2020

Please note the following update to your copy of the **R05** study text:

Chapter 5, section C3, pages 5/11–5/13

Please replace the text in this section with the following:

If a gain has arisen on a UK policy, the legal owner will be liable only to the relevant higher (and additional if appropriate) rate of income tax minus, effectively, the basic rate. This means that where the chargeable individual is a non-taxpayer or a basic-rate taxpayer, there will be no further tax to pay – provided the gain itself does not push them into the higher- or additional-rate bracket. A higher-rate taxpayer will pay income tax of 20% (40% – 20%) and an additional-rate taxpayer will pay 25% (45% – 20%). Because gains are classed as savings income, the personal savings allowance and the starting rate of 0% may be available when calculating the tax on a gain.

If the policyholder has been resident outside the UK during part of the time that they were the beneficial owner of the policy, the amount of the gain is reduced by something called 'time apportionment'. This effectively means that UK taxpayers are only charged on the proportion of the gain that arose during years they were UK resident.

Where the gain would move the policyholder from basic to higher rate or from higher to additional rate it may be possible to reduce the amount of tax using 'top slicing relief'. This is now more complex in its operation than was the case in the past, but the essential point is that top slicing relief can reduce the tax by applying a spreading mechanism.

Tax is calculated as follows (the five steps are identical for UK and offshore policy gains). Although this looks very daunting, the example that follows will try to bring it to life a little:

Step 1:	Calculate the taxable income for the year and identify how much of the gain falls within: • the starting rate for savings income; • the personal savings allowance; and • the basic, higher or additional rate bands, as appropriate. Any gift aid donations are ignored.
Step 2:	Calculate the tax due on the gain across all tax bands. Deduct 20% basic rate tax (treated as paid for both UK and offshore policies) to find the individual's liability for the tax year.
Step 3:	Calculate the annual equivalent of the gain. The annual equivalent is calculated by dividing the gain by *N* (see below). For **full surrender**, *N* is the number of full policy years between the date the policy was taken out and the date of the chargeable event. The general rule for UK policies is that if the gain arises from a **part surrender**, *N* is the number of full years back to the last chargeable event. So, where no chargeable events have occurred, *N* is the number of full years back to the start of the policy. For offshore policies, *N* depends on the policy date: • For pre-6 April 2013 policies, *N* is measured from the start of the policy. • For policies made on or after 6 April 2013 (or earlier policies that have been varied after that date): – For those individuals who have been UK resident throughout the policy period, *N* is based on the number of years back to the last chargeable event. – For those individuals who have not been UK resident throughout the policy period, *N* is measured from the start of the policy (although it will be reduced to reflect the period of overseas residence).
Step 4:	Calculate the individual's liability to tax on the annual equivalent. Deduct 20% basic rate tax (treated as paid for both UK and offshore policies) on the annual equivalent and multiply the result by *N*. This gives the individual's relieved liability.
Step 5:	Deduct the individual's relieved liability at step 4 from the individual's liability at step 2 to give the amount of top-slicing relief due.

The calculation is shown in Example 5.5

Example 5.5

Julia took out a single premium UK bond of £60,000 on 1 January 2014. It was cashed in on 1 July 2019 for £80,000, so the gain is £20,000.

Julia's other taxable income (after deducting the personal allowance) for the tax year 2019/20 is £35,000.

Step 1	Julia's taxable income is £55,000 (£35,000 + £20,000), so she is a higher-rate taxpayer. The tax due on this income is: **£** £35,000 at 20% — 7,000 £500 (personal savings allowance) at 0% — 0 £2,000 (£37,500 – £35,000 – £500) at 20% — 400 £17,500 (£20,000 – £500 – £2,000) at 40% — 7,000 Total income tax — **14,400** Of the £20,000 gain: • £500 of the gain is within the personal savings allowance; • £2,000 is within the 20% basic rate band; and • the remaining £17,500 is in the 40% higher rate band.
Step 2	The tax due on the gain is £7,400. (£400 + £7,000). Basic rate tax treated as paid is £4,000 (£20,000 × 20%). Julia's additional liability on the gain for the tax year is therefore £3,400 (£7,400 – £4,000).
Step 3	*N* is five (the number of full years the policy was in force), so the annual equivalent of the gain is £4,000 (£20,000 ÷ 5).
Step 4	Tax on the annual equivalent of the gain is: £1,000 ((£500 × 0%) + (£2,000 × 20%) + £1,500 × 40%)). The basic rate tax treated as paid on the gain is £800 (£4,000 × 20%). Julia's relieved liability on the gain is therefore £1,000 ((£1,000 – £800) × 5 years).
Step 5	The amount of top-slicing relief is £2,400 (£3,400 – £1,000). Julia's overall liability after top-slicing relief is £12,000 (£14,000 - £2,400). The overall liability after deducting the basic rate credit of: £4,000 (£20,000 × 20%) is £8,000 (12,000 – £4,000). The method of calculation gives the benefit of multiple personal savings allowances, meaning just £1,000 (£8,000 – £7,000 (£35,000 × 20%)) of tax is paid in respect of the gain.

If Julia's bond had instead been taken out, for example, three years earlier on 1 January 2011, but a chargeable event had occurred on 1 January 2014, then (assuming the same gain) the calculation would have been exactly the same as above because *N* would have still been five (the number of full years back to the last chargeable event).

If Julia's bond had instead been offshore, the above five steps would have been identical. However, there would have been no reduction to her liability because basic rate credit is not normally due for an offshore bond. Julia's overall tax liability (after top-slicing relief) would have therefore been £12,000.

Where two or more gains are made in the same tax year, the gains are added together. The annual equivalent is then calculated separately for each gain, and these annual equivalents are added together.

Note that the taxation of chargeable gains is complex and this is only an overview. Clients should be advised to seek specialist tax advice if they are in any doubt as to the effect of a gain on their own circumstances.

Chapter 5, section D, example 5.10, page 5/15

Please replace the text in this example with the following:

Example 5.10

Reeta receives a chargeable gain of £27,000 from an offshore policy, which had been running for nine years. She has other income which falls £2,000 below the higher-rate tax threshold. She can benefit from top slicing to reduce a potential liability to 40% tax on the gain. The calculation of this relief is as set out in section C3.