Insurance Bonds (on-shore)

The vast majority of insurance companies and some other managers offer an insurance bond as part of their product portfolio. Technically they are a single premium non-qualifying unit linked whole of life insurance policy.

Types

Currently (2007) there are four main categories of bond available. These are:-

- **Unit Linked**
- **Distribution**
- **With Profit**
- **Specialist**

Unit Linked

These are policies able to invest in a range of the unitised funds offered by the managers. The funds vary in risk profile and broadly follow the Micropal Insurance fund classifications. They include three way managed funds in cautious, balanced and actively managed varieties right through to specialist sector funds and cash and fixed interest funds.

Distribution Funds

Basically these are usually just another variation on the unit-linked theme. However, there are some specialist Distribution Funds that adopt a specific structure to increase the efficiency of income withdrawal from the bond. Distribution funds vary widely in their asset mix and risk profile and investors need to be very careful when selecting funds since they may be buying something different to that which they expected.

With Profit Bonds

These have been a particular favorite in recent years because of the reduced risk it is assumed that they offer. In reality this may not be the case and investors should be aware that the with-profit concept is as vulnerable to market forces or management errors as other investments. However, the smoothing affect offered by the with-profit concept is very attractive to many cautious investors and the bonds have their market.

Specialist

This type may be marketed with the description ‘High Income’ or Capital Guaranteed’. Generically they have become known as ‘precipice bonds’. They use the insurance bond fund structure to simplify the taxation or the way the income is generated. They are most often sold by banks. To achieve the ‘high income’ and or the ‘capital guarantees’ they use financial engineering techniques. We have never been keen on this type of product, believing that they are designed to be sold rather than bought, and that they look to good to be true. This attitude has been vindicated in recent times by the failure of many of these products and one

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or more of the companies that manufactured them. Steer well clear is our general advice, unless you are absolutely sure as to exactly what you are buying.

Taxation

All insurance bonds invest in Life Funds. In the UK life funds pay income tax and capital gains tax within the fund. Notionally these are at the basic rate of 20%. However life companies work very hard to manage these tax charges. They are also allowed to offset expenses of running the fund against the income so reducing the tax. It is difficult to be precise but we would hope that life companies would pay slightly less than the 20%.

Taxation in the hands of the bondholder is helpfully structured to assume that basic rate tax has been paid by the fund. Therefore for basic rate taxpayers (assuming that top slicing does not apply), there would be no further tax to pay for any withdrawals. By concession, all taxpayers are allowed to withdraw up to 5% per annum of the original investment amount without any tax to pay. In other words the Inland Revenue assumes that the investor can have his or her capital returned over a period of 20 years. This can also be a useful tax planning tool for higher rate taxpayers.

We have mentioned top slicing above. This note is not the place to discuss this, the topic will be covered in a separate WFW Briefing Note, but we will always check for any liability for income withdrawing clients.

A further bonus is that as the income taken is considered to be a partial surrender, or return of capital, it will not affect any income tax age allowance available to bond holders.

Other Considerations

There are no limits to the amount that any investor can place within an insurance bond. The practical maximums are set by the providers. Insurance bonds are also available as an offshore product. Whilst these offer additional tax efficiency they are also more expensive.

Insurance bonds, being a life assurance policy are assignable and are consequentially useful in inheritance tax planning situations.

Furthermore, being an insurance policy, they and the assets within them are frequently not taken into account when the bondholder is applying for State Benefits.

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