Comparison of onshore and offshore bonds

Investment bonds remain a popular investment tool, as they may enable investors to defer tax, a particularly useful option for higher rate taxpayers.

Investment bonds allow clients to make regular withdrawals of up to 5% of the amount invested each policy year without triggering any immediate tax liability. Any unused allowance can be carried forward. However, the tax charge is only deferred as, when the bond is encashed, withdrawals will be taken into account in the chargeable surrender calculation and taxed as income in that tax year.

There are key differences between onshore and offshore bonds, meaning they are more appropriate for different types of investor.

Comparison between onshore and offshore bonds

Taxation of the fund

Onshore bond

Corporation tax on the underlying funds is paid by the insurance company. This tax is deducted from the investment. The investor receives a tax credit for the tax deemed to have been suffered. This is deemed equivalent to basic rate tax (even though the actual tax suffered on the fund may be lower).

Offshore bond

Generally, no tax is paid on underlying funds (however there can be some tax on interest and dividend payments called Withholding Tax).

Tax on surrender or part surrender

Onshore bond

Basic rate tax will deemed to have been paid (even if the effective tax rate on the underlying fund is below 20%). If the client is a higher or additional rate taxpayer, they will have additional tax of 20% or 25% to pay on any chargeable gain. If the client is a non-taxpayer they cannot reclaim the tax deemed to have been suffered.

Offshore bond

Tax is paid on chargeable gains at the client's marginal income tax rate. However, clients can use any available personal savings allowance (PSA), meaning basic rate taxpayers can receive savings of up to £1,000 and higher rate taxpayers up to £500 in a tax year before paying any income tax. Investment bond gains are classed as 'savings' for the purposes of the PSA.

Top slicing

Onshore bond

Top slicing can reduce higher rate tax (or additional rate tax) on a chargeable event gain, and can be used for those who find their chargeable gain pushes them into a higher tax bracket. For chargeable excesses arising from part surrenders or part assignments, the 'top-slice' is worked out using the number of complete years since the policy started. However, if the chargeable event is a second or subsequent part surrender, the gain is top-sliced by dividing it only by the number of full years since the previous chargeable event.

Offshore bond

For chargeable excesses arising from part surrenders or part assignments, the 'top-slice' is always worked out using the number of complete years since the policy started – irrespective of whether there were any previous chargeable events.

Policyholder protection

Onshore bond

Policyholders are covered by the UK Financial Services Compensation Scheme (FSCS) of up to 90% of the value of the claim (with no upper limit).

Offshore bond

The protection offered will depend on the jurisdiction in which the life company is resident.

The Isle of Man operates a policyholder protection scheme. This means that, in the event of a Life Insurance company being unable to meet its liabilities, and subject to the Regulations, the scheme manager shall pay to the policyholder out of the Policyholders' Compensation Fund a sum equal to 90% of the amount of any liability of the insurer under the contract. This applies to all policyholders regardless of where they reside.

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Who might they be suitable for?

Because of their different taxation for policyholders, onshore and offshore bonds are potentially suitable for different types of investors.

Onshore bonds

- These are suitable for investors who want to invest in the UK through a UK provider.
- Investors who are likely to remain in the UK, and aren't planning on living or retiring abroad.
- They are suitable for those who are going to be basic rate taxpayers at the point of encashment.

Offshore bonds

- These are more suitable for those who want to benefit from no UK tax on the underlying fund. For example, those who live abroad now, or plan on living or retiring abroad later.
- They are suitable for those who will be non-UK taxpayers on chargeable gains.
- They may potentially suit those who are interested in wider asset classes for investment.

If you only read one thing read this

- Investment bonds allow clients to make regular withdrawals each year of up to 5% of the amount invested without triggering any immediate tax liability. When the bond is cashed in, withdrawals will be added to any profit made and taxed as income in that tax year.
- For onshore bonds – corporation tax is deducted from the underlying investments. The investor then receives a tax credit for the tax deemed to have been suffered. On surrender, there is no further tax for a basic rate or nil rate taxpayer to pay on any chargeable gain. But higher or additional rate taxpayers will have to pay further income tax.
- For offshore bonds – there is no taxation on the underlying investments except for any irrecoverable withholding tax, and so the underlying investments can benefit from 'the gross roll-up' effect. On surrender, tax has to be paid on gains at the client's marginal tax rate.
- Onshore bonds are probably more suitable for UK residents who are basic rate taxpayers. Offshore bonds are probably more suitable for investors who are not going to be UK taxpayers, and instead are planning on living or retiring abroad. They may also be interested in wider asset classes for investment.