

# TECHNICAL SALES BRIEFING

## TAX PLANNING USING BONDS 'ONE-OFF WITHDRAWALS'

- › This technical briefing is part of a series intended to shine a light on various areas of overseas single premium bond taxation from the point of view of a UK investor
- › It considers the effect of taxation on large 'one-off withdrawals' and whether partial withdrawals across all segments or full surrender of individual segments is more beneficial.

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### PARTIAL WITHDRAWALS ACROSS ALL SEGMENTS OR FULL SEGMENT SURRENDER?

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When an individual decides to make a large 'one-off' withdrawal from a bond, it is normally advisable for the amount to be raised by fully surrendering individual policies (or segments) of the bond, rather than by a part surrender across all of the segments of the bond.

This is because when a part surrender in excess of the 5% p.a. tax-deferred allowances takes place, the whole of the excess is treated as chargeable gain. As a result, the chargeable gain may well be far higher than the real profit in the bond. This has been illustrated recently in the case of Mr Lobler and this case, and the development of HMRC's corrective legislation, is explored in more detail in the technical briefing 'The Danger of Using Partial Surrenders' (UL PR 0030).

Thus, if a bond is effected with a number of segments, then raising funds by way of the full surrender of a number of these segments (as opposed to a part surrender from all of the segments of the bond) will normally give rise to a smaller chargeable gain, resulting in a smaller charge to higher rate tax.

## AN EXAMPLE TO HELP

Andrew purchased a bond for £50,000 issued by way of 100 identical policy segments (£500 premium into each). At the end of the third year, he needs to raise funds of £23,200. The bond is now worth £58,000 and he has made no previous withdrawals.

### PARTIAL SURRENDER (WITHDRAWAL)

|   | £              |
|---|----------------|
| Amount required                                   | 23,200         |
| Less cumulative allowance (5% x £50,000 x 3)      | <u>(7,500)</u> |
| Chargeable gain                                   | 15,700         |
| Top-slicing divisor = 3 (policy in force 3 years) |                |
| Top-sliced gain                                   | <u>5,233</u>   |

### FULL SURRENDER OF SEGMENTS

Now compare this with the situation that would arise if the withdrawal was made by surrender of segments instead. The amount would require a full surrender of 40 segments (£23,200/580 = 40). Where £580 is the equivalent value of each policy at the date of surrender, ie £58,000/100.

|   | £               |
|---|-----------------|
| Amount required   | 23,200          |
| Less original investment pro-rated to 40 policies (£500 x 40) | <u>(20,000)</u> |
| Chargeable gain   | 3,200           |
| Top-slicing divisor = 3                                       |                 |
| Top-sliced gain   | <u>1,067</u>    |

It is worth mentioning that, if Andrew wishes to raise further funds in later years, the full surrender of segments will normally produce a smaller gain. The top-sliced divisor will be the number of years from commencement, and therefore the top-sliced gain should be lower for calculating whether top-slicing relief is available.

However, it should also be noted that where whole segments are encashed, the amount of 5% allowance available in the future will be reduced proportionally depending on the number of segments encashed. In the example above, the 5% allowance was initially £2,500, but were the 40 segments to be surrendered, leaving only 60 remaining, the allowance would be reduced for future years to £1,500.

### FINAL ENCASHMENT OF THE REMAINING SEGMENTS

A final encashment of all remaining segments will normally mean that the top-sliced gain is larger where the required amounts are withdrawn earlier by segment surrender, rather

than partial surrender. Where segments are surrendered following a previous partial surrender across all the policies, a final encashment of the remaining segments will be reduced by any chargeable gains (excess events) where tax has already been paid. This can then help reduce the actual gain on surrender. This is known as deficiency relief, although this reduction cannot result in a loss. However, segment surrender would invariably be the preferred method\* for the following reasons:

- › Bondholders would usually like to pay less tax at the time of any gain, i.e. here utilise the surrender of policies
- › Most bondholders would prefer the higher gain to emerge later rather than sooner (e.g. final encashment could occur after retirement when the marginal rate of tax may be lower).
- › On death, any income tax liability can be deducted from the value of the estate for inheritance tax purposes.

\* The adviser should check whether surrender penalties apply which could change the analysis irrespective of the tax calculations.

## CONCLUSION

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So what can we draw from the above? Well, ultimately, until both options have been fully assessed the correct decision will not be known, and, for advisers, a clear understanding of both calculations is vital. Although rectification may be available where the extraction of funds has led to a 'disproportionate' tax charge, taking the payment in the wrong way can have both immediate and longer term ramifications.

Although the example above shows a clear difference between the two methods, it should be noted that small variations (a slightly larger top-slicing divisor combined with a slightly higher amount withdrawn) can considerably narrow the gap.

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