TECHNICAL SALES BRIEFING

CORPORATE INVESTMENT INTO OFFSHORE BONDS

The following information is based on our interpretation of current law and taxation practice in the Isle of Man and the UK as at 12 January 2021. This could change in the future.

- This briefing has been designed to provide clarity on how insurance bonds held by companies are taxed.
- This briefing is only related to investments made by companies. The information does not apply to company pension schemes or corporate trusteeships.
- The briefing also assesses the reasons for corporate investment and the subsequent tax consequences that may arise on withdrawing monies from the bond.

The technical team is regularly asked whether corporate investments into overseas bonds are still appropriate and, if they are, how the investments are treated for tax purposes. This briefing has been produced to answer these questions.

A BRIEF HISTORY OF THE CHANGES TO CORPORATE TAXATION AND INSURANCE POLICIES

Prior to 2005, all bonds held by companies were taxed under the chargeable event regime, which allows for tax deferral of gains until the time a chargeable event occurs. Chargeable events include, but are not limited to, surrender of the bond or individual polices, maturity and death of the last surviving life assured. The chargeable event regime also allows for 5% of the capital invested into each policy to be withdrawn annually without an immediate charge to tax.

From 10 February 2005 all capital redemption policies began to be taxed under the Loan Relationship rules with transitional rules for cases that were issued prior to this date. Then, from 1 April 2008, investment life assurance contracts followed suit, with any bonds issued from this date also falling into the Loan Relationship rules, again transitional rules were introduced for life assurance cases that had already issued prior to this date. Investment life insurance contracts were defined as:

1. A life assurance policy which has, or is capable of acquiring, a surrender value;
2. A purchase life annuity;
3. A capital redemption policy (although these had already been caught in 2005).

The chargeable event regime remains in place for individuals, and for policies settled into trust. These changes meant company investments into insurance policies could no longer benefit from the chargeable event regime from April 2008. Instead they are taxed under the Loan Relationship regime.

After the announcement that life assurance contracts would be taxed under the Loan Relationship rules, the immediate response from the insurance industry was to presume that corporate business would no longer be placed into insurance bonds. However, it was pointed out at the time that under the Loan Relationship rules, companies using the historic cost basis of accounting could still defer the tax payable on the bond proceeds. This potentially allowed such companies to still benefit from some of the tax advantages offered by the former chargeable event regime.

However, changes in financial reporting standards introduced from 1 January 2016 amend the position yet again. These new standards further restrict the number of companies that will be able to use historic cost in the future and thus benefit from tax deferral.

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THE LOAN RELATIONSHIP RULES IN GENERAL

The Loan Relationship rules state that any profits, or losses, associated with the bond are treated as non-trading credits or debits of the company. Other examples of loan relationships for companies include bank and building society loans, overdrafts in the company bank account, bank and building society deposits and mortgages. These debits and credits are then brought into account dependent on how the company prepares its accounts, i.e. the accounting practice of that company.

THE DIFFERENT METHODS OF ACCOUNTING EXPLAINED

Where the Loan Relationship rules are applied to an insurance contract, there are two methods of accounting:

I) FAIR VALUE ACCOUNTING OR CURRENT COST ACCOUNTING

The fair value recognises the change in surrender value year on year and the company will be taxed on annual basis for any growth in the value of the bond. This simple method is likely to be used by larger companies, as their reporting standards are more stringent and they have the resources to revalue assets on an annual basis. Under this accounting methodology tax deferral is not possible and thus the insurance bond wrapper does not provide any additional tax advantages.

II) AMORTISED COST ACCOUNTING OR HISTORIC COST ACCOUNTING

Under this accounting basis any profits, or losses, on the contract will only be crystallised when the bond, or an individual policy, is surrendered, or where a part-surrender takes place across all the policies under the bond. Using this accounting methodology there is therefore the potential that the company could still benefit from tax deferral. The company can choose when a gain will occur, perhaps shifting any gains to a year where the profits are lower. Prior to the introduction of FRS 102 any company reporting under the Financial Reporting Standard for Small Entities (FRSSE) could adopt the historic cost basis.

THE POSITION FROM 1 JAN 2016

The rules were subsequently amended again with the withdrawal of FRSSE from 1 January 2016 and its replacement with either:

- FRS 102 (The Financial Reporting Standard applicable in the UK and Republic of Ireland) or;
- FRS 105 (The Financial Reporting Standard applicable to the Micro-Entities Regime - FRSME).

Whether a company is assessed under FRS 102 or under FRSME will depend on its size. Companies that are defined as Micro Entities must use historic cost under FRS 105. For a company to be a Micro-Entity (and thus able to use historic cost basis) they must meet at least two of the following three criteria:

1- Turnover - Not more than £632,000

2- Balance Sheet – Not more than £316,000

3- Average number of employees – Not more than 10

All other companies will have to adopt FRS 102 and thus most companies holding a bond will now need to account under FRS 102. However, it may still be possible for a bond to qualify as a “basic” financial instrument if it meets certain conditions. This would still allow for tax deferral to continue as a basic financial instrument is still recorded on historic cost - thus there is no required annual revaluation and reporting under value.

BASIC FINANCIAL INSTRUMENTS

Section 11 of FRS 102 deals with basic financial instruments which include bank loans, trade debtors and creditors, cash at bank, bank loans and other instruments (including corporate bonds and similar debt instruments). The only condition that could perhaps apply to an insurance bond would be to account for them as ‘debt instruments’. The standard also explains that debt instruments are only regarded as ‘basic’ if they comply with the specific conditions given in section 11.9.

FRS 102 then explains the conditions that would all need to apply in order for a debt instrument to qualify as a ‘basic financial instrument’ which are broadly as follows:

CONDITION (A) RETURNS TO THE HOLDER

The holder’s return must be:

- A fixed amount; OR
- A positive fixed rate or variable rate of return over the life of the instrument; OR
- Some combination of fixed and variable rates (as above), provided they provide for a positive rate of return

CONDITION (B) – ABSENCE OF POTENTIALLY DETRIMENTAL CONTRACTUAL PROVISIONS

There must be no contractual provisions that could, by their terms, result in the holder losing their principal amount or any interest attributable to the current or a previous period.

CONDITION (C) – CONTRACTUAL PROVISIONS

Where a contract allows the issuer (the borrower) to prepay a debt instrument or permits the holder (the lender) to put it back to the issuer before maturity, then these conditions should not be contingent on future events (other than to protect the holder against future tax changes or a downgrade in the issuer's credit).

CONDITION (D) – EXTENSION OF DEBT INSTRUMENT

Contractual provisions may permit the extension of the term of the debt instrument, however, any return to the lender, and any other contractual provisions which apply during the extended term, must satisfy the conditions A to C as detailed.

Where a debt instrument does not satisfy **all** the above conditions for a basic financial instrument, then the company must be dealt with as a complex financial instrument under FRS 102. In which case the company would account for the asset using fair value principles, i.e with any revaluation being taxed under the loan relationship regime.

COULD A LIFE ASSURANCE OR CAPITAL REDEMPTION BOND BE CLASSIFIED AS A 'BASIC FINANCIAL INSTRUMENT?

All the four tests set out above would need to be satisfied for this to apply. When reviewing these conditions the overriding principle is that a basic financial instrument is one where the capital is not at risk. However, life assurance and capital redemption bonds have different underlying investment characteristics and thus each bond would perhaps need to be judged based on its own facts.

It is the view of technical services that the majority would probably fail to qualify as a basic financial instrument, especially if they are linked to funds whereby the return to the policyholder is subject to market fluctuation.

For example if we just consider condition A:

If the bond is supported by underlying debt securities, including structured deposits, this may perhaps be achievable. The same cannot be said if the underlying linked assets also consist of funds where the price can fluctuate meaning the policyholder could receive less than their capital.

Of course, if an investment bond can be structured to fit within all the four conditions, this can be accounted for on an amortised cost basis (ie no annual revaluation).

NOTES OF CAUTION WHEN CONSIDERING THESE POINTS

- Regardless of the accounting policy adopted by the company, we understand that HM Revenue and Customs (HMRC) has the power to disregard the accounts produced by the company if it considers that they do not follow 'generally accepted accounting practices' and produce alternative (substitute) accounts. Consequently, the company might adopt a historical cost basis, but HMRC could substitute a fair value basis if it thinks that this is a more appropriate accounting methodology.
- A company may, at some point in the future, want to regularly access the bond in order to use the proceeds in the business. If the company starts to take regular monies from the bond (but not surrender it) then there is a risk that HMRC could reclassify it as being a current asset. This means that it would have to be valued at current cost which may damage any tax planning opportunities. The comparison here could be drawn with a bank account; if money is being continually withdrawn from an account then, at some point, the accountholder would surely want to check the balance to be able to know they had sufficient funds remaining.
- The above point may come into consideration where adviser charging is being paid from the bond as this would reduce the value of the bond (and all the underlying policies).

Unfortunately there is no clear guidance in this area and we can only recommend that companies seek their own independent advice if they are concerned about the impact of these points.

THE POSITION WITH HISTORIC POLICIES

The changes of accounting methodology from 1 January 2016 will require companies to change their accounting basis, i.e. move from one accounting basis to another. This may have required some companies holding assets on historic cost to re-assess their accounting basis and bring any associated credit or debit movement into their accounts. However, since these adjustments are 'forced' on companies by the change of accounting practice, it should be possible to adopt the Loan Relationship and Derivative Contracts (Change of Accounting Practice) Regulations 2014. Here the rules allow any associated debit or credit to be spread over ten years.

TAX TREATMENT OF SURRENDERS AND WITHDRAWALS

The tax treatment of surrenders or withdrawals will depend on the accounting method employed by the company. The examples below do not take into account any other charges that may occur under the bond such as surrender charges. The values given in the examples are provided for illustration purposes only.

Let's assume that a company's accounting period (AP) is to 31 March each year, i.e. it runs its accounts up to the end of March each year. On 20 July 2016, an insurance bond is purchased for £100,000 and then on 15 June 2018 the bond has grown in value to £110,000 and a partial surrender of 10% of the value is taken (10% of £110,000 = £11,000). As the bond is taxed under the loan relationship regime it does not really matter whether the withdrawal is taken as a segment surrender or partial-surrender (across all policies), it will be taxed the same. However, as the bond, or policy, can be assigned, it may have consequences if the bond is subsequently owned by an individual or trust.

BOND HISTORY AND WITHDRAWAL RECAP

Bond Issued – 20 July 2016 for £100,000

Withdrawal takes place on 15 June 2018 for £11,000 when the bond is worth £110,000

COMPANIES USING THE "HISTORIC COST" BASIS:

AP to 31 March 2017: No non-trading credits or debits arise (no movement in balance sheet value of bond)

AP to 31 March 2018: No non-trading credits or debits arise (no movement in balance sheet value of bond)

AP to 31 March 2019: Non-trading credit of £1,000 = proceeds of £11,000 less cost of £10,000 (10% x bond issue value of £100,000) on the disposal.

COMPANIES USING THE "FAIR VALUE" OR "CURRENT COST" BASIS

AP to 31 March 2017: Surrender value of the bond is £105,000 – Non-trading credit is £5,000

AP to 31 March 2018: Surrender value of the bond is £109,000 – Non-trading credit is £4,000

15 June 2018: Company withdraws £11,000 from the policy - surrender value immediately before the withdrawal is £110,000

AP to 31 March 2019: Surrender value of the bond is £102,000 – calculation as follows:-

Tax has already been brought in on previous fair value movements, i.e. as a proportion of the previous non trading credits of £5,000 and £4,000 respectively.

The further tax to pay on the £11,000 partial surrender for the year is therefore as follows:

The amount of the £11,000 that is actual taxable growth: {£11,000 – ((£11,000 / £110,000)x £109,000)} = £100.

The remaining non trading credit is the fair value movement for the year, but it is necessary to deduct the capital element of £10,900 from the opening value to take into account the amount that has been withdrawn in the year. This is then calculated as follows the:

Surrender value as at 31 March 2019– (surrender value as at 31 March 2018 + capital amount of withdrawal)

Which leads to

£102,000 – (£109,000 - £10,900) = £3,900

The total amount taxed for the AP to 31 March 2019 is therefore:

£100 (actual growth on the withdrawal that has not already been taxed) + £3,900 (non trading tax credit for year) = £4,000. This is equal to the value of the withdrawal £11,000 less the fair value movement for the year of £7,000 (£109,000-£102,000).

You should note that corporation tax is payable on gains generated by the overseas bond. Setting up an overseas bond on a life assurance basis means that the death of the last surviving life assured will cause the policy to come to an end which may generate a potential gain and thus a corporation tax liability. It may therefore be preferable to use a capital redemption policy which has no lives assured in order to avoid this potential problem.

TAXATION OF THE BOND – WHY OFFSHORE BONDS ARE USED FOR COMPANY INVESTMENTS

Finally, we are sometimes asked whether the tax benefits of bonds under the loan relationship regime are only available to overseas bonds. Both onshore and overseas bonds will be taxed under the loan relationship regime in a similar way, however, the overseas bond has typically been used for planning in this area. This is because the overseas bond, unlike the onshore bond, does not suffer tax within the life fund other than irreclaimable withholding tax on certain funds. This means the bond is able to grow free of tax until the point that monies are withdrawn; referred to as 'gross roll up'.

CONCLUSION

Investing in overseas bonds could still provide tax benefits for UK resident companies that are able to prepare their accounts using the historic cost basis. This will apply to companies that are micro-entities, but most other companies will probably need to adopt current cost under FRS 102.

Consultation with the company accountant is imperative prior to the company investing into any investment bond. The adviser should seek to understand the accounting basis adopted by the company, as this will be key to any tax advice given in relation to the bond. The directors of the company should be able to approach the company accountant for this information if they unsure of the accounting methodology being adopted.

The addition of adviser charging to any bond should also be discussed when deciding on how to proceed, as taking regular withdrawals could impact the basis of accounting when valuing the bond for tax purposes.

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