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SUITABILITY ADVICE GAME-CHANGER?

AUTHOR
STEPHEN ATKINSON
GLOBAL HEAD
OF SALES AND MARKETING,
UTMOST WEALTH SOLUTIONS

Stephen Atkinson, Global Head of Sales at Utmost Wealth Solutions, considers the likely impact of the recent interest rate rises and the forthcoming personal tax changes on the suitability considerations facing UK financial advisers seeking efficient portfolio management for their clients.

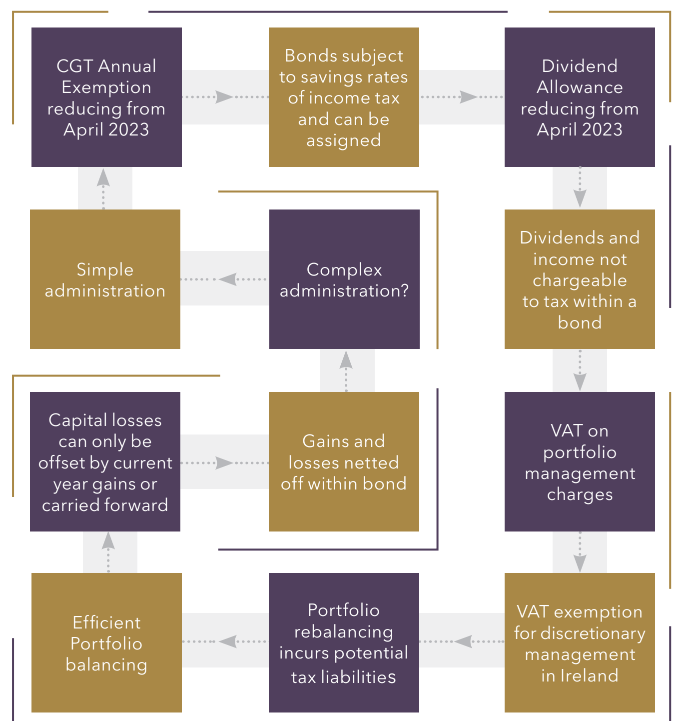
Recent developments have put the spotlight on a well-known but often overlooked feature of offshore bonds i.e., the ability to offset capital losses against income within an offshore bond. No other structure for private capital offers this facility. Let's look at this in more detail and in the wider context of planning in a high interest rate environment.

With interest rates now at a 15-year high and forecast to increase further, levels of inflation not seen in 40 years and volatile investment markets, we are currently witnessing higher levels of asset correlation and investment managers increasing the number of client holdings in a broader range of more diverse 'alternative 'assets. This combination adds to the complexity and cost of running client portfolios. Higher interest rates in particular are a game-changer, with many clients increasing their bond and cash holdings but then having to deal with the tax consequences of income producing assets.

Against this background, Chancellor Jeremy Hunt's Statement on 17 November 2022 signposted the introduction of a number of explicit and 'stealth ' changes to the UK tax regime, including some related to Capital Gains Tax (CGT), to address the UK's projected fiscal deficit, some of which will begin to impact UK investors from April 2023.

In a higher interest rate environment, and given the likely impact of the November Statement CGT measures, what is the best way to achieve efficient portfolio management for clients and what is the likely impact on product and investment suitability recommendations for UK advisers?

> Using an offshore bond to construct an efficient portfolio and solve some problems associated with direct investment



SHIFTING TAX LANDSCAPE

The reduction in the annual exempt allowances for CGT and dividend taxes announced in the November Statement is the clearest indication yet of the revised direction of travel signalled by the Office for Tax Simplification announced in November 2020. The report at this time illustrated several ways in which the UK government might simplify CGT and increase the revenues flowing from it by proposing a general move towards taxing capital assets and income more equally. This shifting tax landscape has some significant implications for the suitability of direct client investments and those into tax wrapper products, including how and when investors take income or switch investments.

SHIFTING SUITABILITY CONSIDERATIONS?

Many wealthy UK clients have a mix of direct and wrapped investments that take advantage of the available tax reliefs to optimise their personal tax position in relation to their unique family, health and lifestyle circumstances. However, higher levels of deposits and other income producing assets with the new emphasis being placed on the taxation of capital assets has the potential to shift the product suitability assessment considerations away from direct investments in favour of wrapped investments such as offshore bonds.

The fundamental characteristics of offshore bonds have not changed but interest rate rises and impending tax changes have begun to shine a light on a number of existing offshore bond features that are particularly helpful when it comes to achieving efficient portfolio management.

One obvious feature is the ability to shield income-producing assets held in an offshore bond from annual taxation on an arising basis.

Let's have a look at some other features that can make an offshore bond a tried and tested suitable recommendation for wealthy clients:

› **Favourable CGT treatment**

Following the November Statement, the CGT annual exempt amount is due to reduce from the current figure of £12,300 per annum to £6,000 from April 2023 with a further reduction to £3,000 from April 2024. In contrast, income tax bands remain frozen until at least April 2028, providing a very visible example highlighting the shifting landscape from taxing primarily income to also taxing capital assets more equally.

On the other hand, offshore bonds are subject to savings rates of income tax allowing for tax-deferral. Whilst the income tax annual exemption is currently frozen and projected to stealthily increase the UK Treasury's revenues over the coming years, the exemption is unlikely to reduce regardless of which political party is in power. Where offshore bonds are assigned for no consideration (money or monies worth) there is no chargeable event, allowing for tax-efficient planning passing wealth down the generations.

› **Dividends not charged to tax**

In addition, as part of the November Statement, the annual dividend allowance on stocks and shares is to be reduced from the current £2,000 per annum to £1,000 from April 2023 and will be further reduced to £500 from April 2024. For private investors with a sizeable portfolio of assets, this reduction in the dividend allowance is unlikely to have a major impact on their investment behaviours.

However, switching assets within an offshore bond is not subject to CGT and, within some UK tax compliant offshore bond structures, it's possible to include just the same stocks and shares whose sale as part of a direct investment portfolio would otherwise attract CGT. As a result, the forthcoming reductions in the UK dividend allowance are likely to make offshore bonds more attractive than directly held portfolios, even for people who have only small amounts of gains.

› **5% per annum tax-deferred withdrawals**

This income tax deferral feature is a characteristic of UK-compliant offshore bonds that has no direct investment equivalent.

5% of the original capital sum can be taken annually, or cumulatively, on a fully tax-deferred basis up to 100% with income tax rather than CGT being payable when the bond is surrendered, and a tax charge is crystallised. Annual withdrawals beyond the cumulative 5% figure are possible but will create a chargeable tax event.

This feature has been utilised extensively by UK advisers over the past 40 years to help manage their client's income tax bill by deferring the taxable event potentially to a date when their tax band is lower, typically in retirement. In addition, with good planning it is possible to use the well established top-slicing relief rules to reduce the tax liability on any eventual gains.

› **Treatment of investment management fees**

Although the discretionary investment management fees associated with an external portfolio in the UK can typically vary from 1.0% to 0.5% per annum, the fee will usually be subject to VAT at 20%.

Where the discretionary investment services are provided to a life insurer based in the Republic of Ireland, the investment management fees are exempt from VAT. On a portfolio containing £2m of assets using an average discretionary fee rate of 0.65%, this currently represents a saving of approximately £2,600 per annum compared to an external UK portfolio holding direct assets or indeed an offshore bond from any other jurisdiction.

In addition, the investment management fees for the offshore bond wrapper and the cost of the offshore bond are effectively paid out of the gross income of the fund representing a form of tax relief on the investment build-up of the bond.

› **Cost effective portfolio rebalancing**

Due to the reduction in annual CGT exemption, any partial disposals of holdings in directly held assets may incur gains that are taxable.

On the other hand, the switching of assets within an offshore bond is not subject to UK CGT. Under an offshore bond, disposals of assets that create gains can be deferred until a chargeable event occurs when income tax rather than CGT will apply, including cash funds. This allows for efficient portfolio management and to use the reduced CGT allowance for other purposes. It also means that the discretionary investment manager doesn't need to consider the impact of any immediate tax liability on the client when rebalancing. With the immediate tax considerations removed from the investment suitability assessment, the discretionary investment manager is able to focus on the investment decisions and not the impact of tax on the assets selected.

› **Netting-off of gains and losses - be 'tax smart'**

For direct investments which are subject to CGT, capital losses can only be offset against current year gains or carried forward to be used against future capital gains. However, capital losses must first be allocated to current year gains excesses before they can be carried forward. Doing this adds a significant level of complexity. In any event, capital losses cannot be offset against income.

The good news is that capital losses in an offshore bond can be offset against both capital gains and income generated with the policy funds (interest, bond coupons, dividends etc.) as they are effectively netted-off within the value of the overall portfolio.

This feature is unique to offshore bonds in the UK with no other structure for private capital offering such a benefit, allowing the discretionary investment manager to focus on generating investment returns.

› **Simple administration**

For all direct investments, as part of their annual tax return individual investors must file self-assessment information for dividends, coupons and capital gains. For experienced investors this may be a well-established and routine exercise, but it can still be complex and time-consuming if their investments are extensive, and the information is not available in a consistent or timely manner. For less experienced or novice investors, the process can be quite daunting or involve them in additional expense in having to seek a professional to help them complete it.

For an offshore bond, the gains and losses are netted off in the value of the overall portfolio, with no requirement to file returns or to consider which assets to sell to net off any capital losses. This allows the discretionary investment manager to focus on generating investment returns rather than selling assets that they may otherwise retain.

A FINAL THOUGHT

Given the individual and family circumstances and financial needs of individual wealthy clients, an offshore bond will not always be the default product or investment suitability advice recommendation. However, the increased attractiveness of holding bonds and deposits within a portfolio, plus the changes in the UK personal taxation landscape towards the more penal taxation of directly held investment assets, enhances the credentials of offshore bonds for most investors via their ability to control taxable charges and simplify the administration of the underlying assets.

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