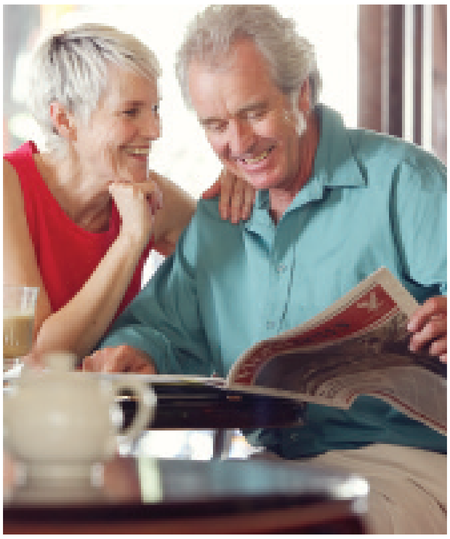
A guide to tax on your investment bond

Investment Bonds offered by Prudential now, or in the past, such as Prudential Investment Plan, PruFund Investment Plan, Prudence Bond, Prudential Investment Bond, or a Flexible Investment Plan, are normally effected as single premium life assurance policies (note that "regular premiums" may also be paid into a Prudential Investment Bond). As such, they enjoy a different tax treatment from other investments. This can offer some valuable tax planning opportunities for individuals.



This tax treatment revolves around the "chargeable event" rules.

Prudential pays tax on income and capital gains accrued within its funds. HM Revenue & Customs regards payment of this tax as equivalent to you having paid Capital Gains Tax and Basic Rate Income Tax, so you have no personal liability to Capital Gains Tax or Basic Rate Income Tax on the proceeds from your Bond. However, the tax paid by Prudential is not reclaimable if you are a basic rate or non taxpayer.

Chargeable events

A liability to Income Tax above the basic rate may arise if a chargeable event occurs and a chargeable event gain or "profit", arises.

- in the event of your death, or
- on certain assignments (transfer of legal ownership of all or part of your Bond) for money or money's worth. This can include an assignment as part of a divorce settlement, but not where formal direction to assign a policy is given under a Court order for ancillary relief under the Matrimonial Causes Act 1973 (or the Family Law (Scotland) Act 1985), or formally ratifying an agreement reached by divorcing parties dealing with transfer of property, or
- on maturity of your Bond (this does not apply to Bonds written as whole of life policies which remain in force until surrendered or the life/lives assured, dies), or
- on full and final cashing in of your Bond or policy within the Bond; or
- if you withdraw more than 5% (please see below for information for Corporate Investors) per policy year of the amount that you have paid into your Bond. This 5% withdrawal allowance is cumulative, and any unused part can be carried forward to future years, subject to the total cumulative 5% allowance amount not exceeding 100% of the amount you have paid into your Bond.

Please note:

- from 6 April 2010, an Additional rate of income tax of 50% for earners with taxable income in excess of £150,000 was introduced.
- the taxation of life assurance investment bonds held by UK corporate investors changed with effect from accounting periods that started on or after 1 April 2008. This change brought life investment bonds held by UK companies within the "loan relationships" legislation and they can no longer withdraw 5% of their investment each year and defer the tax on this "income" until the bond (or their ownership of it) ends. For more information, please speak to your Financial Adviser.

continued overleaf

What happens when a chargeable event occurs?

When a chargeable event occurs, Prudential sends details of the chargeable event gain to HM Revenue & Customs. We also send details to you. These details are used to calculate whether there is any Income Tax above the basic rate to pay. Gains may also affect your entitlement to Higher Personal Allowance (Age Allowance), Basic Personal Allowances where income is above £100,000 and certain tax credits (e.g. Children's Tax Credit, Working Families Tax Credit, Disabled Person Tax Credit). As Basic Rate Income Tax is treated as already paid, the maximum rate of Income Tax that may become payable is the difference between the Higher Rate (and the Additional Rate, where applicable) of Income Tax and the Basic Rate of Income Tax.

Entitlement to Basic Personal Allowances, Age Related Personal Allowances, Working Tax Credit and Child Tax Credit

You should also be aware that any entitlement to age related personal allowances may be affected whenever you cash in some or all of the policies in the Bond or take proceeds in excess of the accumulated 5% allowances. Age related personal allowances are lost at the rate of £1 for every £2 that your income, after addition of the "profit" (without top slicing), exceeds a certain limit.

Age related personal allowances are not affected if your income, plus any profit from your Bond or withdrawal in excess of the accumulated 5% allowances, is less than the limit £24,000. This limit is likely to change in the future.

The amount of Child Tax Credit and/or Working Tax Credit to which you are entitled also depends on your income. Any profit from your Bond or withdrawal in excess of the accumulated 5% allowances will be added to your income (without top slicing) for this purpose and could reduce or eliminate any Tax Credit that you would otherwise be entitled to.

Following changes effective 6 April 2010, earners with taxable income in excess of £100,000 lose any entitlement to basic Personal Allowance at the rate of £1 for every £2, until their basic Personal Allowance is reduced to nil.

Tax liability on death and terminal illness

A chargeable event will occur on the death of the life assured (second death under a joint life second death Bond; first death under a joint life first death Bond). In this situation, the tax treatment is the same as if the Bond had been finally cashed in immediately before death. Any gain or "profit" is calculated on the cashing in value rather than the total amount that is actually paid on the death claim.

Terminal illness claims (where life expectancy is no more than 12 months) under Prudential Investment Bond or Flexible Investment Plan do not give rise to a chargeable event.

Tax liability on withdrawals

Any tax liability on withdrawals is calculated on the amount withdrawn in excess of the accumulated 5% allowances. The gain or "profit", that is taxed is the amount of this excess that falls into the Higher Rate (and the Additional Rate, where applicable) tax bracket when added to your taxable income for the tax year in which the policy anniversary, following the excess, falls.

Where regular premiums have been paid into a Prudential Investment Bond, the 5% allowance is applied separately to the premiums (including any single premium) paid in each year.

Please note that where a policy is assigned (including assignments by way of gift), any tax liability arising from withdrawals will usually be assessed against the policyholder at the time of the withdrawals that have given rise to the Chargeable Event (Finance Act 2001).

"Top slicing relief" may reduce the tax liability on any excess. To work out the profit slice, the excess is divided by the number of complete years that the Bond has been held, or since the last chargeable event, if less. The amount of the profit slice is then added to your taxable income. Any part of the profit slice that falls into the Higher Rate (and the Additional Rate, where applicable) tax bracket is taxable at the difference between Higher/Additional Rate of Income Tax and the Basic Rate of Income Tax. The total tax due is calculated by multiplying this amount of tax on the profit slice by the number of complete policy years that the Bond has been held (or by the number of complete policy years since the last chargeable event, if less).

Top slicing can reduce your tax liability if none of your taxable income, before the profit slice, would have been subject to tax above the basic rate.

Tax liability on final cashing in

Any tax liability on final cashing in or death is based on the gain or "profit" (if any) that the Bond has made.
This profit is defined as:

- the amount you receive when you cash in your Bond plus all previous withdrawals;

  less

- the total amount you have paid in plus any excesses over the accumulated 5% allowances.

Top slicing relief then applies on final encashment as follows:

- HM Revenue & Customs divides the profit by the number of complete policy years that the Bond has been held to give the profit slice.
- The profit slice is added to your taxable income, and any part that falls into the Higher/Additional Rate Income Tax bracket becomes liable to tax at the difference between the Higher/Additional Rate of Income Tax and the Basic Rate of Income Tax.
- The total amount of tax due is calculated by multiplying the amount of tax on the profit slice by the number of complete policy years that the Bond has been held.

Tax planning opportunities

This tax treatment can allow you to plan your affairs to reduce any tax liability. You have no further personal liability to tax on a gain if:

- you do not pay Income Tax above the Basic Rate at the time you cash in your Bond (in whole or in part);

  and

- receipt of these proceeds does not make you liable to pay Income Tax above the Basic Rate.

An individual paying Income Tax above the Basic Rate may, therefore, consider deferring any withdrawal from the Bond in excess of the accumulated 5% allowances until such a withdrawal will not create such a liability to tax.

Large partial withdrawals

Large withdrawals from your Bond can result in an excessive and artificially high tax liability. This is because the excess over 5%, the "chargeable event gain", is always used for the calculation, irrespective of any profit or loss on the Bond.

This is just an example designed to represent a typical situation and does not relate to any particular individual. You should not consider this as financial advice or a recommendation of a particular course of action. You should consider your own circumstances fully and may wish to consult a financial adviser to help you make a decision.

Say an investor invested £20,000 into one single policy. Towards the end of the second policy year she/he unexpectedly needed to make a withdrawal of £10,000. Let's say that the fund used was a "high risk – high potential reward fund" and at the time the money was needed, the investor's bond value was only £17,000.

The investor instructs Prudential to pay him/her £10,000 as a partial withdrawal.

On the second anniversary, Prudential are required to issue a "Chargeable Event Certificate" (CEC) to the policyholder showing that the £10,000 was withdrawn, but 2 years' of 5% were available (2X5% of £20,000 = £2,000) so the "chargeable event gain" (the gain) shown on the CEC would be £10,000 – £2,000 = £8,000.

If the investor was already a "Higher Rate Taxpayer" before taking account of "the gain", tax would be due for the tax-year within which the 2nd anniversary date of the bond, occurred. This would be calculated as (currently) 20% of £8,000 = £1,600.

If the investor was already an "Additional Rate Taxpayer" then tax at 30% of £8,000 = £2,400 will be due.

Thus, even though the overall value of the bond had fallen by £3,000 (–15%), tax on the "excess" withdrawals of £8,000 would have to be paid.

In future years when a full and final cashing in of the Bond (or policies within the Bond) takes place, if the bond shows a loss then some relief (up to the amount of the previous chargeable gain), "Corresponding Deficiency Relief", will be available where the person claiming is a Higher Rate or Additional Rate tax payer (where a policy is taken out, topped-up, an option exercised, or on certain assignments since 2 March 2004, the Corresponding Deficiency Relief will be restricted to only those gains which have previously arisen against the current policy owner).

To help counter such excessive and artificial gains, Prudential issues Single Premium Bonds as a series of identical policies, unless you instruct us to the contrary. This allows for the full cashing in of one or more policies, rather than a large partial withdrawal spread across the whole Bond.

continued overleaf

Important information

This leaflet describes the taxation treatment of UK investment bonds. Offshore and other bonds may be treated differently by HM Revenue & Customs for tax purposes.

Also, the tax treatment described above may not apply if your Bond is held in trust, depending on the nature of the trust. We suggest that you consult your legal adviser if you are concerned about this.

A tax return guide (explaining how to use information contained within a chargeable gain certificate, in your tax return), and a help sheet about life assurance policy gains, are available from your inspector of taxes if required. For self-assessment purposes a chargeable event certificate must be retained for at least six years. If you are in any doubt or require further information you should contact your Financial Adviser.

The information in this document is based on our understanding, as at April 2011, of current taxation, legislation and HM Revenue & Customs practice, all of which are liable to change without notice. The impact of taxation (and any tax reliefs) depends on individual circumstances.

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