



Guide to Unit Linked Bonds

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What is a Unit Linked Bond?

Unit-linked investment bonds are investment-based plans, which can offer the opportunity for better returns than a traditional bank or building society although with higher risk as your capital is not secure within a unit-linked investment bond as it would be within a bank or building society account.

These are single premium, non-qualifying life assurance policies (meaning they may be subject to income tax on encashment), with the investment being made into one or more unit-linked funds of the provider of your choice.

Unit linked bonds do not guarantee to pay out a guaranteed sum assured. Your investment is made directly into the assets defined by the fund investment objectives and the value of your investments varies in direct proportion to the value of the underlying assets. Therefore, the value of your investment on surrender would be based on the value of the fund's assets at that time.

These bonds are intended as long-term investments and therefore require sufficient time to grow. Should you withdraw your investment during the early years of the plan (typically within the first 5 years) you may not get back the full amount invested.

How does it work?

Investments can be made into many different funds, giving you the opportunity of spreading the investment risk.

The investment performance of a unit-linked bond is directly linked to the value of the underlying fund's assets – if these rise in value then your investment will rise and conversely if they fall in value then so will the value of your investment..

The amount invested will buy units in your chosen fund (or funds). The price of units varies daily according to market conditions which means that the value of the bond can go down as well as up in the same way as unit trust units, traditionally making them more risky than with profits bonds. It is therefore important to bear in mind that there is the potential for loss as well as gain.

Unit linked bonds are usually written as whole of life policies, meaning they do not have a fixed maturity date and can continue generally 'for the whole of your life'. There is a small amount of life cover built into the policy with a payment of 101% of the bid value of your investment being made on death. This is because the main purpose of the policy is investment related. The policy may be written in trust or assigned in a similar way to other life policies.

Unit linked bonds will usually appeal to the more experienced investor or those willing to accept a degree of risk. Of course, this level of risk can be refined further depending on your choice of fund.

The unit-linked funds of the provider enable investors to spread their investment across a number of assets classes (such as shares, property or cash), risk profiles or markets but within one investment contract, professionally managed by experts. There may also be some potential tax benefits depending on your individual circumstances.

Can I switch between funds?

During the life of your policy you may decide you wish to change your fund choice, perhaps to move from a poorly performing fund, to take profits on a well-performing fund or simply to adjust the risk profile.

Switching between funds is a simple procedure and, unlike switching between unit trusts, has no tax consequences as you have not encashed the policy, you are simply changing the underlying assets. Costs are usually nominal with most providers offering at least one switch each year without charge.

Can I take an Income from my policy?

Investors can opt to receive a repayment of their original capital investment by way of a regular payment. This can be seen as an income but is in fact a return of the original capital investment.

Under current legislation (tax year 2006/07) it is possible to receive a tax-deferred 'income' each year, for 20 years, of up to 5% of all premiums paid into the Bond. If not used in one year, the unused 5% allowance (or part of it) can be carried forward to the next year. This income can be taken at any frequency (yearly, quarterly, monthly) and provided the total withdrawn does not exceed 5% of your original investment each policy year then there is no further liability to income tax until you encash the policy. When the policy is encashed, a further calculation is made to establish your exact tax position and whether or not further income tax is payable.

You should seek professional tax advice if you are at all unsure about your taxation status and whether or not this type of investment is suitable for you.

What are the tax benefits or possible liabilities?

The tax status of unit-linked bonds can make them more attractive for higher rate taxpayers when compared to a direct investment in unit trusts and OEICs, but not when compared to the greater tax-breaks on offer from a unit trust or OEIC held in an ISA.

- Switching from one fund to another within the bond attracts no income tax or capital gains tax liability.
- The underlying funds in the investment are subject to corporation tax on income and capital gains at the lower rate (currently 20%), which is clearly lower than a higher rate taxpayer would have to pay on other investments (currently a maximum of 40%). There would be no further liability to income tax until the bond is surrendered or death occurs giving rise to the payment of benefits, at which point a calculation would be made (for 'top slicing relief') to establish any liability, to income tax on any gain.
- Should you be a higher rate taxpayer while the bond is in force but likely to become a basic rate taxpayer in the future (perhaps on retirement) then it may be advisable to defer the surrender until that time.
- There is no personal capital gains tax liability on gains arising on a unit-linked bond to the investor (although the fund is subject to corporation tax on capital gains).
- These types of bond may be less suitable for non-taxpayers or 10% rate taxpayers, since the income tax paid at 20% within the bond cannot be reclaimed.
- Basic rate taxpayers have no additional liability to income tax, unless any gains made from the plan, when added to your current income after top-slicing relief, make them higher rate taxpayers in the year of surrender.
- Investors can withdraw up to 5 per cent of their original investment each year, for up to 20 years, which is treated as a repayment of capital. As such there would be no immediate liability to income tax but with a potential liability being deferred until surrender because previous withdrawals are taken into account in establishing the overall gain on the bond. Indeed, if you remain or become a basic rate taxpayer or surrender then there would remain no additional liability to income tax. Should you be a higher rate tax payer then there would be further income tax to pay – please see the section titled 'What is top slicing' below.

What is top-slicing relief?

- This is a term used to determine whether further income tax is due once an investment bond has been surrendered.
- The total gain on the policy (surrender value less original investment) is calculated.
- The total gain is then divided by the number of complete years the investment has been in force, giving what is termed the 'average gain'. This average gain is added to your taxable income in the year of surrender.
- If this makes you a higher rate taxpayer then additional income tax is due on the proportion of the gain in excess of the basic rate tax bracket, multiplied by the number of complete years for which the bond has been in force. The additional liability would be at the marginal (higher rate minus lower rate) of tax (since the bond has already paid 20%tax).

What are the Bid & Offer Prices?

Bid and offer prices are quoted daily for each fund; units are purchased at the current offer price and sold back to the company at the bid price. There is usually a difference between the bid and offer prices to cover any initial charges on the plan and this difference is called the 'Bid- Offer Spread'. The bid and offer prices of many unit linked bond funds can be found in publications such as the Financial Times and the Daily Telegraph.

What are the main Advantages and Disadvantages of a unit-linked bond?

One of the main advantages of investment bonds are their flexibility as they allow the investor to adjust their investment strategy significantly by switching unit linked funds without giving rise to a tax liability. Added to that are the tax advantages for higher rate taxpaying investors in that the fund growth is lower than the investor would pay if they held the investments direct.

One of the disadvantages of a unit-linked bond is that like any other equity based investment they should be seen as a medium to long-term investment (usually with a suggested minimum of 5 years). Of course, the returns from these types of investment can vary significantly depending on the type of fund chosen and any return achieved will be directly affected by the value of the underlying investments. It should be noted that you will not be able to use your annual capital gains tax exemption against any gain made under the bond.

Is a unit-linked bond right for you?

Investment bonds offer a great deal of flexibility in your investment choice whilst offering tax advantages to some investors. Conversely, the tax advantages for some can in fact be tax disadvantages for other (such as 10% or non-taxpayers) since these investors cannot reclaim the income tax paid at 20% within the bond.

Unit linked bonds are vulnerable to fluctuations in the level of the investment markets and should therefore be classed as a medium to long-term investment. It should also be remembered that their value can go down as well as up and past performance is not a guide to future returns. You therefore might not get back what you initially invested.

If you are at all unsure about the suitability of this type of investment for you, then you should seek professional advice from an Independent Financial Adviser. You can request help from us by clicking on the 'make contact now' option on our website.

How much will my bond be worth?

Unit linked bonds do not guarantee to pay a fixed amount. The fund manager manages the investment fund, and the amount payable will depend entirely on the value of that fund on the date that the bond is surrendered. This will be affected by the type of fund chosen, which will in turn be affected by your attitude to risk, and investment performance. The value of your fund will fluctuate on a day-to-day basis according to general market conditions and the value of the individual holdings within your fund. There is no guarantee of the value of the lump sum that will eventually be received.

The risk profile of this investment will be affected by the fund chosen. For example, if you were to choose a 'cash' fund then it would be considered a lower risk investment. However, if a Far Eastern fund was chosen then it may be considered a higher risk investment. Of course, the ability to choose a number of funds means that a balanced approach could be achieved with a mixture of different funds.

If you are unsure which funds are suitable to you then you should seek professional advice from an Independent Financial Adviser. You can request help from us by clicking on the 'Contact Us' option on our website.

How safe are unit-linked bonds?

The risks involved with investing in unit-linked bonds, and the potential return, will vary according to the type of investment fund chosen. The risks are similar to unit trusts, with your fund selection having a large effect on the potential risk. It must be noted that the value of your units can fall as well as rise, as could the "income" you may receive from them. Therefore, the value of your investment is not guaranteed and you may get back less than you originally invested.

There are hundreds of funds to choose from in the market place in many different sectors, including UK equity based, property based, North American, UK fixed interest or even the Far East to name a few. If you are at all unsure about which fund may be best for you then you should seek professional advice from an Independent Financial Adviser.

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