CRS CONSULTANTS

Guide to With Profits Bonds

What is a With Profits Bond?

A with profits bond should be considered to be a longer-term investment, which can offer attractive returns combined with a degree of peace of mind. The term “with profits” means that in addition to providing a limited level of life assurance the investor shares in the returns of the provider’s with profits fund. The bond grows by the addition of an annual bonus (called a ‘reversionary bonus’) which, once added, cannot be withdrawn. As these types of investment are considered longer-term plans, some providers may choose to impose a penalty for early encashment (usually within the first 5 years of the policy term). These encashment penalties usually reduce over the 5-year period on a sliding scale.

With profits bonds are a good way of investing in, amongst other things, equities but at the same time smoothing out the highs and lows of the stock market. They have proved to be a popular option for the investor who is seeking a lower risk approach to investment while wishing to achieve a return in excess of that offered by more traditional cash deposits (Bank or Building Society accounts). There may also be some potential tax benefits depending on your individual circumstances.

How does it work?

Your investment is made into the with profits fund of your chosen provider. This is in turn invested in a wide range of assets including shares (equities), fixed interest investments (e.g. gilts & corporate bonds), cash deposits & property. By spreading the investment in this way, risks are reduced when compared to a full equity-based portfolio.

The idea of with profits bonds is to smooth out the fluctuations in the market, presenting policyholders with a lower risk investment than a traditional equity-based fund.

It is important, however, to bear in mind that although the investment receives regularly declared bonuses, the value of the underlying investments in the fund will still be fluctuating according to world markets.

A terminal bonus may also be added and the longer the bond is kept, the higher the bonus could be. However, if stock markets had been performing consistently well but then suddenly hit a stormy patch then this terminal bonus could be reduced for the future or even withdrawn. It must therefore be stressed that terminal bonuses are NOT GUARANTEED.

Some with profits fund providers may offer enhanced allocation levels, for example they may offer an allocation rate of 101% for new investments. In this example, for every £100 you invest your new policy would have £101 allocated to it. Where a bid offer spread is applied this is usually around 5%. You will find that allocation rates could be enhanced for larger investments (e.g. an allocation rate of 102% means that 102% of your capital will be used to buy units). In some cases however, especially for “minimum” investments, some providers apply an allocation rate of less than 100%, which effectively increases the initial charge. There is normally an annual management charge applied to the fund, but this is expressed in the annual bonus rate. There can be an early discontinuance charge in the first five or six years. Where there is no initial bid/offer spread (“the initial charge”), you will find that in the first few years there is an extra annual management charge applied to the ongoing value of your investment. Please ensure that you are aware of all the charges before you invest.

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.

How safe are With Profits Bonds?

With-profits products aim to have a lower risk than other funds that invest in shares and to provide a better rate of return than a deposit account.

However the value of the returns are subject to fluctuations. This means the amount of any bonuses can fall as well as rise and may not remain consistent year on year.

Should you withdraw your investment during the early years of the plan you may not get back the full amount invested. There are risks in investing in a with profits bond in that you are not certain to make a profit, you may make a loss and may not get back the full amount invested.

How are bonuses added to my bond?

Every year the company will assess its profitability, investment returns, and how it thinks the markets will perform in the next few years. If, after taking into account these factors things look favourable, the company may announce an annual bonus called a reversionary bonus. This is added to the plan increasing its value. Any annual reversionary bonuses, once declared, cannot be withdrawn.

During years when the market returns are poor the providers may dip into their reserves to bolster the bonus payment for those years or may choose to reduce the bonuses declared. This averaging of payments allows for a much smoother and more predictable return.

On encashment of the plan any terminal bonuses accrued to date are added to the plan and paid to the bondholder or their estate on death.

The ultimate value of a With Profits Bond is not guaranteed, and depends on the level of future bonuses, which are variable.

What are the tax benefits or possible liabilities?

Within the bond itself, 20% income tax is treated as having been paid and therefore there is no additional liability to income tax for basic rate, 10% and non-taxpayers. However, this tax paid within the bond is not reclaimable by a 10% or non-taxpayer.

There may be tax advantages, particularly for higher rate taxpayers, in having an investment bond. As any additional liability to income tax is calculated on encashment, provided you remain a basic rate taxpayer after any calculations have been made, there would be no further liability to income tax. So, for example, if you are currently a higher rate taxpayer but may become a basic rate taxpayer in the future (perhaps on retirement) it may be worthwhile deferring any encashment until you become a basic rate taxpayer.

The following circumstances would give rise to a ‘chargeable event’ meaning that further income tax may be due. Please consult a professional tax adviser if you are unsure about your circumstances or require clarification of these issues:

- You are or become a higher rate taxpayer when you cash in all or part of your bond, die, or assign the bond for money or money’s worth (sell it).
- You take withdrawals of more than 5% of the amount you invested and, including these payments, you are or become a higher rate taxpayer.
- You encash a bond when you are over 65 and the gain, when added to your income, affects any age related tax allowances that you may be in entitled to.
- Investors can not use their annual CGT allowance to absorb gains made under single premium bonds.

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 about charges?

Many companies have traditionally charged an initial fee, usually a percentage of your initial investment, although some providers have chosen to have of a Nil initial charge and to apply exit penalties within the first 5 years of the plan.

While charges are important when comparing one bond with another, it is unwise to consider this one factor in isolation when choosing your provider, as cheapest doesn’t always mean best.

Investors should consider all aspects of the plan including the financial stability of the provider, historic performance and their administration capability before making your decision. . If you are at all unsure about any of these issues, then you should seek professional advice from an Independent Financial Adviser using our ‘Make contact now’ option.

Is a With Profits Bond right for you?

You should regard with profits bonds as a medium to long-term investment in order to hopefully achieve the best returns. There is a risk investing in a with profits bond that you are not certain to make a profit, you may make a loss and not get back the full amount invested. With profits bonds are not appropriate if access is needed to the capital within the first five years of the life of the policy.

What other potential penalties could be applied?

With profits bonds are longer-term investments, and providers are committed to smoothing out the fluctuations of the stock market over the long term.

If a bond is encashed during difficult stock market periods or if the investment had only been made for a short time, the provider reserves the right to apply a charge known as a “Market Value Adjuster” or “MVA”. These charges vary from provider to provider and can be applied at any time.

In simple terms, this is designed to protect the remaining investors in the fund and to prevent the fund from suffering adversely should a large number of investors decide to encash their policies at the same time.

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