



STERLING

Tax guide

This guide aims to help you understand the tax treatment of the Sterling Investment Bond, Sterling Individual Savings Account, and Sterling Investment Account. If you are reading it without an adviser, we recommend you take financial advice.

Please consider all the tax implications when taking out, making changes to, and disposing of some or all of your investment.

We have based this guide on our understanding of current UK law and HM Revenue & Customs (HMRC) practice as at March 2011.

The amount of tax due will depend on individual circumstances. Future changes in law and tax practice, or in individual circumstances, could affect the amount of tax you may have to pay.

Trustees and organisations should take separate advice, as their tax position can be more complex.

Sterling Investment Bond

The investment bond consists of a series of 1,000 separate but identical policies that allow for flexibility when making withdrawals.

The investment bond is:

- a whole of life insurance policy, meaning that it does not have a fixed term or specified end date and provides an element of life cover
- non-qualifying for UK tax purposes, meaning that tax may be due on any withdrawals or surrender (cash-in).

Any gain you make from an investment bond, for example following a withdrawal or surrender, is taxed as income. No basic rate income tax is due because an equivalent amount of tax is paid on the income and capital gains produced within the fund(s) the bond is invested in and is reflected in the unit price(s). This tax can't be reclaimed.

If you are a basic rate taxpayer, and part of the gain from a withdrawal or surrender takes your income above the higher rate tax threshold in that tax year, you may pay tax on that part of the gain.

If you are already a higher rate (40%) or additional rate (50%) taxpayer, the whole of the gain will be liable to income tax and you will have to pay an extra 20% or 30% income tax respectively.

A chargeable gain may occur whenever there is a chargeable event, as described below.

Chargeable events

Chargeable events that can cause an income tax charge are:

- regular or one-off partial surrenders that exceed the 5% allowance (described in the 'Withdrawals' section)
- the full surrender of the investment bond (or individual policies)
- the death of the last life insured
- the assignment of the investment bond.

These are all explained in more detail in the sections that follow.

Gains may affect any entitlement you may have to the higher personal allowance (age allowance) and tax credits. From 6 April 2010, gains may also affect your entitlement to the basic personal allowance if they take your income over £100,000.

If a chargeable event happens, we will send you details of any chargeable gain. We will also inform HMRC where we are required to do so under current tax law.

Types of chargeable event

Withdrawals

Regular withdrawals

Under chargeable event rules, each regular withdrawal is considered to be a partial surrender of the investment bond. As such, for tax purposes, regular withdrawals are treated in the same way as partial surrenders as explained in the 'One-off withdrawals' section below.

One-off withdrawals

One-off withdrawals can be made in two ways:

- 1) By taking a one-off withdrawal equally from all the individual policies that make up the investment bond – this is known as a partial surrender.

Each year, by which we mean 12 months from the investment bond start date and each subsequent anniversary, you can take regular withdrawals or one-off partial surrenders of up to 5% of the amount invested without an immediate tax liability. However, if you take out more than the 5% allowance in any year, this will be classed as a chargeable event and any amount over the 5% allowance, the chargeable gain, may be taxable.

If you don't use the 5% allowance in one year, you can carry it forward to the next. For example, if £100,000 is invested and you don't take any partial surrenders in the first two years, you can withdraw up to £15,000 in the third year without an immediate tax liability.

If you withdraw your full 5% allowance every year, after 20 years you will have used up all your allowance. So any withdrawals you make after this will be classed as chargeable events and may be taxable, depending on your circumstances.

Taking a large one-off partial surrender, either on its own or when added to regular withdrawals, may result in an artificially high tax liability. This is because the tax liability is calculated on the full value of the partial surrender over the 5% allowance, and takes no account of investment performance.

Any tax liability will be calculated in the tax year in which the last day of the investment bond year falls. The investment bond year ends on the day before the next start date anniversary.

- 2) By fully surrendering one or more whole policies that make up the investment bond.

If you fully surrender whole policies, your tax liability will depend on how much the value of each policy has increased, in the same way as a full surrender of the investment bond, as described in the 'Full surrender' section.

Any gain is treated as income for the tax year in which the surrender happens.

Taking a one-off withdrawal using either method may result in significantly different tax liabilities (and, where applicable, early withdrawal/surrender charges) depending on your individual circumstances, as shown in the following examples. You should take professional advice before taking a one-off withdrawal. Once completed it cannot be changed or reversed.

Example 1 – withdrawal taken equally from all policies

You pay £100,000 into an investment bond. In the second year its value has increased to £120,000 and you withdraw £40,000. You have not taken any previous withdrawals. The cumulative (total) 5% allowance is £10,000 ($£100,000 \times 5\% \times 2$). The gain over the 5% allowance is £30,000 ($£40,000 - £10,000$).

If you are a higher rate taxpayer*, the tax due is £6,000 (20% of the gain for tax year 2010/11).

If you are an additional rate taxpayer, the tax due is £9,000 (30% of the gain for tax year 2010/11).

Example 2 – surrendering whole policies

As there are 1,000 policies, each individual policy is worth £120 in the second year. This represents a gain of £20 for each policy.

You could surrender 334 policies and receive £40,080, resulting in a gain of £6,680 ($£20 \times 334$).

If you are a higher rate taxpayer*, the tax due is £1,336 (20% of the gain for tax year 2010/11).

If you are an additional rate taxpayer, the tax due is £2,004 (30% of the gain for tax year 2010/11).

* and the gain, after top-slicing relief (see page 6), doesn't take your income into the additional rate tax band.

Each policy has its own 5% allowance, so when you surrender a whole policy, any accumulated 5% allowances on that policy are lost. This means the 5% allowance will then be based on the remaining policies. For the example above, in future the 5% allowance will be based on the amount you have invested in the 666 remaining policies.

Full surrender

When fully surrendering the investment bond, the chargeable event is treated as having happened on the day it is surrendered. Any tax liability is calculated based on the overall gain made on the investment bond.

The overall gain is calculated by adding the surrender value you receive to the value of all previous withdrawals you have taken, then deducting the total value of payments you have made to the investment bond and any previous gains over the 5% allowance.

For example

You invest £100,000 and later surrender it for £120,000. You have previously taken a withdrawal of £10,000 of which £5,000 was taxed as a gain over the 5% allowance.

The tax liability would be calculated as:

£120,000 (surrender value) + £10,000 (previous withdrawal) = £130,000

less £100,000 (original investment) + £5,000 (previous gain over 5% allowance) = £105,000
equals a gain of £25,000 (£130,000 – £105,000).

If you are a higher rate taxpayer*, the tax due is £5,000 (20% of the gain for tax year 2010/11).

If you are an additional rate taxpayer, the tax due is £7,500 (30% of the gain for tax year 2010/11).

* and the gain, after top-slicing relief (see page 6), doesn't take your income into the additional rate tax band.

Death

The chargeable event is treated as happening on the day immediately before the death of the last life insured.

The chargeable gain is calculated on the surrender value of the investment bond immediately before death.

On death, if the investment bond is not written in trust, depending on the overall value of the investor's estate, inheritance tax may be due on some or all of the proceeds from the investment bond.

If the investment bond is written in trust, depending on the type of trust, an inheritance tax liability may be reduced. However, most trusts can't be changed so you should seek professional advice before writing your investment bond in trust.

Assignment

Assignment means changing the ownership of an investment bond. Assigning your investment bond to someone else may cause a chargeable event and a possible tax liability.

If an investment bond is assigned in return for money or something of equivalent value, a chargeable event will occur and there may be a tax liability. If it is assigned as a gift then it will not create a chargeable event.

If the ownership of an investment bond is transferred to someone else, we need to be informed by an appropriate 'Notice of assignment'. This protects the legal position of the person to whom it is transferred. Notices of assignment must be given in writing and must state the date and purpose of the assignment.

Tax reliefs available

Top-slicing relief

Top-slicing relief applies when the addition of the chargeable gain to your taxable income takes you into the higher rate or additional rate tax band.

The gain is divided by the number of full years the investment bond has been in force or (for a partial surrender) since the last chargeable event. This produces an average yearly gain, which is treated as the top slice of income in the tax year in which the gain falls. Any tax payable on the top slice is calculated and multiplied by the same number of full years to give the total income tax payable on the gain.

For example

If you are a basic rate taxpayer and have a gain of £14,000 from an investment bond held for seven full years, the top-slice gain will be $£14,000 \div 7 = £2,000$.

The top-slice gain is then added to your taxable income and the tax liability on the total taxable income (including the top-slice gain) is calculated.

Taxable income = £36,525
Top-slice gain = £2,000
Total taxable income = £38,525

Basic rate tax is payable on the first £37,400 of taxable income. Higher rate tax is payable on taxable income above £37,400 up to £150,000. Additional rate tax is payable on taxable income above £150,000. These are the limits for the 2010/11 tax year.

In this example, £1,125 (£38,525 – £37,400) falls into the higher rate tax band. This amount is taxed at 20% and then multiplied by the number of full years that the investment bond has been in force to give the total tax liability on the gain.

$£1,125 \times 20\% = £225$

$£225 \times 7$ (years) = a total tax liability of £1,575.

A similar calculation would be required if a chargeable gain takes you from the higher rate tax band to the additional rate tax band.

Corresponding deficiency relief

There is no relief available if you lose money on an investment bond. However, 'corresponding deficiency relief' may be available when an investment bond ends.

The relief will only benefit you if your taxable income (before any gains or top-slice gains are added) is above the basic rate limit (£37,400 in 2010/11 tax year). The relief is not available for basic rate taxpayers. The relief does not extend to the additional rate of tax.

Corresponding deficiency relief is available if the chargeable event calculation on death or full surrender shows a negative amount (a loss) and there were gains over the 5% allowance from earlier tax years (because of earlier partial surrenders from the investment bond).

If a loss arises when an investment bond ends, the investor is entitled to a corresponding deduction from their taxable income for that tax year, up to the limit of the previous chargeable gains.

For example

As a higher rate taxpayer you invest £200,000 in May 2009.

In the same tax year you take a one-off partial surrender of £50,000 resulting in a gain over the 5% allowance of £40,000.

Three years later the investment bond is fully surrendered for £170,000.

The gain is calculated as:

$(£170,000 + £50,000) - (£200,000 + £40,000) = £-20,000$.

The deficiency relief is limited to the lower of the previous chargeable gain (£40,000) or the final loss (£20,000).

The relief is given by extending the basic rate band by the amount of the loss. This means that up to £20,000 of taxable income is chargeable at the basic rate instead of the higher rate that would otherwise have applied.

Sterling Investment Account

Income tax

All income generated by a fund, whether paid as income, reinvested in a fund or accumulated within a fund, is subject to income tax.

For funds investing mostly in money market instruments (such as cash deposits) and/or fixed-interest securities, interest distributions are paid (or reinvested or accumulated) with 20% tax deducted.

For funds investing mostly in UK shares, dividend distributions are paid (or reinvested or accumulated) with a 10% tax credit.

Basic rate taxpayers will not normally have any further tax to pay.

Non-taxpayers may be able to reclaim the 20% tax deducted from interest distributions, but will not be able to reclaim the tax deducted at source from UK dividends.

Higher rate taxpayers will have further tax to pay on the income. For interest distributions, an extra 20% is payable. For UK dividend distributions, an extra 22.5% is payable.

Additional rate taxpayers will have further tax to pay on the income. For interest distributions, an extra 30% is payable. For UK dividend distributions, an extra 32.5% is payable.

Distributions from funds investing mostly in property and/or overseas shares are, like interest distributions, paid (or reinvested or accumulated) with 20% tax deducted. As above, depending on your rate of tax, you may have further tax to pay, or be able to reclaim some or all of the tax deducted. Any foreign withholding tax can't be reclaimed.

This income must be declared on your normal tax return (whether paid as income, reinvested in a fund or accumulated within a fund). We will send out income tax vouchers each April covering all income generated during the previous year.

Capital gains tax

A capital gains tax liability may arise if there is a gain from selling investments in the account.

Investments will be sold in the event of:

- full cash-in
- regular and partial withdrawals
- fund(s) switching
- and to cover the account charges.

If investments are sold for more than their original cost, a capital gain will arise. Tax will be payable when the total gain, taking account of all gains and losses from all relevant investments in the same tax year (and any unused losses from previous tax years), exceeds the current annual exemption (£10,100 for tax year 2010/11).

To see what rate of capital gains tax is payable, the amount of the gain exceeding the annual exemption must be added to your taxable income in the year the investment is sold. For gains falling below the higher rate income tax threshold, the rate is 18%. For gains arising on or after 23 June 2010, any part of the gain falling above the higher rate income tax threshold is taxed at 28%.

There is no capital gains tax where investments are sold due to the death of the investor.

Other

Fund managers pay stamp duty reserve tax of up to 0.5% when buying or selling investments. Normally, the fund manager takes this tax from the fund and it is reflected in the unit/share price, so it is spread across all investors. However, fund managers may pass on the tax to individuals when they regard a transaction as significant in value.

Depending on the size of an estate on death, inheritance tax may be due on some or all of the proceeds from the account. The account can be irrevocably designated for a beneficiary(s), which would normally be a potentially exempt transfer (PET) for inheritance tax. You should seek professional advice before taking such action.

EU Savings Directive

If a person invests in certain funds and resides in a country outside the UK but covered by the EU Savings Directive, we will need to ask for certain documents to prove their date of birth, address and tax status. We will also have to give HMRC details on distributions and redemption payments we make. HMRC will pass this information to the tax authorities of the country of residence.

Sterling Individual Savings Account (ISA)

Income tax

ISAs are free of income tax, except for tax paid at source on UK dividends and any foreign withholding tax, which can't be reclaimed.

We reclaim any other tax from HMRC. We either pay this with any income payment or reinvest it in the ISA. If the reclaimed tax is to be reinvested, we use it to buy extra units/shares in the fund.

You do not need to include income from ISAs on your tax return.

Capital gains tax

ISAs are free of capital gains tax.

You do not need to include capital gains from ISAs on your tax return.

Other

Fund managers pay stamp duty reserve tax of up to 0.5% when buying or selling investments. Normally, the fund manager takes this tax from the fund and it is reflected in the unit/share price, so it is spread across all investors. However, fund managers may pass on the tax to individuals when they regard a transaction as significant in value.

The tax advantages of ISAs end immediately on death and the proceeds form part of the deceased's estate for inheritance tax purposes. ISAs can't be irrevocably designated for any beneficiary or gifted into trust.

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