Offshore Life Wrappers in an International Context

Offshore life wrappers (or "offshore bonds") have been around for a long time, but their use in private wealth management is relatively recent and is rapidly increasing in the wealth management sector. This is due in part to an increased awareness among wealth managers of life wrappers, and an appreciation that their unique structure can provide important tax and estate planning benefits and that they can be adapted to meet various needs. Their popularity is also driven by the fact that other traditional structures have lost their attractiveness, either due to legal challenges, or the introduction of targeted anti-avoidance legislation.

An offshore bond is a unit-linked insurance product that contains a range of underlying securities. The amount of life insurance within the bond is usually as low as 1% of the value of the value of the bond, but can be increased. Offshore bonds are regarded as non-income producing products by most jurisdictions and therefore are primarily of use as a tax deferral structure. They can also simplify the holding of assets by putting them all into a single structure. By having a single administrator it can make the day-to-day management of a portfolio of investments much less troublesome.

Advantages of an Offshore Life Wrapper.

Their main tax advantage is that in the UK and most of Europe, investments in offshore bonds give a gross rollup. This means that apart from a small amount of withholding tax deducted at source, they are not taxed on a yearly basis but only when a taxable event takes place, like redemption or the death of a bondholder. Switching of assets within a bond is not a tax event and therefore is a totally tax neutral activity.

Another advantage specifically for the UK investor is that they are allowed to withdraw up to 5% per year of the capital put into the bond. This 5% withdrawal is not included in the tax calculations for that individual. This can continue for 20 years or until the full capital deposited is withdrawn. In addition, if the full 5% is not used in any year, it can be carried forward to the following years. So if the investor withdraws nothing for 10 years he can take a one-off 50% (of capital) withdrawal followed by 5% a year for the next 10 years, or his withdrawal allowance could be increased to 10% for 10 years or anything in between. Gains from life wrappers are not subject to capital gains tax but are taxed under special income tax rules in the UK.

A life wrapper combines the fiscal advantages associated with breaking legal and beneficial ownership of assets as the life company holds the assets, with the control advantages of direct ownership of the life wrapper by the client. Almost any type of asset can be held in an offshore bond, including equities, funds, cash, and bonds, although there may be some restrictions in order to make it tax qualifying e.g.: UK, Spain. They can help:

- Legally minimise the amount of tax
- Control when and where tax is paid
- Ensure that wealth is passed to the right people upon death
- Minimising estate duty

Bond wrappers allow the individual complete freedom to devise his own bespoke portfolio or to appoint an adviser to manage the portfolio.

Summary of benefits of an Offshore Bond:

For the investor:

- **Flexibility**
  Switching between the various underlying assets is tax neutral

- **Centralised Administration**
  Everything happens in one place and the bond provider collates statements and valuations into 1 document.

- **Economies of scale**
  Although the bond provider charges fees, this can be offset by the bond provider using its size to negotiate better rates from fund managers.

- **For UK Investors – 5% Rule**
  UK investors can draw up to 5% of the bond per annum without being immediately taxed on it. There is also a tax benefit due to the "time apportionment" method of calculating tax so that only a proportion of the gains are liable to tax, in the same ratio as the number of years spent in the UK to the duration of the bond.

For Trustees:

- **Opacity**
  Most jurisdictions will not look through a bond to the beneficial owners, so trustees can use it to defer tax.

Uses in International Wealth Planning

Putting the legal ownership of assets in the hands of the insurer simplifies the passing of the assets on death. There is only the need to seek probate in the jurisdiction where the insurer is resident rather than in each jurisdiction where the assets are registered. It is also possible, through the nomination of beneficiaries, to legitimately bypass forced heirship rules.

An insurance wrapper is viewed in most jurisdictions as a non-income producing asset and investments can be traded without incurring immediate tax liabilities. This allows the income and gains to be sheltered from taxation until the benefits are taken. This gives the owner true tax deferral.

When benefits are taken, there are sometimes special rules which exempt a portion of the withdrawal from tax (e.g. UK where the gains are subject to time apportionment, meaning that only part of the gains are taxable - in the same ratio of time spent in the UK compared to time spent abroad during the duration of the bond), or reduce the tax payable by reference to the time held (e.g. Spain).

Because a life wrapper is a "package of separate rights" it can produce opportunities for estate duty/inheritance tax planning in ways that are not open to other structures. For example, placing the life wrapper into an appropriately worded trust that carves out separate rights for the settlor and beneficiaries can legitimately avoid UK IHT whilst giving the settlor access to the capital without

breaching the gift with reservation provisions. In other jurisdictions, nominating beneficiaries can reduce or avoid the charge to estate duty (e.g. France, Finland, Italy) and, in Hong Kong; the proceeds of life policies are completely free of estate duty in all circumstances.

Because the concept of life insurance is a universally recognised concept, it is fiscally transportable, unlike structures like trusts that are only recognised under specific legal systems. This is particularly important for wealthy European families, where individuals may move between civil law and common law jurisdictions.

The reasons why offshore bonds have become more popular in wealth management are varied, but the main reasons are more awareness, greater clarity, and the fact that other structures are becoming less attractive.

Another driver has been the move in recent years to greater transparency in the offshore market in general. With the move towards international information exchange gathering pace, there is more demand for legitimate tax deferral vehicles rather than relying on confidentiality laws. Couple this with the increasing sophistication of tax authorities in introducing anti-avoidance and controlled foreign companies legislation, we have seen a greater demand in general for contract based planning.

Offshore bonds are at the forefront of this planning. Anyone involved in wealth management will have used or encountered offshore and company structures whereby assets are held in a trust or an offshore company and even held in a company which is in turn owned by a trust. However, there are increasingly fewer jurisdictions where these structures still give fiscal advantages. This is due to Revenue authorities introducing anti-avoidance provisions that either look through the structure to the underlying beneficiaries or that tax is structured in a punitive way

Offshore Structures

- Rely on equitable interests held for third parties
- Control issues ("sham")
- Anti avoidance provisions
- Problems with recognition
- Revenue suspicion
- IHT in jurisdiction where assets registered

In relation to trusts, there are many jurisdictions where they are not recognised (or where the potential tax consequences differ depending on which lawyer you ask!!). Merely having a shareholding in an offshore company is sufficient to mark one out for special scrutiny by the tax authorities of certain jurisdictions. Another problem with these structures is that the client normally has to give up day-to-day control of his affairs. There is an increasing amount of case law where offshore trust and company structures have been set aside as "sham" arrangements because settlor have retained too much control over day to day decisions.

An insurance bond, on the other hand, is a simple contract between insurer and policyholder. It is totally transparent and can be held up for Revenue scrutiny. The tax treatment is normally governed by specific, and often beneficial, legislation, leaving little room for attack as a sham arrangement. The policyholder and his adviser retain control over the assets without jeopardising the fiscal advantages. Of course, there are other reasons for creating an offshore trust or company structure, and anyone

involved in the creation and management of offshore trust and company structure can also think of life wrappers as complimentary to such structures.

For example, where a UK resident and domiciled individual creates a trust, which incorporates an offshore company to hold investments, UK anti-avoidance legislation will cause the income and gains created within the company to filter immediately back to be assessed directly on the settlor. There are similar anti avoidance rules in other jurisdictions. However, tax deferral can be achieved in this structure by wrapping the assets in an offshore bond. No tax will be payable as long as no benefits are taken. Furthermore, if benefits are taken, it is only when there is a distribution from the company to the trust that there is a potential income tax charge.

Benefits of Offshore Life Wrappers

- Client is legally and beneficially separated from assets
- Control rest with the client
- Contract based
- Universal recognition of concept
- Generally tax favoured

Although this example is specific to the UK, anti avoidance provisions that treat offshore company and trust structures as transparent are becoming increasingly common.

This article has been extracted from Wealth Management May 2002 Issue by Brendan Harper, Technical Services Consultant, Friends Provident International Limited and from International Investment Supplement March 2003 by Dylan Emery and contains general information only and is not intended to be taken as specific investment or tax advice and is based on the assumption that further information would be required and provides only a guide to some of the relevant routes that an investor can take.