A ‘mistake’ rectified

A lesson in why it pays to take advice has ended with a creative decision from a tax tribunal.

It is unfortunately all too common for the UK’s labyrinthine tax legislation to create some unwelcome tax traps for the unadvised. One of the best/worst examples is the tax treatment of single premium life assurance policies, usually referred to as investment bonds.

The rules on these were revamped many years ago to make small regular encashments free of any immediate tax charge. Very broadly summarized, if withdrawals in a year are not more than 5% of the original amount invested, any tax liability is deferred – the so-called “5%” rule. The corollary is that the excess over 5% is immediately taxable, regardless of whether the policy is showing an overall profit.

It was the corollary which caught out Joost Lobler. He invested about $1,406,000 in offshore investment bonds in March 2006 and less than a year later withdrew $746,485 to repay a loan used in part to finance the bond purchase. In February 2008, he withdrew another $690,171. The end result of these two withdrawals was that under the 5% rule, Mr Lobler was deemed to have received taxable income of $1.3m and was liable to pay $560,000 in tax, even though his overall investment was showing a gain of under $70,000. Had Mr Lobler arranged the withdrawals in a different way (cashing in whole mini-policies rather than partially cashing all policies) his tax bill would have been probably less than $30,000.

Mr Lobler took his case to the First Tier Tax Tribunal, which held that the tax treatment was correct and “with heavy hearts” dismissed the case. Mr Lobler then appealed to the Upper Tier Tribunal where Justice Proudman performed some legal gymnastics to allow Mr Lobler to make a “rectification of a mistake”, i.e. to alter retrospectively the withdrawal basis to the one which produced a much smaller tax charge. The judgement was a surprise to many experts.

Had Mr Lobler sought advice before making the withdrawals, he could have saved himself the cost of two tribunal hearings and the trauma of several years living with the prospect of bankruptcy because of an artificial (but accurate) tax bill.

The value of tax reliefs depends on your individual circumstances. Tax laws can change. The Financial Conduct Authority does not regulate tax advice.