The Gilt That Keeps on Giving?

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This spotlight article aims to highlight the current investment opportunity in the market for UK Government bonds in which tax planning advantages could exist for UK resident and non-UK resident investors.

The UK Government primarily borrows to fund public spending by issuing fixed interest bonds known as "gilts". Each gilt purchased is essentially taking ownership of a £100 loan to the Government. The UK government is one of the safest borrowers available to lend to and so the credit risk involved in a gilt investment is minimal. Multiple gilts with different issue dates, expiry dates, and interest (coupon) rates are currently in circulation. Repayment dates range from 2023 to 2073.

The investment return on gilts has two components. Firstly, there are fixed coupon payments which are specified when the gilt is issued and do not change. If a gilt is issued with a coupon of 0.5%, it will always yield interest payments of 0.5% (paid semi-annually) of £100 until repayment. The second is capital appreciation which arises when you purchase a gilt below its face value of £100, i.e., at a discount. By way of example, if you purchase a gilt valued at £95, the capital appreciation is £5 when the gilt is repaid. Coupons are subject to UK Income Tax whereas any capital gain is exempt from UK Capital Gains Tax.

The price of a gilt moves inversely to interest rates. When interest rates rise the price to purchase an existing gilt will fall, and vice versa. Since the beginning of 2022, the Bank of England have increased interest rates sharply in an attempt to dampen elevated inflation in the UK. The consequence of this is that several short-dated gilts, which were issued when borrowing costs were markedly lower, are now priced at a historically significant discount.

This provides a tax-efficient opportunity to individuals with cash deposits as well as those looking to add diversification to their overall asset allocation. Purchasing short-dated gilts at a discount offers the opportunity for UK taxpayers to benefit from an attractive post tax return when compared to traditional interest-bearing cash deposits.

When considering cash deposits, it is important to note that an 'attractive' gross rate of interest will be subject to UK Income Tax at the investor's marginal tax-rate. For example, assuming an individual is subject to the 45% additional tax rate, a 5% interest rate on a cash term deposit would yield only 2.75% after tax. An additional rate taxpayer would not be eligible for the personal savings allowance.

As a more specific example, a £1m term deposit with a 5% interest rate, accrued daily and paid yearly, would return £71,123 at the 31 January 2025 (assuming investment on 05 September 2023). For an additional rate taxpayer, this amounts to a post-tax return of £35,561. These figures can then be compared to an investment in the gilt expiring on 31 January 2025 which has a yield to maturity of close to 5%.

As at 05 September 2023 the gilt expiring on 31 January 2025 can be purchased for circa £93.70 and the return on a £1m gilt investment in comparison to the equivalent cash deposit would be:

	Pre-Tax	Post-Tax*
Gilt Coupon Return	*£4,002*	*£2,201*
Gilt Capital Return	*£67,235*	*£67,235*
Gilt Total Return	£71,237	£69,436
Cash Deposit Total Return	£71,123	£35,561
Return Difference	-£114	£33,835

*Assumes that all eligible returns are subject to the additional rate of income tax.

It is important to note that our analysis assumes all purchased gilts are held until maturity. Any gilt sale prior to maturity could result in a capital loss if the price was to fall.

An alternative comparison is to consider the interest rate that would be required on a cash deposit to receive the same post-tax return as this gilt investment. To receive a £69,436 return post-tax on 31 January 2025, the rate of interest on a daily accruing cash deposit (paid yearly) would need to be 8.42%.

IHT Exemption for Non-UK Residents

Apart from the tax-efficient and defined return profile of the gilt (held to maturity) compared to cash, the other major benefit is the avoidance of credit risk associated with banks and the limited protection offered by the UK Financial Services Compensation Scheme (£85,000). Moreover, the liquid nature of gilts allows essentially instant access to cash unlike a term deposit where cash is locked away. However, it is important to note that if a gilt is sold before repayment is received, you could receive a price lower than you initially paid. It is therefore recommended not to purchase gilts unless you are likely to hold them until the maturity date.

For non-UK resident, UK Gilts offer an additional and powerful UK Inheritance tax (IHT) tool due to their classification as a FOTRA securities (Free of Tax to Residents Abroad). UK Inheritance tax legislation (IHT Act 1984 s 6(2)) no longer requires individuals to be non-UK domiciled to qualify for excluded property status meaning, that the beneficial interest in a FOTRA asset will be exempt from UK IHT.

Excluded property is deemed not to form part of a person's estate immediately prior to their death (IHTA 5(1)(b)). Furthermore, HMRC clearly states: 'All government securities acquired on or after 6 April 2013 will be exempt provided the beneficial owner is resident outside the UK' (IHTM 4291).

Lifetime transfers of excluded property to another person or trust is also outside the scope of IHT. Technically, no account is taken of the transfer of the beneficial interest in quantifying the loss to the estate of the transferor (IHTA 1984 s 3(2)). For wider succession planning purposes, transfers of excluded property in trusts are not liable to the 20% charge.

Unlike other IHT-efficient assets such as Business Property Relief (BPR) and Agricultural Property Relief (APR), there is no holding period necessary for the exemption under FOTRA securities to apply and no clawback. In fact, HMRC states: 'If a worthwhile amount of tax is at stake you should investigate the possibility of a last-minute purchase.'

By way of summary, buying a UK Gilts offer considerable tax advantages to UK resident and non-resident individuals alike. Gilts can provide certainty, simplicity and good value giving the absence of transaction costs. From an investment perspective the current economic landscape has made their return profile attractive, certainly as an alternative to cash, but perhaps also in the short-term to equities.

If you would be interested in learning more, please do contact your adviser and with respect to any form of tax planning we recommend seeking independent tax advice.

For more information, please contact your adviser.