GUIDE SERIES 8

FINANCIAL STANDARD GUIDE TO

# Investment Bonds

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# Contents




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**One of the best outcomes of this new awareness around investment bonds is that advisers who previously turned away clients who they felt they couldn't help, now realise they can offer them a solution.**

# Industry snapshot

While investment bonds have been around for many years, financial planners tended to overlook recommending them to their clients. The limited choice on offer and the lack of available information contributed to this situation. Instead, superannuation became the vehicle of choice for tax-effective strategies. But the situation is now changing.

Two key things are attracting financial planners to investment bonds: their tax effectiveness and flexibility. Investment bonds are a tax-paid investment vehicle that allow investors to access their funds at any time. The choice of underlying assets has widened over the years and now includes access to every asset class, which makes them a powerful vehicle for investors at all stages of their lifecycle.

Investment bonds are similar to insurance and friendly society bonds. Previously, the three differed only by the underlying tax rebate they offered, which has now been standardised at 30 per cent – the same as the company tax rate. Once super came along, these types of bonds became less attractive but this is changing as interest returns to the sector.

Probably the biggest change in the sector is that investment bonds are becoming better understood. This is partly a result of the concessional caps on super being reduced, which led to financial planners looking for alternative tax-effective strategies. Planners also found investment bonds are a viable proposition for clients who do not meet work test rules but want a tax-effective vehicle for money they may have inherited or received after downsizing of the family home.

One of the best outcomes of this new awareness is that advisers who previously turned away clients who they felt they couldn't help, now realise there is a solution for them. Also, investors who were directed to super too early are now being directed to investment bonds. While there is no denying super is the most tax-effective structure available, it is not always the best strategy for younger clients because of the length of time their money is locked away.

Investment bonds aren't for everyone – they make little sense for those who pay no or little tax. Those that do choose to invest in them do so because he or she wants to:

- Invest tax effectively over the longer term
- Avoid locking all their money away into superannuation and/or pensions
- Save for the future needs of children (for example, education or wedding expenses)
- Generate capital growth from an investment
- Avoid unnecessary tax return complications of other investments

# What is an investment bond?

Investment bonds are often described as a cross between a life insurance policy, a superannuation account and a managed fund. Investors put their money into a managed investment portfolio, which is taxed internally and a beneficiary or beneficiaries may be nominated in the event the life insured dies during the investment term.

Investment bonds are considered to be the most tax-effective structure outside of super but with two major differences: one, you don't need to meet a condition of release and two, you aren't limited to how much you can put in as you are with superannuation caps.

Investment bonds are also known as 'tax-paid' investments, where the tax on earnings is paid by the product issuer at the rate of 30 per cent.

Because the tax on earnings in the bond is paid by the underlying fund itself, investors don't have to declare any income from the bond in their tax return.

As well as offering a tax-effective, nominal rate, investors also benefit from the franking credits the underlying funds generate. There is a misconception that franking credits aren't passed on in an investment bond but this is incorrect. Another advantage for investors is that there is no capital gains tax when the bond is realised or if the investor switches between funds.

Investors can also gain exposure to a wide range of investments through bonds. More conservative investors might invest in predominantly defensive asset classes such as cash and fixed interest, while those wanting more risk can opt for growth assets such as domestic and international shares and property or a blend thereof.

Many investors ask what kind of returns can they expect from an investment bond. However, an investment bond is a structure, not an asset like a share or property. It allows you to hold assets in a tax-concessional environment. The performance of the investment bond depends entirely on the assets that it holds.

# As well as offering a tax-effective, nominal rate, investors also benefit from the franking credits the underlying funds generate.

**Advantages over superannuation**

One of the reasons for the growing interest in investment bonds is the tinkering that the government did with superannuation. While super remains a very tax-effective vehicle, the reduction in contribution caps introduced by the government in its 2012 budget turned attention back towards investment bonds.

Like superannuation, the fund provider pays the tax on the investor's behalf. While the earnings in super funds are taxed at 15 per cent, the investor's money is tied up until at least age 55. There is also a limit on how much can be contributed. Investment bonds pay a higher rate of tax (30 per cent) however investors can access their money whenever they like.

Investment bonds have many additional advantages over super. Their contributions aren't based on the age or employment situation of its investors so they provide an alternative for investors who don't meet the super work test or for those over 75 who can't contribute to super.

There are also very low initial investment limits and no upper limits on the initial investment into an investment bond. Subsequent contributions are however, limited to 125 per cent of the previous year's investment amount if the investor wishes to receive all growth and earnings on their investment without any personal tax liability after 10 years from the initial start date of their investment.

Like super, investment bonds are generally invested in managed funds. This provides investors with a range of options to suit different risk profiles and strategies.

# How it works

When investing in an investment bond, the money is pooled with other investors' capital and placed into funds that specialise in Australian or international shares, property, fixed interest or cash, which are managed by fund managers in a similar way to managed funds. Investors are also able to switch between funds without any capital gains tax implications.

The returns these investments earn are taxed in the hands of the provider and the earnings are reported net of tax. The tax on these earnings is set at the current company tax rate of 30 per cent. This is a nominal rate that can be further reduced through franking credits or other offsets.

Because the provider pays the tax, investors don't need to declare any income in their tax return. Nor do they need to keep any capital gains records.

If the investment bond is held for 10 years or more, there is no additional tax payable on the investment earnings. This is called the 10-year rule. However, if any withdrawals are made before the 10 years is up, the profit – which is the proceeds less the total amounts invested – need to be included in the investor's assessable income. It will then be taxed at their marginal rate, although any profit that is assessable will receive a 30 per cent tax offset.

How the earnings are treated from a tax point of view depends on when the money is withdrawn.

If the funds are accessed within the first eight years, then all the earnings are assessable. If the money is accessed in years eight to nine, then two-thirds of the earnings are assessed, while if they are accessed in the ninth year, then one-third of the earnings is assessed. After the 10th year, all earnings are tax paid and are not assessable.

If the investor's marginal rate is lower than 30 per cent, they will receive a credit. Investors on higher marginal tax rates pay additional tax. For example, if their marginal tax rate is 36 per cent, they will have to pay 6 per cent tax on the earnings.

The other rule that needs to be clearly spelt out to investors is the 125 per cent rule. It states that investors cannot contribute any more than 125 per cent of their previous year's investment if they want to avoid restarting the 10-year rule. (For tax purposes, the 10-year period is applicable from the start date.)

For example, if an investor invests $10,000 into an investment bond in year one, then, using the 125 per cent rule, $12,500 (125% of 10,000) may be invested in year two, $15,625 in year three and so on until year 10 when $93,132 can be invested.

If an investor stops contributing for a year, the next time they contribute, a new 10-year period for that contribution begins. The previous balance continues on the pre-existing 10-year period. No more contributions can be made to the latter because 125 per cent of zero is zero.

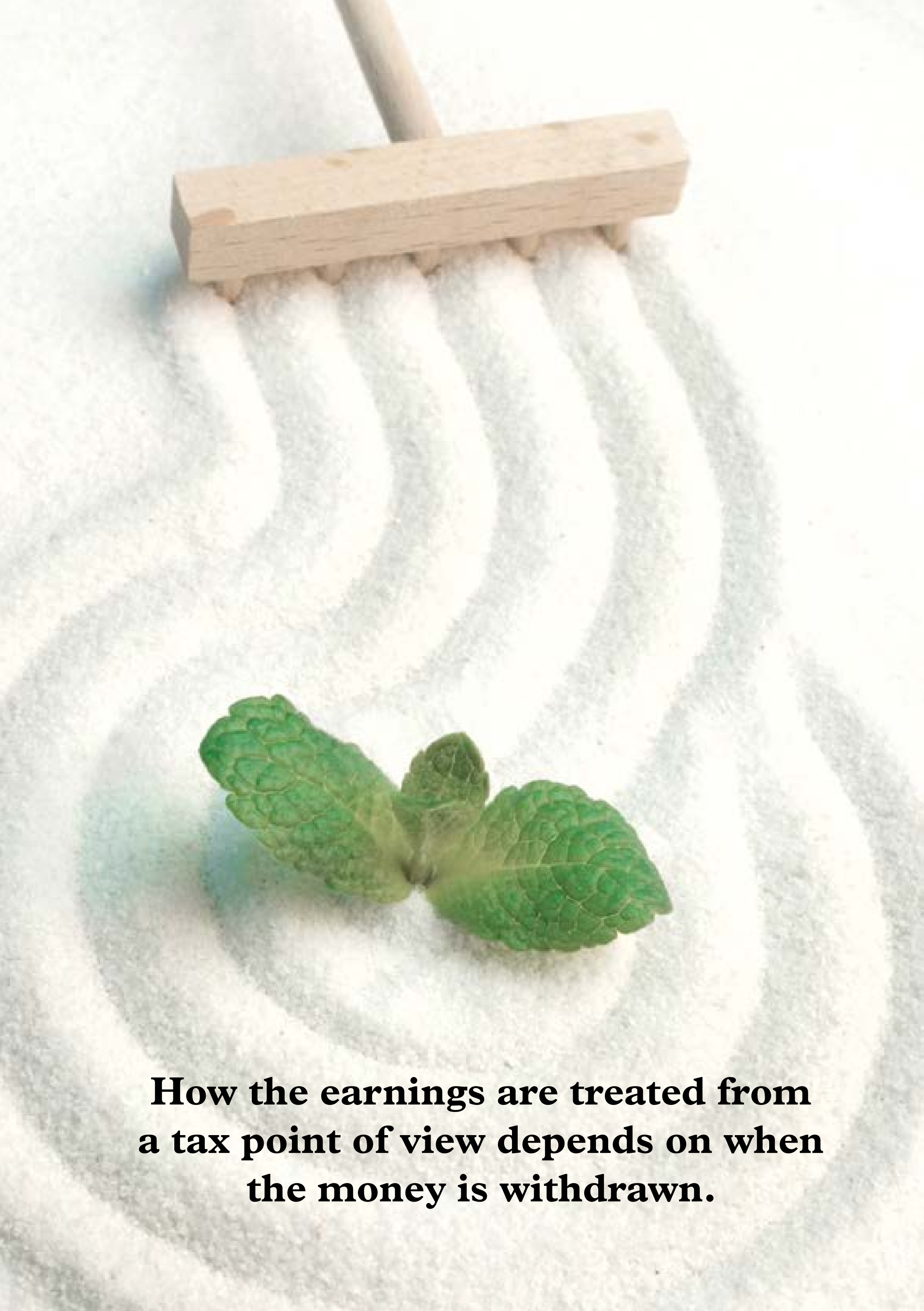
**Deliberate breach of the 10-year rule**

An investor can reset the 10-year period by intentionally breaching the 125 per cent rule, even if 10 years have already elapsed in the bond. This may be beneficial for clients who have a marginal tax rate lower than 30 per cent, as in the following example:

Danny has held an investment bond for 12 years. Over that period of time, the bond has grown from $20,000 to $40,000.

Danny has now retired and only has $20,000 of income for the year. He intentionally breaches the 125 per cent rule then withdraws the funds in the bond, causing the $20,000 to be added to his taxable income with a 30 per cent offset applied.

As Danny is now only just in the 32.5 per cent marginal tax bracket (and can also benefit from the low-income tax offset), the growth in the bond is taxed less than it would have been had it remained in the bond and was taxed at 30 per cent.



**How the earnings are treated from a tax point of view depends on when the money is withdrawn.**

### Breaking and restarting the 125 per cent rule

There are a number of reasons why investors might want to break the 125 per cent rule, such as for personal tax reasons. The following guide shows how the strategy works.

#### BREAKING THE 125 PER CENT RULE

| Date | Contribution amount |
|---|---|
| May 2012: | $10,000 |
| May 2013: | $12,500 |
| May 2014: | $17,625 |

The amount of $17,625 in the third year breaks the 125 per cent rule, as it is 141 per cent of the previous year's amount of $12,500. This triggers a restart of the 10-year period. The new start date is the anniversary date in the year the excess contribution was made, in this example, May 2014.

As an alternative strategy, the investor could contribute $15,625 in the third year, which is 125 per cent of the previous year's contribution and start a new investment bond with the additional $2,000.

#### RESTARTING THE 125 PER CENT RULE

Continuing on from the last example, if the investor chose to make the $17,625 contribution in the third year and restart the 10-year tax period, the following maximum limits within the 125 per cent rule would apply.

| Date | Contribution amount |
|---|---|
| May 2012: | $10,000 |
| May 2013: | $12,500 |
| **May 2014:** | **(This is the new start date) $17,625** |
| May 2015: | $22,031 |
| May 2016: | $27, 539 |
| May 2017: | $34,423 |
| May 2018: | $43,030 |
| May 2019: | $53,787 |
| May 2020: | $67,234 |
| May 2021: | $84,043 |
| May 2022: | $105,053 |
| May 2023: | $131,316 |
| May 2024: | $164,145 |

**There are no taxes or duty when transferring the bond to children and no capital gains tax when the bond is realised or when switching between investment options.**

# Key benefits

As investment bonds have evolved over the years, so have their benefits. Some of the key ones are listed below.

**Tax efficient:** While the funds are invested, the product provider pays the tax on the earnings so there is no assessable income to declare. There are also no taxes or duty when transferring the bond to another person and no capital gains tax when the bond is realised or when switching between investment options. This tax benefit is especially useful for investors who want to keep their income under a certain limit to qualify for benefits that are based on taxable income such as the Commonwealth Seniors Health Card.

**Flexibility:** Having unhindered access to the funds is a key benefit. Investors' money is not tied up as it is with super as there is no condition of release. The money can also be used for any purpose and withdrawn at any time. There are no work tests or contribution caps; contribution limits are only subject to the 125 per cent rule. A regular savings plan can also be set up to make contributions.

**Choice of ownership structure:** An investment bond can be owned individually, jointly or via a company or trust structure. Usually ownership can be transferred to another party without incurring stamp duty or tax liabilities and also without the 10-year period needing to be restarted.

**Borrowing:** Some providers offer an internal loan facility where investors can use their investment bond as security for a loan.

**Easy to understand:** Investment bonds are not complicated and require little paperwork. There is also no need to include any details of the bond's earnings in a tax return.

**Protection:** In the event the investor becomes bankrupt and is the life insured within the investment bond, the bond is protected from the trustee of bankruptcy. However, any transfers to an investment bond where the intention is to defeat creditors may not offer protection from the trustee.

**Certainty around estate planning:** Investment bonds allow investors to nominate a beneficiary in the event of death. Proceeds don't form part of the investor's estate and aren't distributed according to the will so can be paid directly to the beneficiaries. Generally the proceeds of an investment bond are tax free and cannot be challenged. This may vary from State to State depending on their legislation.

**Help with home-care cost:** When an investment bond is owned by a discretionary trust, it can potentially reduce the amount of the means tested care fee while preserving capital.

# IOOF WealthBuilder Investment Bond

Sponsored statement

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At IOOF, we have been helping Australians secure their financial future since 1846. During that time, we have grown substantially to become a leading provider of quality financial services. Our broad range of products and services means that our ability to provide tailored solutions to help clients achieve their financial goals is unparalleled. We believe that success only comes from caring about people and providing quality service and consistent performance.

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# Strategies for every life stage

Investment bonds can be used by investors no matter what life stage they are at for a range of strategies such as wealth accumulation and estate planning. Because they are a tax-effective structure, investment bonds are especially attractive to those wanting to reduce their income to maximise family tax payments, or to become eligible for the super co-contribution or Commonwealth Seniors Health Card.

One of the most common uses of investment bonds is for estate planning as they sit outside the will and cannot be challenged. This may vary from State to State depending on their legislation. Investors can nominate beneficiaries and any funds placed within the bond forms no part of the estate; they are paid directly to those beneficiaries. The beneficiaries don't need to be a tax-dependent beneficiary either; they can be a non-family member or a charity.

Another popular strategy is to use investment bonds to save for a major expense, such as children's education. The earnings don't need to be declared and they can be withdrawn at any time. Also, because bonds don't distribute income, they are an attractive vehicle to gift or hold funds for children. A key benefit is they avoid the punitive rate of tax on investment earnings held by minors.

An increasingly popular strategy is using investment bonds to prepare for home-care costs for the elderly. Individuals are being asked to contribute more to the cost of their care through a means tested care fee, which focuses on an income test. High-net-worth individuals who invest in an investment bond within a discretionary trust to lower their home care fees aren't affected by this.

Other strategies involve saving for a special event, such as a wedding or holiday, transferring assets from a high-income earner to a lower one, and even for business succession planning.

There are many anomalies with investment bonds, which make them an extremely flexible option when planning strategies for clients. For example, some investors will deliberately break the 125 per cent rule in order to restart the 10-year tax period in order to receive the 30 per cent tax rebate if the investment has passed its 10-year period. Alternatively, investors may withdraw funds earlier than the 10-year period because they've retired and want to put their money into super. In this event, investors still reap the benefit of the 30 per cent tax rebate on earnings.

Having this flexibility is a key attraction and it pays to remember that the 10-year rule is just a line in the sand – the funds are always available.

### Strategies for trusts using investment bonds

Having trusts purchase investment bonds can be a solution to issues around distributing income. For example, when children become adults and start earning, they may find the trust distributions pushes them into a higher tax bracket.

This scenario can be avoided when the trust buys an investment bond. In this situation, the money stays in the bond and grows but as the bond doesn't have any distributable income there's nothing to distribute to the beneficiaries. (A key requirement of trusts is that all income needs to be distributed each year and if not distributed, it is taxed at high tax rates in the hands of the trust.)

Another way a trust can utilise an investment bond is through the person insured. Every investment bond has to have a natural person nominated as a life insured. If a trust purchases an investment bond for $1 million it might make the life insured one of the trustees who is terminally ill. After five years the person passes away, and by this time the investment bond may be worth $1.5 million. The $500,000 it has increased by has no further tax liability so it can be returned to the trust tax free and distributed without any personal tax liability to the beneficiaries of the trust.

**Having this flexibility is a key attraction and it pays to remember that the 10-year rule is just a line in the sand – the funds are always available.**

# Switching investment options

Investors can switch the underlying investment options and this does not restart the 10-year period. This is an investment change within the investment structure. No tax implications are included in the client's tax return.

Most providers of investment bonds give investors a choice of underlying investments, such as Australian or international shares, property or fixed interest.

# Tax and compliance

The full amount of any capital gain is taxed at 30 per cent. While individual taxpayers receive a 50 per cent discount on capital gains realised on assets held for at least 12 months, this concession does not apply to life companies.

If a withdrawal (or redemption) is made before the investment bond has been held for 10 years, a portion of the growth is included in the person's assessable income. A tax offset is available, which represents the tax already paid while the investment was held.

Where an amount adds to assessable income, consider the impact this may have on other benefits, for example, the Family Tax Benefit or the Commonwealth Seniors Health Card.

Where there is no growth on the withdrawal, there is no impact on the tax return (i.e. a tax loss is not available).

### Calculating the amount

The growth amount is calculated in accordance with the following formula:

**A/B x [(B + C)] – (D + E)]**

Where:

**A** = amount of current withdrawal

**B** = surrender value immediately prior to withdrawal (not of the investment option in which a withdrawal is being made but the entire policy)

**C** = total of any withdrawal amounts already paid out

**D** = gross premiums paid to date (ie without deductions of charges such as commissions and management fees).

**E** = previous amounts included in assessable income

### Example

David places $1,000 into an investment bond each year. Immediately before the end of the eighth year, the policy is worth $15,000. Details for the investment bond are:

| Investment bond | Amount |
|---|---|
| Investment (premiums) | $8,000 |
| Previous withdrawals | $0 |
| Surrender value | $15,000 |

$5,000 is withdrawn from the investment bond. The growth amount included in the tax return is:

**A** = $5,000

**B** = $15,000

**C** = $0

**D** = $8,000

**E** = $0

= $5,000/ $15,000 x [($15,000 + $0) – ($8,000 + $0)]

**= $2,333**

### 30% tax offset

Any amount received from an investment bond that is included in a person's tax return is entitled to a 30 per cent tax offset. This is equal to the life company rate, which applies to earnings within the bond. The tax offset is non-refundable which means that there is no tax refund if the tax offset exceeds the tax payable.

Using the example shown above, as $2,333 is included in the tax return, the tax offset is:

$2,333 x 30% = $700

## Tax-free withdrawals in special circumstances

### Death

Any amount received due to the death of the life insured, is tax free. This is irrespective of the 10-year rule.

### Pre August 28, 1982 investment bonds

If the bond started prior to August 28, 1982, any amounts withdrawn are not included in assessable income.

### Accident, illness or disability

If the bond is surrendered due to an accident, illness or other disability suffered by the life insured, no amount is included in assessable income.

### Severe financial hardship

No amount is included in assessable income where the bond is surrendered because of serious financial hardship of the owner.

### Compliance

Compliance around investment bonds is the same as for any investment structure a financial planner is recommending to clients. The key point that needs to be communicated is that investment bonds are structures, not assets.

An investment bond gains its tax status from the fact it is regulated as a life insurance investment policy under the Life Insurance Act 1995. It has a policy owner and a life insured and allows for the nomination of beneficiaries to receive the proceeds free of personal income tax liability upon the death of the life insured.

### Social security treatment

Investment bonds are treated as financial assets for social security and DVA purposes.

Under the assets test, the account balance is an assessable asset. As investment bonds are unitised, it is the unit price of the bond multiplied by the number of units owned that is the value used for asset test purposes.

### What happens on death?

An investment bond is a life policy. The death of the life insured will trigger the payment of the investment bond either to the nominated beneficiary or the policy owner if no beneficiary is nominated. If the life insured is the policy owner and there is no beneficiary, then it is paid to his or her estate.

If there are multiple lives insured, the account balance is payable on the death of the last surviving life insured.

Note: When purchasing an investment bond it is important to consider the policy owner, life insured and the beneficiary.

# Fee structure

The fees for investment bonds are generally the same as those for managed funds. Some providers may charge an entry fee of about 3-4 per cent for all contributions including regular savings plans, although in some cases this may be rebated.

There is also an underlying management expense ratio (MER) fee, which is charged by the fund manager. This MER is the fee for managing the money. The only other fee is an administration fee.

There are no establishment, withdrawal, termination or contribution fees. There are also no fees for switching between investment options, although there may be a buy/sell spread.

In some cases a performance fee may be charged by the underlying fund manager for any outperformance of their fund against a specific performance benchmark.

# Case studies

## Case study 1:

### How investment bonds help retirees receive regular income

Tim Hartmann, Managing Director and Founder of Hartmann Planning, says he has a number of clients who have retired or are nearing retirement, for whom superannuation is not an option as they don't meet the work test rules and they are unable to receive a pension.

"But these clients also require a regular income and so they ask me how can they plan for this," Tim says. "A case in point is Doug, 78, and Mary Brooks*, 79. They recently sold the family home and downsized to a smaller property."

Tim says the residual funds from the sale wiped out their entitlement to a small pension they previously received and they now need to replace it with a regular income in order to meet their cost-of-living expenses. They own a small parcel of direct shares, which does give them some income.

"I recommended they place their money into managed funds under the structure of an investment bond and set up a regular withdrawal facility to meet their cost-of-living needs," Tim says. "An investment bond structure also allows them access to lump-sum withdrawals should they require them."

The advantage of the investment bond is that it can be structured in the same way as for account-based pension income. The investment took into account the Brooks' risk profile and the cash option was chosen for a portion of the funds to provide for their regular income payments.

"If we decide to carry out a simple reweighting at review time it will not incur any capital gains tax as switching funds inside an investment bond does not crystallise any tax consequences," Tim says.

The Brooks were also keen to keep their Commonwealth Seniors Health Card but as the fully franked dividends from their direct share portfolio were grossed-up for tax purposes, they were struggling to keep their taxable income below the eligible threshold. Now, however, because they have placed their funds in an investment bond, they are able to keep their taxable income below the thresholds and have no problem meeting the eligibility requirements to receive the card.

Through the tax effective structure of an investment bond, Doug and Mary have been able to achieve everything they wanted: they are in receipt of a regular income stream and have kept the health card.

An added benefit is that their estate planning issues have also been taken care of.

"This is because they have been able to nominate their beneficiaries on the investment bond," Tim says. "This means the funds do not form any part of their estate and will pass quickly and efficiently to their beneficiaries without any personal tax consequences to either their estate or to their beneficiaries."

* *Not their real names*

**Through the tax effective structure of an investment bond, Doug and Mary have been able to achieve everything they wanted: they are in receipt of a regular income stream and have kept the health card.**

## Case study 2:

### Tax-effective strategies using investment bonds

Managing income distributions in trusts can be a headache, especially when beneficiaries grow up and are earning their own income.

Rod Tate, founder of Tate Financial Planning, says his clients often find that family trusts that used to “work tax effectively” for them, no longer do so in later years.

“You often find that once children grow up and start earning income in their own right, it’s not effective to distribute income to them anymore,” Rod says. “Particularly now the unearned income thresholds for minors have been removed.”

Rod cites two of his clients who have found this to be the case. Bob and Irene have used a trust structure for many years. They recently sold a property and parked the proceeds in a bank account in the trust’s name.

“Bob and Irene chose not to distribute all of the income from the family trust as it affected their entitlement to the Commonwealth Seniors’ Health Card, which they want to qualify for as Bob has health issues,” Rod says. “They needed to keep their personal taxable income below the level required to qualify for the Health Card, but by choosing not to distribute all the trust income, the trust had to pay tax at the highest marginal tax rate.”

However, this situation could be avoided by strategically using investment bonds. Rod recommended that Bob and Irene invest the property proceeds in the trust, but inside an investment bond.

“The investment bond does not distribute assessable income while the funds remain invested so this approach means there is no income to the trust,” Rod explains. “This means Bob and Irene can keep their distributable income down and qualify for the card. There is also no flow-on effect of needing to distribute income to the trust’s beneficiaries or the trust having to pay tax on it at the highest marginal tax rate.”

A requirement of an investment bond is the need for a natural person to be nominated as the life insured. In this case, Bob was named.

"When Bob passes away, all income and growth of the funds invested will 'mature' back to the trust as capital and will be distributed to the beneficiaries without any further personal tax liability to them," Rod says. "This is because there is no personal tax liability to the beneficiaries of the trust if the life insured passes away. This is regardless of the amount of time invested and therefore negates the 10-year rule."

Bob and Irene have been very pleased with the investment bond strategy. It has enabled them to stay qualified for the health card and they know their beneficiaries will eventually enjoy the proceeds of the trust but without any adverse tax consequences.

Rod adds that with investment bonds, the life insured can also be amended. "This means some more strategic planning can be carried out in the future if required."

**With investment bonds, the life insured can also be amended. This means some more strategic planning can be carried out in the future if required.**

# Glossary

**125 per cent rule**
Any additional investment made to an investment bond after the initial amount must not exceed 125 per cent of the amount made in the previous year, otherwise they will restart the start date for the 10-year period.

**10-year rule**
10 years after the commencement of an investment bond, all proceeds are generally available without any additional taxation liability, providing each year's contribution does not exceed 125% of the previous year's contributions.

**Beneficiary**
The person nominated on the policy to receive the investment bond proceeds on the death of the insured. There are no restrictions on who can be nominated as a beneficiary (unlike superannuation).

**Child advancement policy**
A policy where the adult is the owner and the child is nominated as the life insured. The adult can nominate an age (between 10-25 years) when the policy is to be transferred into the name of the child as the policy owner – known as the nominated vesting age. When no vesting age is given, it automatically transfers when the child turns 25.

**Conditions of release**
The conditions by which the benefits of an investment can be released.

**Discretionary trust**
A trust in which the number of shares of each beneficiary are not fixed by the settlor in the trust deed, but at the discretion of the trustees.

**Home care packages**
A co-ordinated package of services tailored to meet specific care needs to help people stay in their own home as they age.

**Life Insurance Act**
The Life Insurance Act of 1945 laid out the main legislation to be followed by life insurers. In 1995 this Act was embedded with the Contemporary Act.

**Low income tax offset**
A tax offset available to all taxpayers on lower incomes. Being an "offset" means it is an amount subtracted from tax payable.

**Means tested care fees**
This is an additional contribution towards the cost of care that some people may be required to pay. It contributes to day-to-day care costs such as nursing and personal care.

**Policy holder**
The person who owns the policy.

**Tax paid**
This is where the tax is paid on investment earnings, at the applicable company rate of 30 per cent, by the financial institution before the earnings are added to the investor's account.

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