Investment Bonds:
Tax-effective alternatives to superannuation

A White Paper by Centuria Life Limited

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For financial adviser use only

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Introduction

Superannuation is a proven tax-effective vehicle for long-term retirement savings. Currently both contributions and investment earnings (in accumulation phase) are concessionally taxed at a rate of 15% for people with taxable incomes less than $180,000 (or 30% for those over $180,000). These are significant tax breaks compared with the highest personal marginal tax rate of 49%[1] (including the Medicare levy). Put simply, less taxes paid through the accumulation phase helps maximise retirement income in pension phase.

However, there is no certainty that superannuation's current tax benefits will remain in the medium to long term with superannuation flagged as a key component of the Commonwealth Government's broader tax system review. An increase in tax payable on either superannuation contributions or earnings would clearly reduce its appeal as a retirement saving vehicle.

Superannuation restrictions

While tax effectiveness is the key benefit, it comes with a number of restrictions:

1. Contribution restrictions

- To contribute to superannuation an investor needs to meet eligibility rules. The investor must be under age 65, or if aged 65 to 75 needs to meet a work test.

- Even if eligible, contribution caps then limit the amounts that can be contributed to superannuation.

- Contributions from an employer (including amounts paid under a salary sacrifice agreement) and contributions for which a personal tax deduction is claimed cannot exceed $30,000 in a financial year if aged under 50 and $35,000 if aged 50 and over (for the 2014/15 year).

- Personal after-tax contributions (that is, non-concessional where no tax deduction is claimed) are not taxed further on amounts up to $180,000 each financial year. Contributions above $180,000 are taxed at the marginal tax rate of 49%. Where an investor is under 65, they may be able to combine the limits for up to three years to contribute up to $540,000 in a single year.

2. Access restrictions

Access to money in superannuation is restricted until a "condition of release" is met. This generally means that the investor will not be able to withdraw or use the money until they have reached a "preservation age" and have retired.

Preservation age is 55 for an investor born before 1 July 1960 but increases up to age 60 for those born after this date. Earlier access may be allowed in exceptional circumstances, such as permanent disability.

[1] *Marginal tax rate effective for the 2014-15 tax year plus the Medicare levy of 2.0% and excluding the Medicare levy surcharge.*

While superannuation currently provides tax benefits, the inclusion of superannuation as a key consideration of the Commonwealth Government's broader tax system review may create future uncertainty for financial advisers and their clients, particularly should the review lead to changes in the taxation concessions currently available for superannuation.

Introducing Investment Bonds

Is there an investment vehicle with fewer limitations? Ideally this would be an investment structure providing investment flexibility to complement superannuation and potentially reduce the investor's tax liability over the long-term (10 years or more).

An Investment Bond structure presents a tax-effective vehicle which can complement superannuation in saving for retirement, and particularly for investors with higher marginal tax rates. A key benefit is where funds remain invested for at least 10 years, then personal tax obligations are permanently removed after year 10. An Investment Bond also combines a life insurance policy with the investment, and can be used in estate planning to simplify wealth transfers external to a will.

Centuria Life is a leading issuer of Investment Bonds.

The key benefits of Investment Bonds in complementing superannuation are outlined below.

An alternative tax-effective structure

In both superannuation and Investment Bonds, tax is paid within the investment vehicle, not personally by the investor. Investment Bonds pay a maximum a tax rate of 30% on investment earnings and growth, although franking credits and tax deductions can reduce this effective tax rate. This makes Investment Bonds an attractive investment option for high-income earners with marginal personal tax rates as high as 49% (including the Medicare levy).

With tax paid on bond earnings capped at 30%, if an individual's taxable income is at least $37,001 p.a. the tax paid on any additional income from discretionary investments will be greater than on Investment Bond earnings, per the table below:

Taxable income	Marginal tax rates (%)*
0 – $18,200	Nil
$18,201 – $37,000	21
$37,001 – $80,000	34.5
$80,001 – $180,000	39
$180,001 and over	49

**Please note that the rate is inclusive of the Medicare levy and temporary budget repair levy, and is exclusive of the Medicare surcharge.*

A key feature of investment bond structures is if the investment is fully or partially withdrawn after 10 years, the investor pays no personal income tax. If a withdrawal is made within the first 10 years, the investor will pay tax on the assessable portion of growth, as shown in the table below.

Withdrawal occurs	Taxable portion (of growth withdrawn)
Within first 8 years	100%
In year 9	Two-thirds
In year 10	One-third
After 10 years	Nil

If investments are withdrawn within the 10 years, the investor receives a full 30% tax offset from tax already paid within the Investment Bond. This reduces the effective tax payable by the investor on the taxable amount. For example, assume a $50,000 withdrawal containing a $10,000 growth component. The tax implications for the various individual marginal tax rates are calculated in the table below.

Marginal Tax Rate	21.0%	34.5%	39.0%	49.0%
Up to 8th year (100% Assessable)	$10,000	$10,000	$10,000	$10,000
Marginal Tax Payable	$2,100	$3,450	$3,900	$4,900
30% Tax offset	$3,000	$3,000	$3,000	$3,000
Net tax	$900 benefit	($450)	($900)	($1,900)
9th year (2/3 Assessable)	$6,667	$6,667	$6,667	$6,667
Marginal Tax Payable	$1,400	$2,300	$2,600	$3,267
30% Tax offset	$2,000	$2,000	$2,000	$2,000
Net tax	$600 benefit	($300)	($600)	($1,267)
10th year (1/3 Assessable)	$3,333	$3,333	$3,333	$3,333
Marginal Tax Payable	$700	$1,150	$1,300	$1,633
30% Tax offset	$1,000	$1,000	$1,000	$1,000
Net tax	$300 benefit	($150)	($300)	($633)
After 10 years (Nil Assessable)	$Nil	$Nil	$Nil	$Nil
Tax	$Nil	$Nil	$Nil	$Nil

Tax simplicity

Investment bonds provide simplicity as earnings are automatically reinvested in the bond and taxed within. This means that income and capital gains are not distributed to investors and do not need to be annually tracked or included in investors' personal tax returns.

If investors' financial goals or views change, they can also switch easily between investment options within their bond without incurring any tax or Capital Gains Tax implications. Switching also does not affect Investment Bond's 10-year tax period.

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Flexible contributions

There is no limit on either the initial contribution amount or total contributions in the first bond year. Contributions can also be made at any time thereafter. As long as contributions in any subsequent bond year do not exceed 125% of the contributions in the previous year, all contributions and growth will be free of personal income tax after 10 years. This means that additional contributions can have a term of less than 10 years, and their growth or earnings will still be tax-free.

For many investors the ability to progressively increase contribution amount over time is consistent with life events and greater disposable income, for example through paying off the mortgage, lower outgoings in school fees, or investing proceeds from an inheritance. Under the 125% rule an investor making an initial contribution of $25,000 can invest up to a further $6,250 in year 2, and progressively build savings as illustrated in the table below.

Bond Year	Contribution	Total Contribution
1	$25,000	$25,000
2	$31,250	$56,250
3	$39,063	$95,313
4	$48,828	$144,141
5	$61,035	$205,176
6	$76,294	$281,470
7	$95,367	$376,837
8	$119,209	$496,046
9	$149,012	$645,058
10	$186,265	$831,323

Over 10 years $831,323 has been contributed but only $25,000 for the full 10 years. Importantly the investor can withdraw their investment plus any growth or earnings tax-free at the end of the 10-year term. Or the investor may keep the Investment Bond open and make additional contributions beyond 10 years with these investment amounts also tax-free on withdrawal.

If additional investments exceed the 125% limit in any year, the 10-year tax period will restart from the year in which the excess contribution is made. However, Centuria monitors additional contributions to help ensure investors do not breach the 125% limit, so exceeding the limit is likely to be a deliberate decision of an investor’s strategy.

If the investor does not contribute in a particular year, then a contribution in any subsequent year will restart the 10-year tax period. This may be a deliberate investment strategy, or may have resulted from a life event adversely impacting the investor’s ability to contribute. However, with a minimum additional investment of $500 per year there is great flexibility for investors to maintain their 10-year tax benefit.

Flexible withdrawals

Investment Bonds provide flexibility and peace of mind as they allow investors access to their money at any time.

Where an investor's original intent in establishing the Investment Bond may have been as a complimentary retirement saving vehicle to superannuation, their circumstances may change – for example a family illness or extended unemployment – and they may need access to part or all of their investment.

Unlike superannuation, the assets are not preserved until retirement or subject to age-based restrictions, any condition of release, or amount limits. There are also no break costs. However, the tax position varies for different types of withdrawals. With Investment Bonds, investors can make tax free full or partial withdrawals at any time where:

- suffering a disability, without having to satisfy any strict rules that limit the tax concession to a terminal medical condition, if the investor is also the nominated life insured within the Bond.

- experiencing unforeseen serious financial hardship, without having to satisfy the onerous procedural rules that apply to superannuation.

Investors can also make taxable full or partial withdrawals:

- if going overseas without being restricted by the preservation rules that apply with superannuation benefits, even when leaving Australia permanently (special inter-fund portability rules apply with a transfer to New Zealand).

- for any other reason.

Where these withdrawals are made within 10 years of the commencement of the Investment Bond's term, then some or all of the investment growth will become assessable and may be subject to personal income tax adjusted for a 30% tax offset.

Flexible estate planning

An Investment Bond combines a life insurance policy with an investment and enables tax-effective estate planning and simple wealth transfers external to a will. The life insured within the Investment Bond has significant flexibility and control in determining beneficiaries of any ‘death maturity’ payments.

In superannuation, death benefit tax concessions apply only to dependents of the life insured. However, an Investment Bond’s death benefits can be directed tax-free to any nominated beneficiary, including adult family members, or the estate. How long the bond has been held does not impact the tax-free status. This flexibility may reduce the risk of disputes over estates and enable the benefits to be paid more quickly.

Investment Bonds may be jointly owned, for example with a spouse or partner. In the event one co-owner dies the ownership continues and is treated as being held by the surviving owner. There can also be more than one life insured. In the event one dies then the surviving person continues as the life insured.

Investment Bonds can also be established on behalf of children, providing simplicity in managing the tax that applies to children’s income. An Investment Bond may also be assigned to a child in the future (subject to parental or guardian consent) without any tax or legal complications. The child has the option to continue holding the Investment Bond without affecting the original 10-year tax period start date.

Conclusion

Centuria Investment Bonds are a tax-effective investment vehicle providing investors with a range of flexible contributions, withdrawal, and estate planning benefits. They can effectively complement superannuation in saving for retirement, and especially where funds can remain invested for at least 10 years.

Centuria Capital is an ASX-listed diversified funds manager with $2 billion in funds under management. Its Investment Bonds and other businesses offer something refreshingly different to direct clients, and to financial advisers and their clients. Your investment is constantly under the control of an expert with in-depth market knowledge, commercial acumen and an unerring sense of what matters to you.

Summary comparing strategies

Factor of comparison	Investment Bond	Superannuation
Tax concessional contributions	N/A	Currently taxed at 15% Annual limit of $30,000 if aged under 50, or $35,000 if over 50
After tax contributions	No annual limits, but 125% cap on previous year's contribution to maintain 10 year tax free withdrawal option.	Annual limit of $180,000. Contributions above $180,000 taxed at 49%.
Contribution eligibility	No restrictions	Investor must be under 65, or meet work test if aged between 65 and 75.
Tax on growth and earnings through accumulation	Headline rate of 30% Paid within structure	Headline rate of 15% Paid within structure
CGT when switching options	Nil	Nil
Withdrawal eligibility	No age limits or other restrictions	Preservation age of 55 or 60 subject to year of birth
Disability / hardship release	No restrictions Tax free for all disabilities	Subject to procedural rules Tax concession limited to terminal condition
Tax on growth at withdrawal	Within 8 years 100% In year 9 two-thirds In year 10 one-third No tax after 10 years	No tax if aged over 60
Death benefits	Tax concessions for any beneficiary or estate	Tax concessions only for dependents
Ownership	Can be joint owned, established on behalf of other person, or assigned to child in future	Sole owner, not transferable