What You Need To Know About Insurance and Investment Bonds

Unless everyone you want to provide for already has income of over $135,000 a year investment bonds do not offer a tax benefit. Even then the limited tax benefit may be completely offset by the fact that capital gains on investment bonds do not qualify for the 50% CGT discount. Probably the only advantage you will gain is bypassing your will to leave money to someone but there are other ways of doing this. Further, consider that the only people who can challenge your will are those dependent on you, spouse and your adult children the tax losses of using these bonds are a high price to pay to keep your wealth out of the hands of your immediate family.

There is no secret trick to Investment bonds that mean they will earn any better than any other market investment. If anything they have a lesser chance because most of the bonds take a notional tax out of your balance for unrealised capital gains whenever they value your portfolio so you actually have less money working for you.

Taxation of Bonds:

The Bonds are run by companies so qualify for the 30% tax bracket. People with a taxable income between $45,000 and $135,000 are also in the 30% tax bracket though individuals also have to pay a 2% Medicare levy. The kicker is that companies do not qualify for the 50% CGT discount. They pay 30% tax on capital gains whereas individuals even in the maximum tax bracket only pay 45% plus Medicare /2 = 23.5% tax on capital gains. When you cash in the insurance bond all investments are sold and the CGT @ 30% paid out of the sale proceeds then given to you. Some Investment bonds even calculate your unrealised capital gain each month and reduce your account balance by the notional CGT. So it is spin to say that you receive the investment at the end of the term tax free. It is just tax paid by you out of the money they hold for you.

Understanding the Hype:

- Claims that the bonds pay less than 30% tax. This is because they claim franking credits received on dividends to pay some of the tax. Something that any individual investor would also do. This statement is a deliberate attempt to mislead.
- Claims that after 10 years your investment is returned tax free. This is a ploy to lock you into them for 10 years when all they will do at the end of the time is deduct the tax payable out of the money they give you back. As the tax is already paid of course you do not have to include it in your tax return again.
- It is not an effective way of keeping money from Centrelink as the gifting provisions still apply and if your income is so low you qualify for the age pension you are probably in a lower tax bracket than the insurance company providing the bond. If you are under 75 put it into super where the earnings or capital gains won't be taxed at all if you have retired or at worse 15% on earnings and 10% on capital gains.
- Claims that it is a way of controlling from the grave when the beneficiary receives the money. That is what your executor can do. Also consider if these children are minors and inherit money then they will not be charged the penalty tax rates that apply to normal passive income of minors. They will be taxed at normal adult tax rates which even if they have $135,000 a year in income will not go over 30% but even better still they will get the 50% CGT discount on any capital gains.
- Claims that you can switch between types of investment options without triggering CGT are just smoke and mirrors. When they determine the value you are transferring across they have already reduced it by the CGT on any gain at 30%! Do they really expect us to believe that some how there is not tax payable on the gains on these investments? That somehow they have a loophole that avoids CGT. If they claim that you just switch and someone else picks up the share you leave then it is a Ponzi scheme they are really saying the new investor has to pay tax on your capital gain. There is no magic trick to avoid CGT it is as certain as death.

Providing for a Child's Education:

Education Bonds are a similar product. Even if both parents are earning over $135,000 so over the 30% tax rate consider the capital gains tax when the investment is sold. If the parents are both in the maximum tax bracket then consider holding it in the child's name the maximum tax rate is the worse they are going to be taxed at but the capital gains can be deferred until they are 18. If you are a grandparent or older parent wanting to provide for a child's education, odds are you will be 60 and retired by the time they need the money. So you will have reached a condition of release to be able to draw the money out of super to give it to them. Meanwhile the absolute worst tax rate the earnings will suffer is 15% and the worst capital gains tax will be 10%. If you are in pension phase it will be zero. Even better still you will probably qualify for a tax deduction when you put the money into super to invest for them. There is no tax deduction for money that is paid for an insurance bond yet you are quite probably moving the money into a higher tax environment.

Discretionary Trusts Cover all the Options plus Give You the CGT Discount:

Investing in through your own discretionary trust can provide a solution to all the issues Investment bonds are intended to address and still give you a better tax outcome than Investment bonds. You can keep the cost down by being the trustee yourself rather than set up a trustee company. The key is that every year the trustee gets to decide who gets the income and who gets the capital gains earned within the trust. Income and Franking credits can go one way and capital gains the other to ensure the 50% CGT discount applies

If all members of your family are above the 30% tax bracket then make a bucket company the income beneficiary of the discretionary trust in that year. Try to avoid selling any investments so you do not have to distribute capital gains until the child is 18 but if there are some capital gains then stream them out to individuals even if they are in the maximum tax bracket, because of the discount they will only pay 23.5% not the company rate of 30% which would be the case inside an Investment bond. The bucket company will have to pay 30% tax just the same as an Investment bond and can use the franking credits from the investments to do so. But this is not a final tax just a holding account, you can claw that back when you have a low tax bracket family member when maybe someone goes on an overseas holiday or takes time off to look after family. The idea is the shares in the bucket company are owned by a discretionary trust. When the time is right all the income stored up in the bucket company can be paid out to the second discretionary trust along with the franking credits which then distributes them to a low income beneficiary and if their income is low enough the unused franking credits can be refunded. Maybe even wait until retirement to do this. In the meantime there will be funds sitting in the bucket company that will need to be invested. If the bucket company buys the investments direct then any capital growth will not be entitled to the 50% CGT discount. Consider lending the money to a discretionary trust at a commercial interest rate so that it is the trust that makes the capital gain. The trust will get a deduction for the interest paid so it all works out in the wash.

Now this all may seem complicate and not suitable for the average investor. This strategy is directed at a family that can't find anyone that is not in the maximum tax bracket so they no doubt have a lot of wealth to make this strategy worthwhile.

If you don't think it is worth the trouble and your family are all in the maximum tax bracket then consider investing in their name. Sure it will cop the maximum tax bracket until they reach 18, no worse then in your name but at least you can put off realising the capital gain until they are over 18 and strategically pay little or no CGT.

Both discretionary trust and holding the investment direct in the name of a child bypass your will. In the case of a discretionary trust the real controller is the trustee and the appointer decides who the trustee is. If you appoint yourself and the person you ultimately want to benefit as appointer of the trust then when you die the control of that trust will pass to them. No CGT triggered because the assets are still owned by the trust. This also means that while in your lifetime you may flick around the distributions to suite tax brackets once you die the other appointer can if they choose distribute the lot to them or their family at their discretion.

Conclusion:

Investment bonds defy logic and you have got to wonder how they manage to sell these products now that Cigar magazine has gone out of print. The whole investment bond argument turns on don't trust your family, don't trust superannuation law but do trust insurance companies and pay 30% tax on income and capital gains because you should not trust your family to do the right thing but you can trust them. The investment bond industry is a lot less regulated than superannuation funds, beware.