Cashing in on insurance bonds

The new super changes may see insurance bonds make a comeback.

Summary: Ahead of super changing on July 1, and the Government cutting back retirement planning options, insurance bonds are set to regain popularity. An insurance bond accumulates earnings and capital growth and is most tax-effective if held for more than 10 years.

Key take-out: Insurance bonds are a tax-effective tool in the investment mix for some, especially high-income earners who have maxed out their super contributions.

We all know the saying, "everything old is new again" – and so it is with insurance bonds.

Technically termed 'insurance and friendly society bonds', most of us think of insurance bonds as relics from the 1980s. But with the Government cutting back retirement planning options, they are being brought out of the bottom drawer again. In particular, for those currently fortunate enough to be cashed up but still wanting to invest tax effectively (or provide an intergenerational wealth transfer).

An insurance bond (IB) is a tax-effective medium- to long-term investment which accumulates earnings and capital growth. Earnings are not included in the owner's tax return, unless the IB is cashed in early. After a decade, the earnings can be paid out tax free. Extra payments of up to 125 per cent of the previous year's contribution can be added and, if added correctly, these increments will not reset the '10-year cycle'. Switches within IB investment options are also usually permissible.

Some older-style IBs are capital guaranteed by the financial institution which offers them. Some providers also guarantee earnings when they are credited to the bond. Others are market-linked to less volatile investments, such as government bonds, or have a limited exposure to shares and are marketed as 'capital secure' or 'capital stable'.

'Managed growth' IBs are usually linked to stock markets, so their value will fluctuate. Past performance is, of course, no guarantee of future performance.

Fees may range from zero to 5 per cent on IBs, depending on the institution and the terms of the bond. Additional deposits and withdrawals may attract fees. There may be an annual management fee deducted before the return is declared.

A tax haven

When withdrawn in the first eight years, all earnings from the IB are taxable, less a 30 per cent tax offset. If withdrawn in the ninth year, two-thirds of the earnings are taxable, less a 30 per cent tax offset. In the tenth year, one-third of all earnings are taxable, less a 30 per cent tax offset.

After 10 years, there is no tax due and no tax offsets. And, on death, an IB is free of further tax to the estate/beneficiaries.

Some modern IBs allocate income and capital gains in the same way as a superannuation fund, or an account-based pension. But, unlike super, they can be accessed within the first 10 years, subject to the tax implications outlined above.

As Canberra's new 'anti-retiree' super regime comes to the fore, there are benefits to be considered in using an IB to protect your cash.

Post July 1, 2017, the new pension transfer balance cap (PTBC) and total super balance rules start to apply. The retirement strategies of many investors will need to change dramatically. The 'good old days' are over – where you could contribute excess cash into super each year, possibly until age 75.

In the new financial year, anyone with more than $1.6 million in superannuation will be ineligible to make additional non-concessional contributions. While the recent federal budget discusses allowing 'downsizers' to include $300,000 into their super, this is not yet law (in any case, there may also be a few negative consequences of this legislation, to do with Centrelink, if it were enacted).

Worth it for the high net worth

Academics, public servants and politicians – in fact, anyone expecting a defined benefit pension over $100,000 per annum – will be affected post-July 1, 2017. Most people don't yet realise they are caught in the net of the changes. A defined benefit pension is valued by Canberra at 16 times its annual payout; so expect to hear a lot of grief from those negatively impacted in the new financial year.

A significant benefit for the high net worth individual who has now officially 'maxed out' their non-concessional contributions prior to June 30 this year is that the IB is only taxed at a maximum of 30 per cent within the fund. This can be very advantageous for anyone

paying tax at the top marginal rate of 47 per cent, with the added benefit of not having to pay a Medicare or NDIS levy.

There may be benefits for those on more modest incomes as well, given that the average Australian worker has between $37,000 – $87,000 in annual taxable income to place them in the 34.5 per cent personal marginal tax bracket.

A tool in estate planning

My clients are often reluctant to use IBs when I first float the idea. As most retirees, they are over 60 and, by then, they are well aware of their own mortality.

Which leads neatly into a further advantage afforded by IBs in estate planning. On the death of the owner, the proceeds can be paid out 100 per cent tax free. If you happen to live long enough to benefit, there could be a very good tax-free party at maturity 10 years from now.

And if you must withdraw funds early, the sliding taxation scale – less a 30 per cent tax credit for the tax paid by the IB on your earnings and growth – still makes withdrawals attractive prior to the 10-year mark.

Acquiring an IB may also be a useful strategy on diagnosis of a terminal, but not immediately acute, medical condition. Ensure, however, that you explore with your financial adviser as a matter of urgency all available strategies to maximise returns to your estate – including cash-out and re-contribution strategies – to remove the almost 20 per cent 'death tax' on unspent superannuation.

Bear in mind that IBs are not as tax-effective as superannuation. They are not for everyone. They are a strategy option for when super has been maxed out and all the bring-forwards have been enjoyed.

From a financial planning perspective, the Federal Government's clampdown on superannuation is not without a silver lining. It challenges us to get on with what our clients pay us for – that is, designing and implementing new strategies which will help them get rich slowly and stay rich.

Theo Marinis