What to do when you have too much money…

Theo Marinis tells the story of a client who received an unexpectedly large inheritance and how she could use an investment bond to achieve intergenerational wealth transfer.

Life inevitably presents us with challenges. This particular challenge came via a new client aged 61, divorced, and with around $400,000 in super, plus an entitlement to a similar amount from her ex-husband's super.

She came to me to seek advice regarding the super split of her ex-husband's Public Service Super benefits – and then her father passed away.

Suddenly, she was presented with a rare and somewhat interesting phenomenon – she had too much money…

Dad obviously cared deeply for his family but worried about new partners exploiting inheritances and had set up a $2 million testamentary trust for each of his children, generating an average return of approximately $180,000, or around 9.0 per cent, per annum.

They had no idea it was coming – or that he was so wealthy.

The scenario generated the potential for a number of strategies – superannuation, a capital gains tax-free house upgrade… and a secret 'game-changer' – long-term inter-generational wealth creation.

For my client, the inheritance, in addition to her own pre-planning, represented far more than she wanted or needed. At the time, her annual living expenses were covered by around $60,000 from her combined super accounts, some $800,000 in total. Owning her home and car, she was happy with her lifestyle and didn't feel a great need to splash cash.

There were, however, her two adult children she felt would benefit from some immediate support (and who in fact, will eventually inherit the trust) and her new (informal) partner to whom she wished to cautiously provide some assistance.

Finding herself with $2,800,000 in income-generating investments, with the potential to generate $240,000 p.a., she understood that a significant amount of money would create some investment challenges, not the least of which was to keep the tax liability within the legal and morally permissible limit.

Not surprisingly, the first wealth creation 'bucket' I advised my client to fill was superannuation.

With superannuation contributions taxed at 15 per cent on the way in, just 15 per cent on earnings, and tax-free on the way out (either as a lump sum or as regular pension payments after age 60) the tax benefits are compelling.

If this client is able to work 40 hours within a 30 day period each year, after age 65, she will be deemed to be 'gainfully employed' and able to make additional annual super contributions of up to $100,000 until age 75, or until she reaches the Transfer Balance Cap of $1.6 million – which won't take too long. When reached, based on a portfolio with an assumed earning rate of 5.0 per cent pa, her TBC balance will generate tax-free income of $80,000 p.a. for as long as it is needed.

Bear in mind that on this same amount of $1.6 million, the income generated via the fully invested direct share portfolio within the testamentary trust has been closer to $144,000 p.a., based on recent earnings of 9 per cent p.a. However, this relates to an aggressive asset allocation, and for reasons borne out by the current investment climate, this is not an asset allocation I would generally recommend for an income strategy.

Under the terms of the trust, my client is able to pay for education expenses and housing; therefore she has the option to pay off the HELP debt for her son and daughter – and to loan funds to each of them to buy an apartment, if she chooses.

But what else?

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If she does nothing more the trust will be kicking off a lot of income which will attract up to 47 per cent in tax.

Given that my client did not want to move into a more expensive CGT-free home, effectively discounting this second repository, there was a third line in the strategic approach, and (depending on the individual) one worthy of consideration after the first two logical steps had been addressed.

This strategy involves the use of the 'tax paid' investment bond (previously known as an insurance bond) and considered by many as the 'ugly duckling' of the investment world. Like a swan, however, the beauty of the investment bond emerges with time.

Not for short-term thinkers and not without some surrounding misconceptions about their benefits, there are several rules which make this vehicle especially appealing to long-term investors interested in intergenerational wealth transfer.

Investment bonds are tax-paid investments i.e., issuers pay the tax on earnings at the tax rate of 30 per cent rather than the investor's personal marginal tax rate, and these earnings do not contribute to the investor's personal income.

This can be particularly tax-effective for investors with a marginal tax rate above 30 per cent – and bearing in mind that my client was at risk of paying 17 per cent above that rate.

No personal tax liability is incurred by the investor on investment earnings while they remain invested.

If an investor makes a withdrawal within 10 years of their initial investment date, they will generally need to include a portion of the earnings generated by the investment bond as part of their assessable earnings for that financial year.

There is, however, a compensating tax offset available (currently 30 per cent) which can be used against any personal tax payable in the financial year the withdrawal was made.

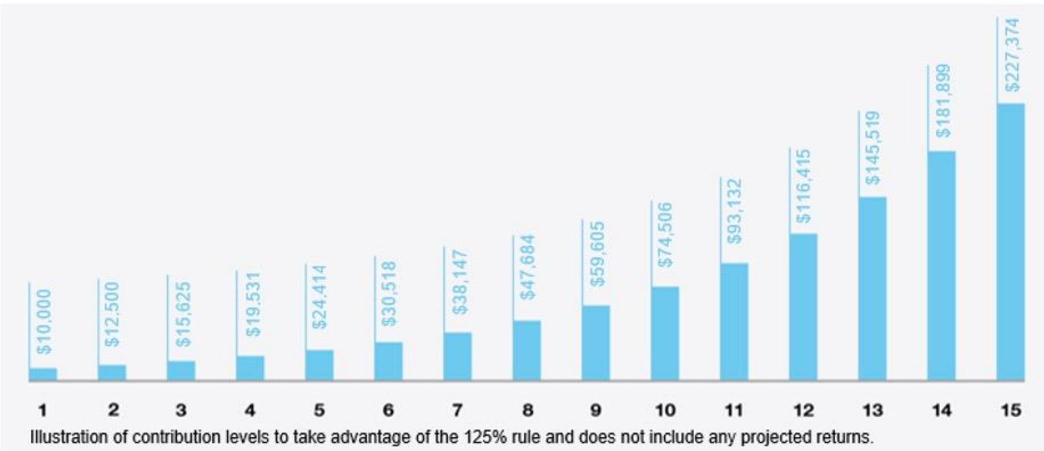
The really exciting thing is that if an investment bond has been held for 10 years, there is no personal tax liability on withdrawals made after this time. This is commonly referred to as the 10-year rule and this period begins on the date the investment bond is first established. The 10-year rule period can be re-set in certain circumstances which are explained in the paragraphs which follow.

Unlike superannuation, there are no contribution caps, and no limits on the amount investors can contribute in the first year.

For each subsequent year, additional contributions of up to 125 per cent of the previous year's contributions (commonly referred to as the 125 per cent rule) can be made without re-setting the 10-year rule period.

For tax purposes, these additional contributions are treated as if they were invested at the same time as the initial contribution. This means these additional contributions do not have to be invested for the full 10 years to be included as part of the 10-year rule period.

The following 125 per cent rule contribution calculations are based on an initial investment $10,000:



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One of the common misconceptions about investment bonds relates to the way in which they are invested, but the underlying portfolio is the same as any other diversified investment.

Investors can also build their own portfolio by investing in a single asset sector or use diversified investment options designed to suit their individual risk profile.

Product providers generally offer access to a wide range of leading Australian and international investment managers, allowing investors to diversify across asset classes, markets and regions, or across different managers with different investment strategies. There is also the flexibility to switch between investment options if required.

This facility allows my client to establish a new investment bond, to park her excess cash in a tax-effective environment each year. After 10 years she has the option to reset or distribute the proceeds – without incurring a personal tax liability.

As is the case with any asset, the investment bond will form part of her estate, however, some product providers also facilitate the transfer of ownership to a nominated beneficiary on death – effectively bypassing the estate, but also allowing the investment bond to continue without resetting the 10 year period.

The transfer of ownership can be made without the prior knowledge of the intended recipient. There is even the option of restricting how much can be accessed annually by the transferee, which is a great way of managing how funds are distributed after death.

I expect that before too long my client will have more than double the annual income she had expected – tax-free – and a massive $2.8 million-plus investment machine behind her.

I have encouraged her in the philosophy, now that we have her financial strategy in place, to plan for a happy life, and to live generously by identifying causes which mean something to her, to donate, become a known benefactor, and to be involved as a volunteer.

And in these COVID times, I also encouraged her to spend her budget, not just save. That means buying jobs for her fellow Australians.

Research shows that as Australians, our spending reduces as we age. This makes sense as we are less likely to go on expensive holidays and out to expensive restaurants (when we can again – and we will in time) as a lot of people fear they will 'blow' their investments in their old age.

Provided you have a reasonable amount in retirement savings and stick to the age-based statutory superannuation drawdown limits designed to fund you until age 110, this should not be the case.

I expect my client's children to inherit many millions of dollars from their mother and grandfather, but that can also be personally destructive. I am encouraging her to be like her own dad and keep quiet about what her children will eventually receive.

It will hopefully, come as a pleasant shock, and equally, come at a time they are more mature and able to make sensible long-term intergenerational plans, as their mother and grandfather did.

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