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Using Investment Bonds for tax-effective investing

A White Paper by Centuria Life Limited

June 2015

Introduction

For investors seeking tax-effective investment vehicles, there are a number of choices. Superannuation may work well, especially for some high net worth investors, but the money may be locked away for a long time and they may wish to diversify to other structures to build wealth.

Many set up private companies to hold investments, as earnings on funds held within a private company are taxed at the company rate of 30%.

However, investing in a company structure may only be a tax deferral mechanism. Eventually funds paid out of the company will be taxed at the investor's marginal rate at the pay-out date. In the case of high net worth investors, it's probable that the marginal rate will be higher than the company tax rate.

So while a company structure may offer increased flexibility, it is not without its limitations. Aside from the tax payable, there are other considerations:

- Capital gains tax reporting or compliance
- Little protection from creditors following a bankruptcy event
- Estate duties may be payable if the investor dies, at a loss to the surviving beneficiaries.

What if there was an alternative investment vehicle with less of these limitations? What if that investment structure provided the flexibility to complement a superannuation fund but did so with greater simplicity, and also potentially reducing the tax liability of the investor over the long-term (10 years or more)?

Introducing Investment Bonds

For high-income earners, Investment Bonds are a tax-effective alternative investment vehicle. If funds remain invested for at least 10 years, then personal tax obligations are permanently removed after year 10. Investment Bonds can thus provide a significant tax saving, especially if the investor is paying tax at the highest marginal rate.

How are Investment Bonds taxed?

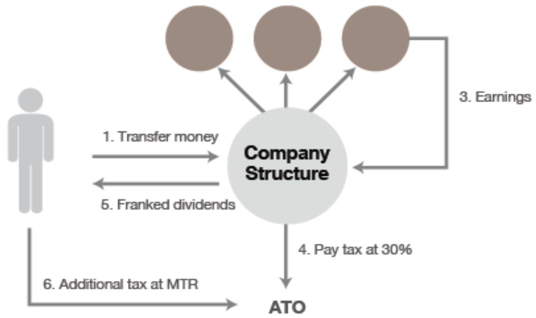
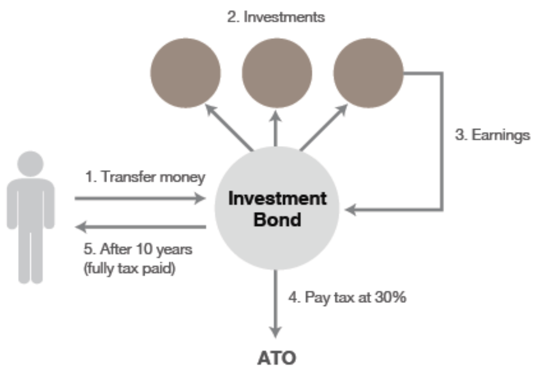
The taxation of an Investment Bond falls under company tax rules. Tax on earnings is payable at the company tax rate, currently 30%. In contrast, the top marginal rate on personal taxes, inclusive of the Temporary Budget Deficit and Medicare Levies, is 49%. If an Investment Bond is held for at least 10 years, earnings do not need to be included in the investor's tax return. Tax within the Bond is capped at the company tax rate of 30%.

Compared with a company structure, there are other tax advantages worth considering:

- ✓ If a withdrawal is made within the first 10 years, the earnings are included in the investor's personal tax return (only a portion is included in the ninth and tenth year) and a 30% tax credit applies. However, unlike a company where the grossed-up dividends are included as taxable income, only the net after-tax income received from an Investment Bond is taxable.

- ✓ If the Bond proceeds are withdrawn due to the death of the life insured, neither the beneficiary nor the estate needs to pay any further tax.

The differences between these two investment structures are outlined in the examples below.

Tax: Company Structure	**Tax: Investment Bond**
	
Harry set up a private company and transferred \$120,000 into the company. This was invested in a range of investments. All earnings are retained within the company. After six years, Harry withdraws the full investment and declares a fully franked dividend of \$36,000. At the time, Harry is on the top marginal tax rate (49% including Temporary Budget Deficit and Medicare Levies). His tax position after receiving the dividend payment is shown below.	Harry decides to invest \$120,000 into an Investment Bond. After six years he withdraws the full balance of \$156,000 (includes \$36,000 earnings). His tax position is shown below.

Fully franked dividend	$36,000
Franking credit ($36,000 x 30/70)	$15,429
Total included in taxable income ($36,000 + $15,429)	$51,429
Tax at 49%*	$25,200
Less: franking credits	$15,429
Net tax payable	$9,771
Net earnings	$26,229

* Budget Medicare Levy is included.

Investment	$120,000
Amount withdrawn	$156,000
Growth portion (included in taxable income)	$36,000
Tax at 49%* ($36,000 x 49%)	$17,640
Less tax offset ($36,000 x 30%)	$10,800
Net tax	$6,840
Net earnings ($36,000 - $6,840)	$29,160

* Budget Medicare Levy is included.

Though Harry includes the earnings in his tax return, the fact that only the net earnings received are taxable results in Harry paying $2,931 less tax than under the company example.

If Harry retained his Investment Bond for at least 10 years he would not pay any personal tax. This results in a tax saving of $9,771 compared to a company structure.

Features of investing in an Investment Bond structure

While the Investment Bond offers a tax advantage alternative to the company structure as described above, it also offers more key benefits that make it a viable component of an investor's portfolio.

Flexible investment options

Investment Bonds allow clients to access many asset classes and provide a market-linked investment vehicle to help meet investment goals.

No limit on the investment amount

There is no limit on the amount that can be invested to establish an Investment Bond. Investors can also make subsequent investments up to maximum of 125% of the previous year's contribution without restarting the 10-year period. Investors can choose to start new Investment Bonds if higher amounts (than the 125%) are to be invested.

No excess contributions tax

Investment Bonds avoid the excess contributions tax that may apply in superannuation.

Flexibility

Investment Bonds give investors the flexibility to access funds at any time, which can act as a hedge against the restricted access for superannuation.

Capital gains tax simplicity

Investment Bonds provide simplicity as earnings are automatically reinvested in the Bond. This means reinvestment dates do not need to be tracked for capital gains tax purposes. Investors can also switch between investment options without triggering personal capital gains tax.

Transfer of ownership

The ownership of the Investment Bond can be easily assigned or transferred at any time. The original start date is retained for tax purposes. This may not be achieved within a company structure without creating tax liabilities.

Bankruptcy protection

Investment Bonds may offer protection from creditors in the case of bankruptcy (subject to certain rules), which may not be provided through a company structure.

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A side-by-side comparison

	Feature	Investment Bond	Company Structure
1.	**Personal tax rate** ***When entity income is distributed on an on-going basis, such as dividends*** ***When entity income is distributed upon a wind-up, effectively a final dividend***	No personal tax if bond withdrawn (or part-withdrawn) after 10 years or if withdrawn anytime due to: - death or disability of life insured - unforeseen serious financial difficulties of bond investor. 30% tax rate cap remains.	30% replaced by personal tax at marginal tax rate (via operation of dividend imputation system). 30% company tax rate is only temporary (or provisional).
2.	**Personal tax rate** ***On capital gains (only applicable when an individual's investment is disposed of)***	Treated no differently to bond income. No capital gains tax (CGT) reporting or compliance required.	Effective 50% tax reduction applies to discount capital gains (investments held for more than a year). Capital gains tax reporting or compliance required.
3.	**Investment transfers** ***To another person (including to spouse, inter-generational, another entity, etc)***	Bond assignment can be seamlessly made. Retains original start date. No personal tax event for transferor, if assignment is for nil consideration.	A share ownership transfer creates a CGT event, with personal tax consequences.
4.	**Bankruptcy protection**	Full protection from creditors if nominated life insured is either the bond investor or investor's spouse. Protection extends also to future bond payout monies.	No protection from creditors
5.	**Nomination of beneficiaries**	If there is no separate life insured (to the investor), specific bond beneficiaries can be nominated, outside a will. May also be better quarantined from will contests.	Company share investment generally falls into a person's estate, and dealt with under a will (if it exists).
6.	**Investment life after death**	If life insured survives a bond investor, a bond can continue and be held as an asset of the estate.	Generally, share investment has to be transferred (via the estate).

Conclusion

Investment Bonds are an alternative way to invest in a tax-effective manner with a range of advantages for investors seeking flexibility and diversification to complement their superannuation.

When compared to company structures, Investment Bonds can provide significant advantages, especially if funds are invested longer than 10 years.

A Centuria Investment Bond provides flexibility, certainty and value in tax-effective investing.

Centuria Capital is an ASX-listed diversified funds manager with $2 billion in funds under management. Our businesses offer something refreshingly different to our direct clients, and to financial advisers and their clients: we manage investments personally. That means 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.

For more information about achieving flexibility with Investment Bonds, contact Centuria on 1300 50 50 50 or visit www.centuriataxastute.com.au.