



Client Fact Sheet

July 2009



Understanding Investment Bonds

Bonds are a form of managed fund operated by life insurance companies and friendly societies. An insurance or investment bond (referred to as a bond) is essentially a life insurance policy and provides a simple and flexible way to save for a future goal. A bond may involve a once-only premium payment (or investment); alternatively investors may take advantage of the 125% rule (see below) and make regular “top-ups” once the initial premium has been paid.

By investing in a bond, investors pool monies and the funds are managed by investment professionals. In this sense, they operate similarly to managed funds; the main difference being the tax treatment of investment earnings. Bonds also offer the ability to switch between different investment options.

Depending upon the product, monies may be invested in a range of investment options such as cash, fixed interest, property, Australian shares and international shares. This provides the opportunity for diversification within a single investment structure.

The investment returns on a bond are taxed in the hands of the insurance company and the earnings are reported net of this tax. The tax on investment earnings is 30%. This can be reduced by dividend imputation credits and other offsets where the underlying investment has an exposure to Australian shares and property.

As the life insurance company pays the tax on investment earnings, there is no need for an investor to make any annual tax declarations or keep capital gains records from year to year.

The 10-year rule

If the bond is held for 10 years or more, no additional tax is payable on investment earnings. If the bond is withdrawn before the expiry of the 10-year period, the profit (proceeds less total amounts invested) will be included in the investor’s assessable income and be taxed at their marginal tax rate. However, any profit that is assessable receives a tax offset of 30%.

The tax treatment of investment earnings from the bond depends upon the timing of the withdrawal as follows:

- Up to the 8th year all earnings are assessable
- During the 9th year 2/3rd earnings are assessable
- During the 10th year 1/3rd earnings are assessable
- After 10th year all earnings are not assessable (tax paid)

The 125% rule

Each policy year, an investor can make contributions of up to 125% of the previous year’s investment. The benefit of this is that the additional contributions do not have to be invested for the full 10 years to acquire the tax paid status. The example below illustrates the opportunity available.

Period	Amount contributed	Period	Amount contributed
Year 1	\$5,000	Year 6	\$15,257
Year 2	\$6,250	Year 7	\$19,071
Year 3	\$7,812	Year 8	\$23,838
Year 4	\$9,765	Year 9	\$29,797
Year 5	\$12,206	Year 10	\$37,246

(Based on additional investments of 125% of the previous policy year's investment).

The 125% opportunity can be used past the 10-year mark. As the rule refers to 125% of the previous year's investment, if no investment is made in any year, an investment cannot be made in the subsequent year without re-starting the 10-year tax free period on the whole balance.

Other tax considerations

Any death benefit paid will be tax free in the hands of the recipient.

Changing investment options within a bond does not usually change the tax status of the bond and therefore generally has no tax consequence for the investor.

Bonds are tax paid investments and therefore do not generate any assessable income for an investor (unless redeemed before 10 years). They are not suitable investments for gearing purposes (ie. borrowing to invest). As bond earnings are taxed at a maximum of 30%, a bond can be an attractive investment for those on higher marginal tax rates.

If an investor withdraws a bond within the first 10 years, and their marginal tax rate is below 30%, any excess tax offset, can be used to reduce tax payable on other income.

Risks

Taxation & legislative risk

Our information is based on legislative practices of the Australian Taxation Office and other relevant government bodies as they presently exist. As with most financial related matters there is always legislative risk that provisions may be amended.

Investment risk

The value of an Investment Bond may fluctuate over time as a result of changes in the value of the underlying investments held. Investors should be aware that the original capital is not guaranteed (unless the investment option selected offers a capital guarantee) and the value of the investment will rise and fall with prevailing market conditions. Investment values and returns are dependent upon the circumstances of individual investments included in the diversified portfolio, changes in interest rates and exchange rates, and the economic and investment cycles of different countries.

Summary

By investing in a bond, an investor has the potential benefit (depending upon the choices within the particular product) of being able to diversify their investment across all asset sectors and the ability to switch between investment options.

A bond investment provides the investor with tax simplicity as the investor does not have to make any annual tax declarations or keep capital gains records from year to year unless a withdrawal is made within ten years.

Bonds may also provide tax benefits to investors on marginal tax rates in excess of 30% as there is no capital gains tax or income tax payable on withdrawals after year 10.

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