Financial planning strategies – insurance bonds

Produced by IOOF Technical Advice Solutions

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Contents

Introduction

IOOF Supersaver Options is an investment life insurance policy (sometimes called an insurance bond), which is a tax-paid investment vehicle that can give investors access to a variety of asset classes.

Insurance bonds (bonds) can be tax effective for many investors because bond earnings are taxed in the hands of the life company at the company tax rate of 30 per cent. This rate may be lower than some investors' marginal tax rate (up to 47 per cent) which would be applicable to earnings from other investment options, such as managed funds.

Due to the tax effectiveness of bonds, they can be particularly useful for investors who are trying to minimise their tax liabilities whilst continuing to grow their wealth. For example, bonds can be ideal for saving for children's or grandchildren's education, as the bond owner is not required to include bond earnings as part of their assessable income for tax purposes while the investment is retained in the bond.

This brochure has been produced by the IOOF Investment Management Technical Advice Solutions team for use by advisers only. The objective of this booklet is to enable advisers to compare different financial planning situations they commonly face when dealing with clients seeking tax effective savings vehicles. There are six strategies analysed.

Strategy 1: Tax effective wealth accumulation for high income earners

Overview

In August 2005, the Government passed tax changes announced in the Federal Budget relating to the 2005/06 financial year, whereby clients with taxable income of between $63,000 and $95,000 are subject to the marginal tax rate of 42 per cent plus Medicare Levy. This income range will increase to $70,000 and $125,000 for the 2006/07 year. Taxable income above these figures is taxed at 47 per cent plus Medicare Levy. This is an important development when providing tax effective wealth accumulation for high income earners.

Strategy analysis

Clients earning a taxable income in the 42 per cent and 47 per cent tax brackets who are concerned about tax efficiency and want to accumulate tax effective wealth, could consider utilising an insurance bond to achieve tax effective savings.

An insurance bond can be used as an alternative to superannuation for wealth accumulation. There are no Reasonable Benefit Limits (RBL) or 'preservation' issues as are applicable when investing through superannuation.

For individuals who are interested in gearing as a wealth accumulation strategy, bonds can usually be used as security for borrowing, whereas superannuation assets cannot be used due to legislative restrictions.

Advantages/disadvantages

Advantages	Disadvantages
Maximum tax rate of 30 per cent taxed in the hands of the life company. This rate may be lower than some investors' marginal tax rate (up to 47 per cent) which would be applicable to earnings from other investment options, such as managed funds.	The 125 per cent rule[1] regarding regular savings plans and the 10-year rule[2].
As bonds are a tax-paid investment, there is no need to include bond earnings in client tax returns while the money remains in the bond.	Tax implications for early withdrawal[2].
Simple investment structure as opposed to establishing a family trust and/or investment company.	
No Capital Gains Tax (CGT) payable upon sale of bond.	
Generally protected from creditors.	

1. Every year, up to 125 per cent of the previous year's contributions can be added to the bond without restarting the 10-year investment period for tax purposes.

2. Bonds can be withdrawn with no personal income tax liability after a 10-year period but withdrawals before this time can create tax liabilities. The tax assessment is based on the year of withdrawal. Any withdrawals received in less than 9 years receive full assessment on growth; received in year 9 is 2/3rd growth assessable; received in year 10 is 1/3rd growth assessable.

Tips and traps

For investors who have the ability to make regular contributions to their insurance bond, always ensure that the contributions are within the 125 per cent rule to avoid having to restart the investment term for tax purposes.

In addition, withdrawals within 10 years may be assessable for tax purposes for the investor (based on rule 2 under the table on the left). However, the investor will also be entitled to a tax rebate for tax already paid by the life company.

Consider this example:

Paul invests in an insurance bond and establishes an annual contribution of $5,000. After five years, his bond has an investment value of $27,800. Paul wishes to withdraw $10,000 in year five. He is on the top marginal tax rate of 47 per cent plus Medicare Levy.

Formula to calculate assessable amount:

A/B * [(B+C) – (D+E)]

Where:

A = amount withdrawn
B = surrender value of the policy immediately prior to withdrawal
C = any earlier amounts paid out under the policy
D = total gross premiums paid to date of withdrawal
E = previous amounts included in assessable income

$$\left(\frac{10{,}000}{27{,}800}\right) \times [(27{,}800 + 0) - (25{,}000 + 0)] = \$1{,}007$$

Assessable amount[1]	= $1,007	
Tax payable	= $1,007 * 48.5%#	= $488 tax liability
Tax offset	= $1,007 * 30%*	= $302
Tax to be paid (by investor)	= $488 - $302	= $186

1 The assessable amount is equal to the portion of investment growth withdrawn.
Includes Medicare Levy.
* Tax rebate for tax already paid in insurance bond.

Case study: comparing bonds with managed funds

John, aged 40, has recently received a lump sum of $250,000 from his mother's estate. He has no non-deductible debt and is on the top marginal tax rate (MTR) of 47 per cent plus Medicare Levy. He also has a $15,000 annual surplus income and would like a flexible tax effective investment.

Let's compare an insurance bond with a different investment structure such as a managed fund. John has a 15 year investment time horizon and is investing in an Australian portfolio that provides a total return of 6 per cent (2 per cent income (net of fees) and 4 per cent capital growth). This assumes a bond tax rate of 30 per cent versus a managed fund taxed at his MTR of 48.5 per cent. Note that the managed fund will be subject to CGT upon sale and as managed funds are not tax paid investments like bonds, investment income earned may be assessable to the investor each year. See calculations in the table below for further detail.

Investing in a bond such as IOOF Supersaver Options (Supersaver) can achieve John's tax effective wealth accumulation objective, whilst offering investment choice and accessibility.

Opportunities

Investing in bonds can provide clients with the option to invest over the long term outside of the superannuation environment. They can still retain access to capital and invest in a potentially more tax effective vehicle than a comparable managed fund.

Resources

- Flyer - IOOF Supersaver Options insurance bond range.
- IOOF Supersaver Options Product Disclosure Statement (PDS).
- IOOF Key Account Manager.

Product solution

Supersaver offers a simple way to help build your clients' savings and wealth using a tax effective, flexible investment. Supersaver is ideal for investors of all ages and particularly attractive for those seeking competitive returns and prefer the convenience of a tax-paid investment.

Supersaver offers five different options to suit the investment objectives of a range of individuals. These include:

- capital guaranteed;
- fixed interest;
- capital stable;
- balanced; and
- Australian equities.

Investment options	Capital value after 15 years	Summary of assumptions	
Insurance bond	$934,920	Investment amount	$250,000.00
		Regular investment	$15,000.00
		Investment return	6.00%
		Fees	0.00%
		Tax rate	30.00%
		Franking credits	50.00%
Managed fund	$809,939	Investment amount	$250,000.00
		Regular investment	$15,000.00
		Investment return	6.00%
		Fees	0.00%
		Tax rate	48.50%
		Franking credits	50.00%

Supersaver Performance Summary as at 30 June 2005 and effective tax rates within the bond

		3 month return % p.a.			1 year return % p.a.			2 year return % p.a.			3 year return % p.a.			5 year return % p.a.		
Supersaver investment option	Effective annual tax rate as at 30 June 2005	Supersaver return	Morningstar Insurance Bond Index (as at 30 June 2005)	Out-performance %	Supersaver return	Morningstar Insurance Bond Index (as at 30 June 2005)	Out-performance %	Supersaver return	Morningstar Insurance Bond Index (as at 30 June 2005)	Out-performance %	Supersaver return %	Morningstar Insurance Bond Index (as at 30 June 2005)	Out-performance %	Supersaver return	Morningstar Insurance Bond Index (as at 30 June 2005)	Out-performance %
Australian equities	25.87%	2.86	3.09	-0.23	21.03	16.29	4.74	18.31	14.88	3.43	21.03	9.39	11.64	9.23	7.01	2.22
Balanced	25.87%	2.31	2.15	0.16	10.01	7.59	2.42	10.40	7.44	2.96	10.01	5.08	4.93	4.24	3.27	0.97
Capital Stable	26.68%	1.95	1.59	0.36	7.54	5.65	1.89	6.89	4.53	2.36	7.54	3.46	4.08	4.55	2.81	1.74
Fixed Interest	28.03%	1.61	1.51	0.10	4.27	3.58	0.69	3.38	2.60	0.78	4.27	3.76	0.51	3.42	3.42	0.00

The Morningstar Insurance Bond Index returns include fees and charges and is therefore an appropriate benchmark for comparison to all investment options within the IOOF Supersaver insurance bond range. Performance is net of fund manager fees and charges. Performance is on an exit-to-exit price basis with all income reinvested. Past performance is not a reliable indicator of future performance.

Strategy 2: Saving for children

Overview

It can be difficult to find a suitable investment option when investing for a child/minor, as income earned by a minor may be subject to minor tax rates. The minor tax rates for 2005/06 are:

Taxable income	Tax rate
Up to $416	Nil
$416 - $1,445	66%
Over $1,445	47%

Note that the tax-free threshold may effectively increase to $772 if the low income tax offset of $235 is applicable. In addition, for taxable income over $1,445 the full income is taxed at 47 per cent.

Strategy analysis

Bonds are an attractive vehicle for parents and grandparents who wish to gift or hold funds for children under 18 years of age. Investment earnings are taxed at a maximum of 30 per cent compared to much higher minor tax rates.

Bonds invest in the same types of assets as unit trusts or managed funds, but they do not make distributions. Tax on investment earnings are paid by IOOF as the taxpayer at the rate of 30 per cent and earnings are credited back to each investment option after this tax has been paid. As IOOF is the taxpayer, the investor does not need to declare ongoing investment growth in their personal tax return.

Furthermore, franking credits can be used to reduce any tax liability within the bond.

This strategy allows for long-term savings plans for a child's benefit, e.g. private school fees, university education, deposit for first home or even saving for a wedding. This strategy is best utilised when both of the child's parents have taxable incomes within the 42 per cent or 47 per cent tax range.

Note that insurance bonds are not subject to personal Capital Gains Tax (CGT), so an investor with a marginal tax rate of 30 per cent may still benefit.

Advantages/disadvantages

Advantages	Disadvantages
Maximum tax rate of 30 per cent taxed in the hands of the life company. This rate may be lower than some investors' marginal tax rate (up to 47 per cent) which would be applicable to earnings from other investment options, such as managed funds.	The 125 per cent rule regarding regular savings plans and the 10-year rule (see explanation in strategy 1).
Ability to establish a savings plan for education.	Child investors between age 10 and 16 (or the parent or grandparent of the child) cannot exercise their investment rights (e.g. switching, withdrawing) in regards to the bond until the child reaches 16 years.
As bonds are a tax-paid investment, there is no need to include bond earnings in client tax returns while the money remains in the bond.	
No CGT payable upon sale of bond or upon transfer to child. Also does not trigger a new start date for the 10-year period. 125 per cent rule does not recommence upon transfer to child.	
Can be established with child vesting age up to 25 years.	
Ability to structure ownership, life insured and beneficiary to meet client objective.	

Tips and traps

Children aged 10 years or more can own a bond directly. However, children between age 10 and 16 require written consent from a parent or guardian, and the child investor does not have the power to exercise their investment rights under the account until they reach 16 years of age. Alternatively, an adult can own the bond and put in place a vesting age between age 16 and 25. Vesting age is defined as the elected age when the child will receive full ownership of the bond.

Case study: comparing bonds with master trusts

Bill wants to provide twin grandchildren with a head start in life of $100,000 each. They are aged 10 and will have access to their funds at age 21. His investment options are:

- invest $100,000 in each child's name in an Australian share portfolio through a master trust, with annual gross rate of return of 8.5 per cent (5 per cent growth and 3.5 per cent income with 1.33 per cent ongoing fees); versus
- invest $100,000 in Australian share portfolio within a bond, with annual gross rate of return of 8.5 per cent (5 per cent growth and 3.5 per cent income with 1.33 per cent ongoing fees).

In both options, interest income is paid annually.

Please see calculations in the table below for further detail.

Opportunities

Investing in bonds provides investors with an opportunity to have a stand-alone yet simple vehicle to save for children's education, home deposit or wedding. Grandparents can also create an investment for their grandchildren that they control whilst alive and then upon their death, is transferred directly to the named grandchildren. There is no CGT applicable upon transfer and no income assessment for the beneficiary if received upon the death of the life insured. Such investment policies are called Child Advancement Policies.

Resources

- Flyer - IOOF Supersaver Options insurance bond range.
- IOOF Supersaver Options Product Disclosure Statement (PDS).
- IOOF Key Account Manager.

Product Solution

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Supersaver offers five different options to suit the investment objectives of a range of individuals. These include:

- capital guaranteed;
- fixed interest;
- capital stable;
- balanced; and
- Australian equities.

Supersaver Performance Summary as at 30 June 2005 and effective tax rates within the bond

Refer to performance summary on page 5.

Net return after 10 years

Investment options	Net proceeds after 11 years	Assumptions
Investment in an Australian share fund at 70 per cent franking.	$175,376	Minor's tax rate applied with low income rebate tax rate for CGT based on 30 per cent. Investment amount $100,000.00 Regular investment $0 Investment return 8.5% Ongoing Fees 1.33% Tax rate 47.00% Tax up to $1,445 = $444.14 Franking credits 70.00%
Bond investment in an Australian share fund at 70 per cent franking.	$201,435	No CGT on insurance bond. Investment amount $100,000.00 Regular investment $0 Investment return 8.5% Ongoing Fees 1.33% Tax rate 30.00% Franking credits 70.00%

Strategy 3: Gearing utilising bond loanback facility

Overview

Investors with a Supersaver investment have access to a simple and tax effective loan facility, whereby they can borrow money from IOOF using their Supersaver investment as security for the loan. Otherwise known as the IOOF Loan Facility or 'loanback', the facility allows investors to access interest-only loans, with the principal being repayable when the Supersaver investment matures or is surrendered by the investor. The current borrowing capacity is based on the balance of the investor's investment portfolio. The table below shows the maximum percentages available for loan to individual investors.

Investment	Maximum Limit
Capital Guaranteed	90%
Fixed Interest	90%
Capital Stable	80%
Balanced	70%
Australian Equities	60%

Currently, there are no loan fees, establishment fees, stamp duty or margin calls. The interest rates effective as at 1 January 2006 are detailed in the next column (please check the IOOF web site (**www.ioof.com.au**) for current rates).

Loanback Interest Rates		
Fixed Rate Loan	Paid in advance	7.63%
Variable Rate Loan	Paid in arrears every 30 June	7.61%

Current market margin loan rates are around 1 to 1.25 per cent above variable home loan rates (currently averaging 7.25 per cent) which are higher than the current IOOF rates.

Strategy analysis

Gearing through a bond gives investors the opportunity to use the power of their original investment to access additional funds to reinvest in other income-producing assets.

Unique in the market place, the Supersaver Loan Facility provides a straight-forward and tax effective way of combining the tax advantages of borrowing to invest, with the security of having your client's original funds invested tax effectively.

The facility can give investors the ability to borrow additional funds to invest in an alternative investment at the gearing rate specified above. This can maximise the overall return on the ordinary investment due to tax benefits associated with negative gearing.

Advantages/disadvantages

Advantages	Disadvantages
Maximum tax rate of 30 per cent taxed in the hands of the life company. This rate may be lower than some investors' marginal tax rate (up to 47 per cent) which would be applicable to earnings from other investment options, such as managed funds.	The 125 per cent rule regarding regular savings plans and the 10-year rule (see explanation in strategy 1).
Competitive interest rate and no loan fees.	Limitation of borrowing percentages.
No CGT payable on sale of bond.	Cannot reinvest in bond and claim a tax deduction on interest costs.
No margin calls.	Need to find an appropriate investment to invest borrowed funds, e.g. IDPS or alternative managed fund.
Ability to maximise the benefits of gearing. Up to 90 per cent of the investment value is available for loan.	
Two flexible loan repayment options: fixed or variable.	

Tips and traps

- If the value in the investor's bond portfolio reduces, they still have to pay back the original loan amount plus interest.
- Due to the benefits of franking, the dividend yield required for an investor to break even on a fully geared share investment is much less than the interest rate. And remember that the capital gain on the sale of shares is generally taxable at the investor's marginal tax rate in the year of sale. 50 per cent of the gain is exempt from tax if the shares have been held for at least 12 months. Ideally, the sale should be made in a low tax year.
- A negatively geared investment does provide tax benefits to the investor. These benefits are of no use unless the investment generates income or the investor has other sources of income to offset the cost of financing that investment.

Case study: comparing the bond loanback with a gearing facility

James has repaid his home mortgage, pays the top marginal tax rate and has an annual cash surplus of $15,000. He has an investment timeframe of 11 years.

James's investment options

James can:

- invest in a regular Australian shares managed fund with an 8.5 per cent return (5 per cent growth and 3.5 per cent income with 1.33 per cent ongoing fees) and use a gearing facility (providing an extra $9,000 p.a.); or
- invest via Supersaver with an 8.5 per cent return (5 per cent growth and 3.5 per cent income with 1.33 per cent ongoing fees) utilising the loanback option (providing an extra $9,000 p.a.).

After 11 years with an annual investment of $15,000 and $9,000 borrowed each year, results show the following (assume interest rate of Supersaver loanback is 7.60 per cent and margin lending interest rate is 8.25 per cent).

Opportunities

- Investing a client's own capital into a bond and utilising the loanback facility to invest in a regular investment can maximise returns due to associated tax benefits.
- Generally, bank margin lending interest rates are higher than Supersaver loanback rates.

Resources

- Flyer - IOOF Supersaver Options insurance bond range.
- IOOF Supersaver Options Product Disclosure Statement (PDS).
- IOOF Loan Facility application form.
- IOOF Key Account Manager.

Product solution

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- fixed interest;
- capital stable;
- balanced; and
- Australian equities.

Supersaver Performance Summary as at 30 June 2005 and effective tax rates within the bond

Refer to performance summary on page 5.

Investment options	Net proceeds after 11 years	Assumptions
Investment in Australian shares managed fund at 70 per cent franking.	$345,137	Tax rate for CGT based on 47 per cent and interest rate of 8.25 per cent.
Bond investment in Australian shares fund at 70 per cent franking.	$372,384	Only CGT payable on geared investment of $9,000 p.a. and interest rate based on current variable loanback rate of 7.60 per cent.

Strategy 4: Negative gearing direct property investments and insurance bonds

Overview

Negative gearing direct property is a commonly used wealth accumulation strategy for many high earning taxpayers. For tax reasons, it is generally suitable for individuals with a taxable income in the highest marginal tax bracket (for the 2005/06 financial year).

Strategy analysis

To maximise benefit from investment gearing strategies, taxpayers can utilise negative gearing. This is achieved when income from the investment is less than the expenses associated with the investment.

When utilising negative gearing as an investment strategy, investors generally pay interest-only on their investment loan (as long as the interest expense is tax deductible) and are then able to invest surplus cash flow back into another investment (e.g. bond).

Bonds invest in the same types of assets as unit trusts or managed funds, helping investors to diversify, but they do not make distributions. Tax on investment earnings is paid by IOOF as the taxpayer at the rate of 30 per cent and earnings are credited back to each investment option after this tax has been paid. As IOOF is the taxpayer, the investor does not need to declare ongoing investment growth in their personal tax return.

Furthermore, franking credits can be used to reduce any tax liability within the bond.

Advantages/disadvantages

Advantages	Disadvantages
Maximum tax rate of 30 per cent taxed in the hands of the life company. This rate may be lower than some investors' marginal tax rate (up to 47 per cent) which would be applicable to earnings from other investment options, such as managed funds.	The 125 per cent rule regarding regular savings plans and the 10-year rule (see explanation in strategy 1).
Maximise negative gearing tax benefits.	Does not fit with some investor's risk profile.
No CGT payable upon sale of bond.	
Achieve investment diversification.	

Tips and traps

The client's investment/market risk can be minimised by investing within Supersaver and retaining exposure to their direct property.

The important part of this strategy is to make sure the client is comfortable with the level of gearing and their ability to service the loan if there is a change in the interest rate, i.e. their risk profile matches up with a gearing strategy recommendation.

Case study: comparing different gearing approaches using bonds

David, aged 40, earns $140,000 p.a., pays the top marginal tax rate, has living costs of $60,000 p.a. and is looking at an investment property (assume 4 per cent growth and 2.5 per cent net income). He will have to borrow $250,000 over 15 years at 7 per cent interest (assuming fixed for term of loan). Wealth accumulation options are:

- repay principal and interest (P&I) over 15 years and then sell the property, with the annual surplus invested in an insurance bond (incorporating CGT liability); versus
- repay interest only and invest principal component in Australian shares in an insurance bond, with an annual gross rate of return of 9 per cent (5 per cent growth and 4 per cent income with 1.5 per cent ongoing fees).

Please see calculations in the table below for further detail.

Opportunities

The investor has the ability to maximise the tax effectiveness of negative gearing, whilst providing further investment diversification via growth asset portfolios accessible through the original bond investment.

Resources

- Flyer - IOOF Supersaver Options insurance bond range.
- IOOF Supersaver Options Product Disclosure Statement (PDS).
- IOOF Key Account Manager.

Product solution

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Supersaver Performance Summary as at 30 June 2005 and effective tax rates within the bond

Refer to performance summary on page 5.

Net outcome utilising property income and tax savings to repay the mortgage versus reinvesting earnings in a bond (based on 2006/07 marginal tax rates).

Investment options	Net worth in 15 years	
Investment property: repay P&I and invest surplus cash flow in a bond.	Property value	$450,236
	CGT on property	($48,557)
	Value of insurance bond	$380,656
	Net worth	$782,335
Investment property: repay interest-only and invest surplus cash flow in a bond.	Property value	$450,236
	CGT on property	($48,557)
	Value of insurance bond	$734,380
	Mortgage	($250,000)
	Net worth	$886,059

Strategy 5: Tax efficient saving for estate planning

Overview

Bonds are regulated under the *Life Insurance Act* and are treated ex-estate if paid to nominated beneficiaries. This can provide investors with peace of mind knowing that not only will their investment be passed on to intended family or loved ones upon their death, but that it will not be tied up in the sometimes lengthy and expensive estate probate process. Benefits paid upon death of the life insured are not subject to tax when paid to beneficiaries.

Strategy analysis

Investment savings for estate planning purposes can be held under various structures including:

- company;
- superannuation;
- family trust;
- insurance bond;
- individual name; and
- joint or tenant-in-common ownership.

These structures offer various tax and estate planning benefits. Generally, for high net worth clients, superannuation can be the most tax effective if paid within the member's pension Reasonable Benefit Limit (RBL) and paid to a superannuation dependant (under current superannuation and tax law).

Where an investor has already accumulated assets within their pension RBL and does not require the capital, when established correctly, a bond can provide the investor with a simple, tax effective estate planning vehicle which guarantees that their asset will be received by their elected beneficiary.

Advantages/disadvantages

Advantages	Disadvantages
Maximum tax rate of 30 per cent and no RBL assessment.	The 125% rule regarding regular savings plans and the 10-year rule (see explanation in strategy 1).
No tax/CGT payable on capital being transferred to the beneficiary upon death of the life insured.	Needs to have appropriate ownership structure to ensure tax effectiveness.
Achieve investment diversification.	
Simple investment structure with no requirement to withdraw minimum annual pension payments (compared to superannuation).	

Tips and traps

If the investor's intention is to provide capital directly to a beneficiary, the bond should be established with the owner and life insured as the same person. This will reassure the investor that the benefit will not go through the estate probate process and will be available to the elected beneficiary with no potential family maintenance proceedings.

Case study: estate planning using bonds

Bob recently passed away, aged 70. His net worth upon death was:

• home	$400,000
• allocated pension (AP)	$50,000
• managed fund portfolio	$240,000 (cost base $120,000 purchased post-1985)
• personal effects	$15,000
• car	$10,000

He left the entire estate to his son, Travis, aged 33, who is married with two children. Upon settling the estate, valued at $715,000, Bob's estranged daughter, who he has not spoken to for over 20 years, has contested the will. Unfortunately, the AP death benefit election had been to pay the benefits to the estate, and this was something Bob had been concerned about prior to his death. Bob had never received professional advice regarding the ownership of his assets and his estate planning concerns.

Had Bob discussed the issues with a financial adviser, the superannuation election could have been a binding nomination to the son and the managed fund portfolio could have been invested in a bond, with his son as the elected beneficiary. This would have prohibited his estranged daughter getting access to the capital and potentially saved the maximum CGT payment of $29,100 upon sale of the managed fund portfolio.

Opportunities

Investors have the ability to accumulate assets and retain control whilst alive and also have their wishes met regarding their estate.

Resources

- Flyer - IOOF Supersaver Options insurance bond range.
- IOOF Supersaver Options Product Disclosure Statement (PDS).
- IOOF Key Account Manager.

Product Solution

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Refer to performance summary on page 5.

Strategy 6: Asset protection and business succession planning for retirement

Overview

As the baby boomer generation move closer to retirement, we will see a large generational change throughout employment markets. This strategy will encompass a large proportion of Generation Xers taking over the employment and business opportunities of retiring baby boomers. This may be of interest to some self-employed baby boomers who are considering selling their business upon retirement.

Many small business owners fail to consider what will happen to their business if they die, have a long period of illness, suffer a total and permanent disability, or retire. They may not have plans for selecting a successor or distributing the proceeds of the business. Failure to address these issues is a common oversight amongst self-employed people and can lead to unnecessary complications, should any of these events occur.

Most unplanned events can be covered by appropriate insurance but generally, difficulty arises in the event of retirement. Is there a better way of managing the retiring owner's financial interests in their business?

Strategy analysis

Using a buy/sell agreement: saving capital for the purchase of a business interest via a buy/sell agreement can be complex. There are many issues to consider such as:

- ownership structure;
- valuation of the business interest; and
- transfer of ownership upon retirement.

A regular savings plan into an insurance bond can provide business owners with some certainty that they will have a guaranteed transition of their business interests at an agreed price upon retirement. The benefit of investing via the insurance bond will cap the tax payable on earnings at 30 per cent and will not be subject to CGT upon withdrawal of the investment.

Utilising a bond as the investment vehicle will mean that the individual parties to the buy/sell agreement will have to determine the appropriate investment amount utilising their own after-tax dollars. In some situations where a buy/sell arrangement is between the owner and an employee, a sinking fund (accumulated investment fund) can be established with the owner contributing potential employee bonuses into the fund as a savings plan in the owner's name. This can provide the business owner with certainty and retention opportunities for senior employees.

Advantages/disadvantages

Advantages	Disadvantages
Maximum tax rate of 30 per cent and no RBL assessment.	The 125 per cent rule regarding regular savings plans and the 10-year rule (see explanation in strategy 1).
No tax/CGT payable upon capital being transferred to the beneficiary upon the death of life the insured.	Potential Fringe Benefits Tax (FBT) liability if benefits paid to existing employees via a salary packaging arrangement.
Achieve investment diversification.	Understanding the buy/sell agreement and the ownership structure.
Retention of high level employees.	Investment into a bond has to be with after-tax dollars.

Tips and traps

To keep the structure simple, the business owner and life insured should be the same so that upon death, the capital is still available to the beneficiary in line with the buy/sell agreement.

Make sure that you consult with an experienced business succession solicitor to draft an appropriate buy/sell agreement.

Case study: succession planning through bonds

Bill, aged 55, runs a small but successful automotive business in a regional Victorian town. He is planning to retire at age 65 but is concerned about the saleability and value of his business at retirement. Ken is employed as the head mechanic and has approached Bill about the opportunity to purchase the business when he retires. Bill is aware that Ken has minimal savings so has sought professional advice from a financial adviser about his business succession options.

The financial adviser recommends that Bill enters into a buy/sell agreement with Ken regarding his planned retirement. The agreement states that Bill will pay Ken an after-tax annual bonus (via PAYG so not liable for FBT) into a bond which will be structured with Bill as the owner and life insured. This allows funds to accumulate over a period to the projected business value upon retirement. As part of the buy/sell agreement, if Ken leaves his employer, the funds will remain with Bill and Ken will have no entitlement to the funds. This will offer Bill certainty regarding an agreed future business value and know that he has locked in a future buyer, Ken.

Opportunities

The investor has the ability to accumulate assets and retain control of their investment whilst operating the business, with an agreed exit strategy upon retirement.

The employee has a long-term goal and feels like they have a more active role in the business and the business owner has created a key strategy to retain senior staff.

Resources

- Flyer - IOOF Supersaver Options insurance bond range.
- IOOF Supersaver Options Product Disclosure Statement (PDS).
- IOOF Key Account Manager.

Product Solution

Supersaver offers a simple way to help build your clients' savings and wealth using a tax effective, flexible investment. Supersaver is ideal for investors of all ages and particularly attractive for those seeking competitive returns and prefer the convenience of a tax-paid investment.

Supersaver offers five different options to suit the investment objectives of a range of individuals. These include:

- capital guaranteed;
- fixed interest;
- capital stable;
- balanced; and
- Australian equities.

Supersaver Performance Summary as at 30 June 2005 and effective tax rates within the bond

Refer to performance summary on page 5.

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