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Josh has been working in the Financial Services industry since 2007 in Paraplanning and Advisory Support roles. Before joining IOOF in October 2015, Josh worked as a Provision of Advice Specialist for UBS Wealth Management and as a Technical Specialist for Shadforth Financial Group.

Over this time he has developed a passion for technical strategy particularly around superannuation, social security and insurance planning. His previous experience in advisory technical support includes developing and delivering professional development seminars, preparation of advice and responding to ad-hoc technical queries from advisers.

MYTHBUSTERS – INSURANCE BOND AND AGED CARE

Josh Rundmann

There has recently been somewhat of a revival in the ‘set up a Family Trust and invest in an insurance bond’ strategy in relation to reducing residential Aged Care fees. Not surprisingly, the main advocates for such a strategy are insurance bond providers, who are looking for any avenues to become more relevant in today’s financial planning environment. Additionally, this revival has come with a lack of analysis.

Our position at IOOF TechConnect has been that there is no net benefit from implementing the above strategy by establishing a Family Trust, and transferring excess financial assets into the structure to fund an insurance bond investment. This is due to the means testing framework for residential Aged Care from 1 July 2014. However with these recent claims, we decided to take a second look and see if the statements held up to scrutiny.

The idea

The claim is that by implementing the strategy, the Means Tested Amount (MTA) calculated for residential Aged Care fees would reduce, as there is less deemed income since insurance bonds do not distribute income. This is true – however only so long as no withdrawals are made from the bond.

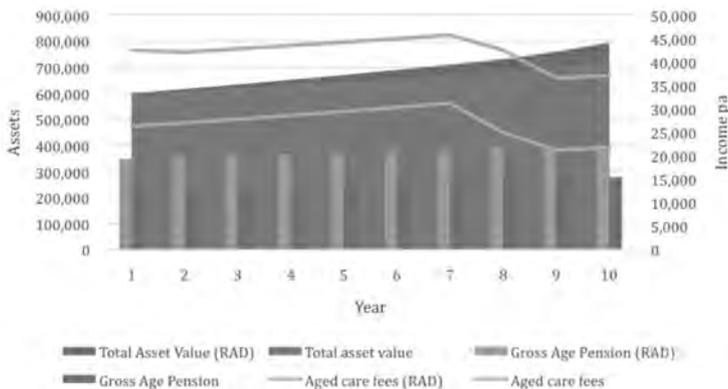
The counter-claim is that, whilst technically true this could reduce the MTA, the larger contributor to the MTA is the assets test, with the income test having only a marginal impact on Aged Care fees. In most cases, this reduction is not going to be worth the additional complexity of the strategy. Further, tax is paid within the insurance bond at the company tax rate of 30 per cent. While your withdrawals may come with a rebate, or be tax free altogether, generally your personal rate is lower than this rate and you are worse off overall.

The framework

To put the idea to the test, we established a framework for our analysis, based on the following high level assumptions:

- Where there is a cash flow shortfall, this is funded from assets at the start of the following year. Where possible, it is funded from personal investment assets, otherwise it is drawn from the trust and distributed.
- Any cash flow surpluses are added to the financial investment.
- Each projected period includes calculations for:
 - Age Pension entitlements, based on what happened the previous year (particularly in relation to any Trust distributions)
 - Aged Care fees (noting that whether there is a liability to pay an Accommodation Contribution v Payment, and any lump sum payments, are locked in from year one)
 - tax on earnings within the investment bond
 - tax on earnings on personal investments. These are taxed at marginal tax rates, including the Senior’s Australian and Pensioner Tax Offset and Low Income Tax Offset where relevant. This does not include any Net Medical Expense Tax Offset.
 - Tax on realised capital gains (including the 50per cent discount) and realised insurance bond bonuses (including 30per cent tax credit).
- Earnings on investments (both within the bond and personal investments) are assumed to be the same on a before-tax basis whether invested in a bond or personally. The projection uses a total gross return of 7 per cent pa.
- The maximum permissible interest rate on DAP is 6.22 per cent per annum
- Everything is indexed (tax brackets, Age Pension entitlements and thresholds etc) at 2.5per cent pa.
- There is no cost allowances for the Family Trust in the numbers below.

Figure 1. \$600k in assets v 250k RAD, 350k assets



The numbers discussed below are a subset of our testing, however we believe they are a fair representation of the results achieved.

The typical modelled scenario

Susie has been living rent-free in her daughter’s home, but as she continues to age and her daughter looks to establish her own family Susie decides to take matters into her own hands and talk to her doctor about moving into a residential Aged Care facility. After an Aged Care Assessment Team assessment supporting her need for Aged Care, Susie is offered a place at Autumn Leaves Care Facility, where, depending on her means testing, she would be required to pay a Refundable Accommodation Deposit (RAD) of \$250,000 (or a Daily Accommodation Payment (DAP) equivalent) or simply an accommodation contribution.

Susie’s entire asset pool is captured as a term deposit owned personally, and she seeks financial advice as to how she should pay for her Aged Care fees, and invest any remaining funds. Given her age and circumstances, the only viable options for the deployment of the capital are:

- Payment of a RAD
- Establishment of a personal investment portfolio
- Establishment of a Family Trust and investing in an insurance bond within the Family Trust

The analysis

Establishing a common ground

1. Pre pay RAD vs investing in personal name

Firstly, we looked at the case where Susie’s term deposit is valued at \$600,000. As a starting point, we looked at the impact of pre-paying the RAD (from an Age Pension standpoint) compared to investing personally.

Figure 1 indicates, as would be expected, paying a RAD has the following benefits:

- There is a reduction in the ongoing Aged Care fees. Why? Accommodation costs have been pre-paid rather than being paid over time.
- There is an increase in the Age Pension benefit. Why? The RAD is an exempt asset from an Age Pension standpoint.
- The combination of increased Age Pension and lower ongoing fees allows for the accumulation of additional assets.

Note the sudden drop in the level of Aged Care fees is a result of having reached the lifetime cap in relation to means-tested care fees. The basic daily care fee and any accommodation payments are not impacted by the caps. The slight reduction in in Aged Care fees in the first year is a result of reduced income from the Age Pension, as the 1 January 2017 asset testing changes reduce this benefit.

2. Pre pay RAD vs invest in bond

Figure 2 performs the same analysis using the investment bond strategy, rather than investing personally.

Figure 2. \$600k in bond v 250k RAD, 350k bond

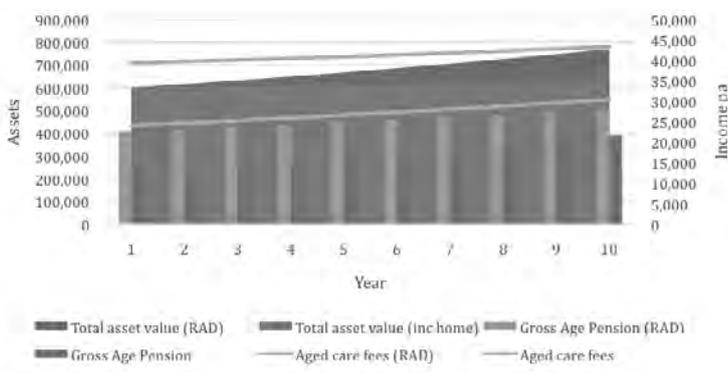
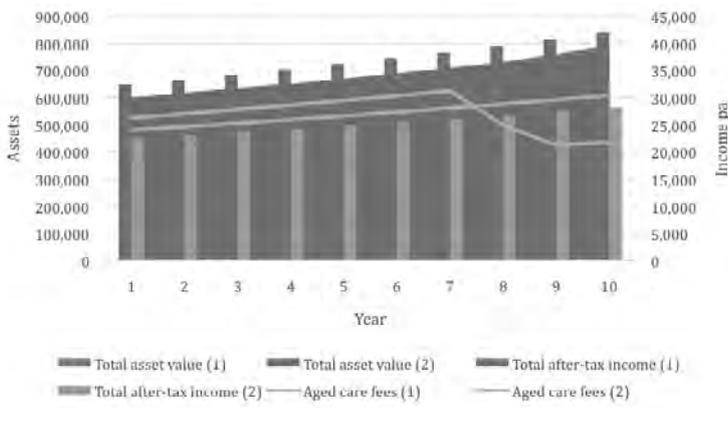


Figure 3. \$350k personal (1) v \$350k bond (2)



This achieves the same results in relation to Aged Care fees, Age Pension entitlements and overall benefit.

However, the base case of having all assets invested in the bond leads to an interesting outcome in that since there is a cash flow shortfall (particularly where no RAD has been paid), a distribution has to be made from the Trust. This increases the amount of income which is assessed for:

- Age Pension purposes, resulting in the Income Test being the harsher test, even after the changes to the Assets Test effective 1 January 2017, and
- Aged Care fees, which simply adds 50c into the Means Tested Amount for every dollar distributed.

Despite this, paying the RAD provides a clear advantage from both a reduction of ongoing care fees standpoint, coupled with an increased Age Pension entitlement.

From the above two scenarios, it is reasonably apparent that in most cases the prepayment of a RAD where liquid assets are available results in a better projected outcome.

As a result, the remainder of our projections will be completed on that basis.

We will also start comparing based on 'total after tax income' rather than isolating the Age Pension benefit, as we have done above.

3. RAD fully paid, balance invested personally vs in bond

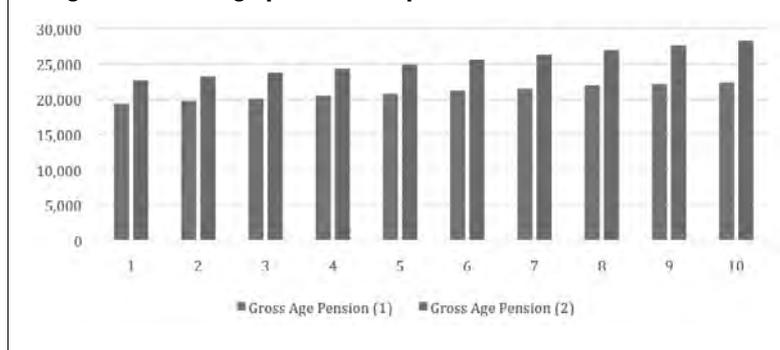
With that established, let's compare the scenarios where a RAD is fully paid and the balance is invested personally (scenario 1), versus in an insurance bond within a family trust (scenario 2).

Breaking down Figure 3 - by investing personally, it can be seen that although the Aged Care fees are initially lower under the bond scenario, there is additional free cash flow (sufficient to meet the increased fees) and a slight added gain of assets. One additional metric to consider before drawing additional conclusions is the amount of Age Pension the person is entitled to under these scenarios, as shown in Figure 4.

Despite what could be implied by the first Figure 3, the Age Pension benefit under the bond scenario is noticeably higher each year. However, the lack of investment income causes the overall level of cash flow to be insufficient to meet the Aged Care fees itself. This means drawdowns will need to be made from the Family Trust to fund Aged Care costs.

To put the specific numbers to Figures 3 and 4, overall the level of assets at the end of the projected period for the personal investment (including the RAD of \$250,000) is \$794,317, compared to \$769,287 under the bond scenario (an increase of \$25,030 or 4.17 per cent of the starting capital). The bond strategy also sees a slight increase in Aged Care costs of \$2,045 over the projected period. It should be noted that despite resulting in a lower overall level of assets, the bond scenario also provides an increased Age Pension benefit of \$34,258 over the same period.

Figure 4. Gross age pension comparison



What does this mean?

The first question you likely have is "This strategy supposed to reduce Aged Care fees, not increase them?" It should be noted that under the bond scenario, the fees are lower on an annual basis until the personal investment scenario hits the lifetime fee cap. Given the lifetime cap is indexed, the insurance bond scenario ends up paying slightly more in notional terms (less than 1% of the total Aged Care fees over the period) in this particular circumstance, as the bond scenario does not reach the fee cap until year 11. Under the bond scenario, halfway through the projection there is a reduction of \$12,670 in Aged Care fees, which is 10% of the total fees paid at that stage. It is clear there is a reduction in Aged Care fees before the care fee caps come into play.

The other piece to keep in mind is that for Aged Care purposes, the Means Tested Amount is the sum of the assets and income tests. Given the level of assessable assets remains the same (and this is generally the bigger contributor to fees), the savings are only modest.

The second question arising from the above is "How does the scenario which pays a higher Age Pension, and virtually the same Aged Care fees result in a slightly lower level of assets at the end of the day?" The answer, dear reader, is taxes.

Earnings within the investment bond are taxed at a flat rate of 30%. Given investment income and Age Pension are taxed personally, this generally results in a marginal rate of tax substantially lower than 30%. Over the projection, total tax paid within the investment bond is \$90,242 (with no personal tax liability), compared to just \$14,474 in tax paid personally under the investing personally scenario. Note this is tax paid within the bond, not tax paid personally. Regardless of how long the bond has been held for, tax is always payable at 30% on its earnings.

So the increased Age Pension benefit and decreased Aged Care fees are more than offset on an overall basis by the increased tax liability on investment earnings. So instead of paying more to your Aged Care provider, you are indirectly paying more to the tax office to help fund the Government's subsidy for Aged Care!



The quote

A Family Trust could be established to provide an investment vehicle for future generations.

Pushing to the extremes

To see if there is a level of assets at which the bond strategy begins to provide a net benefit, we have considered a number of other scenarios.

Lowering the level of assets

At lower levels of assets, the amount of Aged Care fees and Age Pension entitlements under each scenario begin to converge. Additionally the level of personal income tax reduces faster than in the bond given the various tax offsets available personally, which the bond cannot access.

The following table summarises the main results for a scenario where Susie has \$400,000 in liquid assets (so \$150,000 in available funds after paying the RAD).

	Invested in personal name	Invested in bond
Aged Care fees over period	\$238,345	\$225,139 (reduction of \$13,206)
Age Pension paid over period	\$244,967	\$252,547 (increase of \$7,580)
Tax paid over period	\$1,010	\$39,436 (increase of \$38,426)
Total asset value at end of period	\$536,586	\$513,122 (decrease of \$23,463)

By investing assets personally, Susie is projected to have an additional \$23,463 in assets compared to implementing the bond strategy, which equivalent to 5.87 per cent of the initial liquid assets. This is despite the reduced Aged Care fees and increased Age Pension obtained by using the bond.

Raising the level of assets

When looking at the same “all spare cash invested in the bond / personally” scenarios as asset levels increase, first thoughts may be that the increased personal tax, as well as deemed income for Aged Care fees starts really adding up, making the bond strategy more appealing... however as assets increase, Age Pension benefits decrease for both scenarios meaning the Aged Care fees must be solely paid from liquid capital.

For the bond scenario, this means having to realise and distribute larger amounts from the Family Trust, and the assessable income portion of that distribution is captured in the definition of ‘income’ This means the benefit of having reduced income for Aged Care fee assessment purposes is also partially eroded. When these funds are invested personally, there is no change to how the income is assessed and thus selling down a portion of the portfolio to fund costs has a less severe marginal impact.

For example, the following table considers the impacts where Susie has liquid assets of \$1,000,000 (resulting in investments of \$750,000 after the payment of the RAD):

	Invested in personal name	Invested in bond
Aged Care fees over period	\$263,341	\$263,341 (nil impact)
Age Pension paid over period	\$7,118	\$29,158 (increase of \$22,040)
Tax paid over period	\$29,031	\$168,254 (increase of \$139,223)
Total asset value at end of period	\$1,274,806	\$1,133,810 (decrease of \$140,996)

Blended strategy - considerations

We have also looked at whether, once asset values reach level where it could be warranted running two separate strategies, there is any benefit obtained in operating a combined approach (i.e. keeping some liquid cash in the bank account, with the majority of assets being invested within the bond).

To this end, we looked at various combinations of investing the \$750,000. While running a blended strategy is better than running the bond-only strategy, this approach is still less ideal than having a single personal investment portfolio. The relationship is relatively linear in that the less you have in the bond, the closer you are to reaching the relative maximum benefit of having all funds invested personally.

When could this make sense?

To try and understand a situation where this blended strategy may have some appeal, we need to look at what we are trading off when implemented.

What you are giving up	What you are getting
Cash flow generated in your own name	Lower deemed income for Age Pension
Income taxed at your marginal rate	Lower deemed income for Aged Care
	Potential for realised bonus to be assessed as income for Age Pension and Aged Care purposes

Based on this, we believe there could be some benefit where a person is cash flow rich (so they can afford to meet ongoing costs) and still has a significant level of assets (which can be invested for future purposes). However, the interaction of the annual and lifetime caps effectively limits the amount of aged care fee saving you can generate given the value of the bond is still counted as an assessable asset for Aged Care means testing. The benefit of such a strategy are more strongly related to increased Age Pension benefits from a reduction in income testing.

For example, if Susie was receiving a fully taxable income stream of \$20,000 (which is fully assessed for Centrelink purposes and has no associated asset), and had \$750,000 in liquid assets (so \$500,000 remaining after fully paying a RAD), the investment bond strategy would have some merit as shown below:

Under this scenario, over the projected period the Aged Care fees are effectively the same (with the Bond strategy providing a lower daily fee and reaching the cap later, as discussed earlier), however as there is less income to assess for Age Pension purposes, the Income Test is no longer the limiting factor to Susie’s Age Pension entitlement and she receives a higher rate of Age Pension.

The result is additional accumulation of assets to the value of \$23,471 or 3.12 per cent of the net asset value (total assets of \$1,103,898 compared to \$1,080,427 when all assets owned personally). The increased Age Pension benefit is shown in the next graph.

There is a near doubling of the Age Pension benefit over the scenario, and indeed in some years the benefit is more than double. This increased Age Pension is more than sufficient to offset the increased tax paid within the bond, producing the net positive outcome for the strategy. However, this benefit is virtually independent of any Aged Care fee saving, and given the marginal benefit each year, the additional complexity may not be worth the slight increase in overall assets.

Non-monetary considerations

Transferring an asset into a Family Trust, or even simply investing in an insurance bond can remove assets from your Estate, which can help provide Estate Planning outcomes. Further, a Family Trust could be established to provide an investment vehicle for future generations, however there is additional complexity in ensuring the control of the Family Trust is effectively passed to the intended Trustee on death.

Whether there are any ancillary benefits in putting in place this strategy will depend on a client's specific circumstances which may not be able to be quantified. Indeed in some cases the non-monetary benefits may indeed outweigh the additional tax, costs and complexity of this arrangement.

The verdict

Asset testing of Aged Care fees since 1 July 2014 has significantly reduced the ability to reduce overall aged care costs to a level which offsets the increased tax payable on earnings in the bond.

Overall, there may be some marginal merit in the 'Insurance bond in a Family Trust' strategy in cases where there are relatively high levels of assessable income, without an associated assessable asset and the client has funds remaining after paying a RAD.

Additionally, any benefit of reduced fees is capped due to lifetime care costs being capped at an indexed rate, so any reduction in fees may only be a short term benefit. In most cases, clients with a significant level of assets will also be limited by the annual care fees cap, further reducing the benefit of this strategy.

Combined with the additional costs and complexity this arrangement can introduce, for most clients this does not appear to be a feasible strategy on a holistic basis.

Please note rates are effective 20 September 2015. **FS**