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Tax and other benefits of investment bonds

Investment bonds can be a tax-effective option for clients wanting to build wealth for retirement, childrens’ education and other longer term goals.

Overview

An investment bond is a long-term investment option which is a life insurance policy purchased with one or more payments. The value of the policy depends on the amount invested and earnings.

Investment bonds are tax paid investments with tax on earnings capped at 30%. The life insurance company pays tax of 30% on the earnings as opposed to the investor personally. Withdrawals can be made at any time, but tax implications should be considered. When held for at least 10 years, without breaching the 125% rule, no personal tax is paid by the investor on any withdrawals.

Withdrawals within 10 years result in all or part of the growth being included as assessable income in the client’s tax return. However, a 30% tax offset is available.

Investment bonds may be a viable alternative to super for some clients, with potential tax and estate planning advantages. They may also appeal to clients wanting to save for other long-term goals, like their children’s education. Investment bonds may have new planning opportunities given recent legislative changes such as Division 296 tax (from 1 July 2026) and capital gains tax changes (from 1 July 2027).

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Taxation

Earnings

Earnings, including realised capital gains, on an investment bond are internally taxed at the life company's tax rate (30%). The fund also receives the benefit of franking credits and other tax benefits from the underlying income derived. Any capital gain realised is not discounted.

Withdrawals or redemptions

Withdrawals after the 10-year period

Funds can be withdrawn and any growth component is not taxable where an investment bond has been held for at least 10 consecutive years immediately prior to withdrawal, providing there is no breach of the 125% rule. The 125% rule requires that contributions in a year do not exceed 125% of the previous year's contributions. The year is based on the bond's anniversary date. If the 125% rule is breached, the 10 year period recommences from the last breach of the 125% rule. See section '125% rule – additional investments'.

Withdrawals within 10 years

Funds can be accessed at any time but how long the bond has been held, determines the amount of growth included in the person's tax return. Negative returns do not create an income loss. The growth component of withdrawals made within 10 years of starting, or within 10 years of the last breach of the 125% rule, are taxed according to the following table:

Withdrawal made (or if 125% rule is breached, time period is from the last breach)	Amount of growth included in assessable income
Within 8 years	Full amount
Between 8-9 years	Two thirds
Between 9-10 years	One third

Advice tip

Where an amount increases assessable income, consider how this may impact other benefits, eg Family Tax Benefits, low income tax offset, Division 293 tax or the Commonwealth Seniors Health Card.

Calculating the growth amount

The growth amount is calculated using the following formula:

$$A / B \times [(B+C) - (D+E)]$$

Where:

A = amount of current withdrawal

B = surrender value immediately prior to withdrawal (not of the investment option in which a withdrawal is being made but of the entire policy)

C = total of any withdrawal amounts already paid out

D = gross premiums paid to date (ie without deduction of charges such as commissions and management fees).

E = previous amounts included in assessable income

Example 1: withdrawal prior to 10 year anniversary

James places \$1,000 into an investment bond each year. Immediately before the end of the 8th year the policy is worth \$15,000. Details for the investment bond are:

	Amount
Investment (premiums)	\$8,000
Previous withdrawals	\$0
Surrender value	\$15,000

An amount of \$5,000 is withdrawn from the investment bond. The growth amount included in the tax return is calculated below:

A = \$5,000

B = \$15,000

C = \$0

D = \$8,000

E = \$0

Growth amount

= $\$5,000 / \$15,000 \times [(\$15,000 + \$0) - (\$8,000 + \$0)] = \$2,333$

30% tax offset

Any growth component received from an investment bond that is included in a person's assessable income receives a 30% tax offset. This is equal to the life company tax rate which applies to earnings within the bond. The tax offset is non-refundable, therefore personal income tax offsets exceeding the tax payable are not refunded. Using the example above, as \$2,333 is included in assessable income, the tax offset is:

$\$2,333 \times 30\% = \700

Tax free withdrawals in special circumstances

Death

Any amount received due to the death of the life insured, is tax free, irrespective of the 10 year rule.

Pre 28 August 1982 Investment bonds

If the bond started prior to 28 August 1982, any amounts withdrawn are not included in assessable income.

Accident, illness or disability

If the bond is surrendered by the policy owner due to accident, illness or disability suffered by the life insured, no amount is included in assessable income.

Severe financial hardship

No amount is included in assessable income where the bond is surrendered because of serious financial difficulties of the owner.

Advice considerations

Target clients for investment bonds

The table below outlines the types of clients who may benefit from an investment bond, and some of the possible reasons that they may benefit.

Clients who...	Reasons why an investment bond may be suitable
Want to save funds in a non-super environment	<p>Unlike superannuation, there is access to capital within the investment bond.</p> <p>An investment bond may suit clients who have maximised contribution caps or cannot contribute due to total super balance thresholds or age restrictions.</p>
Want to explore tax concessions available	<p>The earnings of an investment bond are taxed in the hands of the life insurance company at a maximum of 30% and not at the person's marginal tax rate, which may be higher.</p> <p>For clients subject to Division 296 tax in super, the percentage of earnings on assets held above \$10 million is up to 40%, which is higher than the 30% tax rate on earnings in an investment bond.</p> <p>As capital gains accrued post-1 July 2027 are generally taxed under an indexation system with a minimum 30% tax payable, investment bonds may provide a tax-effective, and simple alternative.</p> <p>The bond does not directly affect the tax position of the owner unless withdrawn within 10 years.</p>
Wish to provide for beneficiaries	<p>Investment bonds allow benefits to be directed to a person without forming part of the deceased's estate. However, the bond may still form part of the notional estate in NSW.</p>
Are at risk of bankruptcy	<p>Generally, investment bonds are protected from the trustee in bankruptcy where the life insured is the bankrupt individual or their spouse. However, transfers to an investment bond intended to defeat creditors may be available to the trustee in bankruptcy.</p>

Higher income taxpayers

A taxpayer on a marginal tax rate above 30% may achieve an overall higher investment value by using an investment bond and maintaining it for at least 10 years.

Example 2: using insurance bond for high income earner

Max, a widower, is 81 years of age, a conservative investor and is ineligible to make non-concessional contributions. He generates \$160,000 investment income each year, including from a lifetime annuity which is indexed to inflation. The current level of income is above Max's requirements. His financial adviser recommends investing a portion of his savings in an investment bond which will reduce his assessable income as investment bond earnings are taxed at 30% instead of Max's marginal tax rate (up to 39% including Medicare).

Advice Tip

If a client has an aggressive risk profile requiring greater allocation to growth assets, you should consider the lack of the CGT discount in the investment bond.

If taxation is a key issue for a client, other investment options such as superannuation or investing in the name of a low income earning spouse, may be considered. However, eligibility to contribute and access to capital may restrict the superannuation option.

Lower income taxpayers

A bond that is cashed in earlier than the 8th year has the full amount of the growth assessable with a 30% tax offset available.

If a person (for example, a non-working spouse) has a marginal tax rate below 30%, any remaining tax offset after accounting for the investment bond earnings can reduce tax payable on other income. Any excess tax offset is not refundable.

Investors close to retirement can use investment bonds as a means of deferring assessable income to a time after retirement, when their marginal tax rate may reduce.

Switching investment options

Most providers of investment bonds give investors a choice of underlying investments, such as Australian shares, international shares and diversified options. The change to underlying investment options within the investment bond does not restart the 10 year period. Realised gains within the investment bond are not included in the client's tax return. There may be buy-sell spreads when switching between investment options.

125% rule – additional investments

Most bond providers allow additional amounts to be invested each year. Provided such amounts do not exceed 1.25 times the previous year's deposits (the 125% rule), the additional contributions have the same start date as the original investment for calculating the 10 year term. However, if no contributions are made in a year and a contribution is made in a later year, the 10 year term recommences from the date of contribution.

The initial contribution used to commence the bond is included in the first year's contributions. Some providers may limit additional amounts to ensure the 125% rule is satisfied.

Intentional breach of 125% rule

The 10 year period can be reset by intentionally breaching the 125% rule, even where the 10 year period has elapsed. This may provide a small tax benefit to clients with a marginal tax rate lower than 30%. Consider the potential impact on any other tax or assessable income related benefits.

Estate planning

An investment bond is a life policy. On the death of the life insured, the proceeds are paid to either the nominated beneficiary or the policy owner if no nominated beneficiary exists. If the life insured is the policy owner and there is no beneficiary, then the proceeds are paid to their estate. If there are multiple lives insured, the account balance is paid on the death of the last surviving life insured. When purchasing an investment bond, it is important to consider the policy owner, the life insured and the beneficiary.

Policy owner

The policy owner is the person who owns the policy. The policy is an asset of the policy owner and they can make changes at any time, such as changing beneficiaries or investment options.

On the death of the policy owner (who is not the life insured), the bond is transferred to a new owner in accordance with the policy owner's Will. However, if the owner of a child advancement policy (discussed later) dies, during the child's lifetime and before the child reaches the vesting age, the executor of the deceased's estate holds the policy in trust for the child until they reach the vesting age. The executor may assign, withdraw or vary the policy and/or apply the proceeds for the benefit of the child.

Beneficiaries

The beneficiary is the person who is nominated to receive the proceeds on the death of the life insured. There are no restrictions on who can be named as a beneficiary of an insurance policy (unlike superannuation).

Example 3: using investment bond as part of estate plan

Agnes is 78 years of age. She has three adult children who are all financially secure and does not wish to give her capital away currently.

The income she derives from investments exceeds her current requirements. One of Agnes' goals is estate planning. Agnes' adviser recommends an investment bond with her as the policy owner and life insured. The bond achieves her estate planning goals by:

- paying proceeds upon her death
- allowing her to nominate the three children as beneficiaries (bypassing her estate, with a possible exception for the notional estate within NSW)
- simplifying the taxation of the inheritance as there is no tax on receipt of the proceeds by the beneficiaries and no CGT implications.

Transferring ownership of investment bond

The transfer of ownership (or assignment) of an investment bond may have tax implications. Ownership may pass due to the death of the policy owner (who is not the life insured) or it is gifted to another by the policy owner (eg child advancement policy).

Where a transfer occurs and no consideration is given, there are no income tax or CGT implications for the parties involved. The new owner now controls the investment and can make withdrawals.

The tax implications of withdrawals for the new owner are the same as those outlined in the section 'Withdrawals or redemptions'. The anniversary date is based on the date the original owner purchased the investment bond.

An investment bond may change ownership for no consideration if it is:

- inherited from a deceased estate
- assigned to the new owner by gift, or
- transferred to a surviving joint tenant on the death of a joint tenant.

Example

Phil purchased an investment bond on 1 July 2011. On 1 July 2020, he gifts the bond to his son Peter. There are no tax consequences at the point of transferring the investment bond for Phil or Peter. On 1 July 2027, Peter fully withdraws the funds in the investment bond. As the bond has been held for over 10 years without breaching the 125% rule, no amount is assessed in Peter's name. Ownership is determined from original purchase date.

Bankruptcy protection

The bankruptcy legislation provides protection for an investment bond where the life insured is the bankrupt or their spouse, unless the amount transferred into the investment bond was intended to defeat creditors. The client should seek their own legal advice to confirm the bankruptcy protection of an investment bond.

Social security treatment

Investment bonds are treated as financial assets for social security purposes. If the bond is owned individually, the account balance is an assessable asset and deemed under the income test.

If the investment bond is owned through a company or trust, Centrelink use a 'control' and 'source' test to determine which individual/s are attributed with the income and asset of the entity, known as the attributable stakeholders. Income is only generated for the company or trust from the investment bond if a withdrawal is made containing an assessable amount or a capital gain is realised upon disposal where the investment bond was acquired for consideration.

Child advancement policies

A child advancement policy is an investment bond arrangement which meets the following criteria (according to the Life Insurance Act):

- policy is issued before a child has reached 16 years
- life insured is a child
- original owner is a person other than child
- policy provides for the payment of the proceeds to the child when they reach a specified vesting age (from age 10 to 25)
- until the child reaches vesting age, the policy is the absolute property of the original policy owner (or person(s) assigned ownership of the policy)
- when child reaches vesting age, the policy is the absolute property of the child.

The 10 year period does not restart when the ownership of the bond transfers to the child.

Investment bonds – a super alternative

While earnings in an investment bond are generally not as tax effective as superannuation, there is more flexibility regarding contributions, withdrawals and passing on wealth.

Contributions

Investment bonds do not restrict the amount of the initial or ongoing contributions or the age of the contributor. However, clients may elect to restrict any contributions in future years to no more than 125% of the previous year's contribution for tax purposes on withdrawals.

With super, on the other hand, the ability and amount that can be contributed is restricted by the:

- concessional and non-concessional contributions cap
- total superannuation balance limit, and
- transfer balance cap limiting the amount that can be transferred to super's retirement phase.

These caps make it difficult for high income earners and high superannuation account balance holders to contribute to super.

Withdrawals

Withdrawals from investment bonds can be made at any time and can be either adhoc or set-up at regular intervals (ie monthly payments). In contrast, superannuation preservation rules generally restrict withdrawals to when a client attains age 60 and retires or reaches age 65. Withdrawals from a taxed super fund at age 60 or older are tax free.

Tax on earnings

The table below illustrates the various rates of tax on earnings and capital gains for super, investment bonds and personally owned investments. Investment bond earnings may provide a more tax-effective alternative to personally owned investments where earnings and gains are taxed at marginal rates of up to 47% (including Medicare levy). In contrast, investment bond earnings, are less tax-effective than earnings accrued in superannuation.

	Tax on earnings	Tax on capital gains
Super ¹ - accumulation	15%	10% (held for more than 12 months)
Investment bonds	30%	30% (regardless of holding period)
Personally owned investments	Up to 47% (incl. Medicare levy)	Up to 23.5% (held for more than 12 months) – for pre 1 July 2027 accrued gains Up to 47% with indexed cost base (held for more than 12 months) – for post 1 July 2027 accrued gains

Estate planning

A nominated beneficiary(s) can be listed on investment bonds. Like superannuation, the funds can be paid directly to certain beneficiaries and do not automatically form part of the estate (although may form part of the notional estate in NSW). But, unlike superannuation, there are no restrictions on who can be nominated as a beneficiary and the proceeds are received tax-free by all potential beneficiaries.

	Benefit can generally be paid to	Tax on proceeds
Super	SIS dependants or estate	Tax-free to tax dependants Tax payable to non-tax dependants, based on components
Investment bonds	Any beneficiary	Tax-free

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¹ Clients with a total super balance exceeding the large super balance threshold are subject to Division 296 tax and will pay a higher rate of tax, please refer to our article [Division 296: key rules advisers need to understand](#).