

Guide to...

Boosting your super by swapping salary for pension income

Who does this apply to?

This paper discusses a strategy potentially available to people aged between 55 and 70 who wish to increase the rate at which they accrue their savings in the superannuation system.

Background

In recent times there have been a number of favourable legislative developments affecting retirement planning that not only make the system more attractive and flexible, but also will assist people in accruing benefits for their retirement.

From 1 July 2005, new rules apply that mean allocated pensions can be started by people aged 55 and over while they are still in the workforce. The pensions are similar to normal allocated pensions with a restriction on lump sum cash withdrawals or commutations – hence they are commonly known as “non-commutable allocated pensions” (or “transition to retirement pensions”).

Prior to 1 July 2005, people generally had to declare retirement from the workforce to commence a pension with their preserved superannuation benefits;

How does the strategy work?

The strategy involves two steps. This paper contains only a basic outline of the strategy and does not address all issues potentially involved – in particular, the optimum application of the strategy to your circumstances. Your financial adviser can assist with these issues.

Step one – enter into a salary sacrifice agreement and/or increase the amount of salary you sacrifice to your superannuation fund

Salary sacrificing to superannuation is negotiating with your employer to reduce your wages or salary in return for your employer contributing to your superannuation fund. You contract with your employer to do this via a written salary sacrifice agreement.

There are potentially two limits to the amount of your salary you may have directed to your superannuation fund.

First, your employer, your industrial award or your workplace agreement may impose limits to the amount you can salary sacrifice (for example, “maximum of 60% of salary”).

Second the tax legislation also imposes limits on the amount your employer can tax-effectively contribute – for people in the age 55 to 70 band, this amount is \$100,587 in the 2005-06 year.

Bearing in mind this limit, the attraction of salary sacrifice is that you reduce the amount of your salary that is taxed at your marginal rate (which may be as high as 48.5% including Medicare Levy) and at the same time build your retirement assets in the tax-effective superannuation system. Your superannuation contributions are taxed at 15% by the superannuation fund on entry to the fund.

Case Study – Part 1

Robert aged 55 has \$650,000 in his superannuation account and earns \$90,000 plus 9% compulsory superannuation (\$8,100). His taxation and net income position is as follows: -

Salary	\$90,000
Tax payable	<u>(\$27,450)</u> (based on 2005/06 personal income tax rates, includes Medicare Levy)
Net income	\$62,550

Robert negotiates with his employer to salary sacrifice \$65,000 of his salary, reducing his take-home pay to \$25,000.

The \$65,000 being invested into superannuation will be subject to 15% entry tax (\$9,750), which equates to a net investment of \$55,250.

The main issue with salary sacrifice to superannuation from a day to day perspective is a reduction in cash flow and potential commensurate reduction in your current living standards. This strategy can replace your foregone salary with tax-effective pension income.

This is where the second leg of the strategy comes into play.

Step 2 – Commence a non commutable allocated pension

Robert asks his superannuation fund to commence a non-commutable allocated pension with \$600,000 of his superannuation benefit so that his net income will remain unchanged: -

Salary	\$25,000	(after salary sacrifice to superannuation of \$65,000)
Pension	\$50,664	
Tax payable	<u>(\$13,114)</u>	(net of 15% pension offset and Mature Age Worker Tax Offset)
Net income	\$62,550	

Note: if you are 65 or over, you can commence an allocated pension without the commutation restriction.

What are the benefits of the strategy?

First, Robert is investing an extra \$55,250 (net) into his superannuation fund, while drawing down a pension of only \$50,664. That means that an extra \$4,586 in the first year is effectively being invested into Robert’s superannuation fund at no cost to his lifestyle – he is still receiving an income net of tax of \$62,550.

Second, Robert has converted \$600,000 of his \$650,000 superannuation balance into a pension. While the investment earnings on superannuation assets are taxed at concessional rates (maximum 15%), the tax rate on investment earnings of pension fund assets is nil. This means effectively a higher investment earning rate for Robert (assuming earnings are positive).

The beneficial results of the strategy are more pronounced over time.

In Robert’s case the table below illustrates the projected benefit over a 10-year period. The projection assumes a 7.5% earning rate (gross of fees and tax) in Robert’s pension and superannuation funds and also takes into account his compulsory superannuation: -

Year	Before strategy	After strategy	Increase in benefits
1	\$704,951	\$713,440	\$8,490
5	\$968,240	\$1,017,076	\$48,836
10	\$1,422,001	\$1,539,347	\$117,346

A note of caution

An issue to remember is that reducing your take-home salary in this way may affect other benefits, particularly: -

- The amount of compulsory superannuation you are entitled to in some cases may be reduced by salary sacrifice. Some employers may base the 9% compulsory superannuation on the lower salary after sacrifice. So for example in Robert's case, the compulsory superannuation could drop to \$2,250 (9% of \$25,000) rather than \$8,100 (9% of \$90,000);
- Other benefits such as termination benefits (redundancy payments, long service leave and annual leave paid on termination) may be reduced as they are sometimes based on the lower salary amount. If this is the case ensure you can unwind the salary sacrifice arrangement prior to any termination of employment;

Other points to note: -

- The strategy increases your superannuation benefits, which may have Reasonable Benefit Limit and lump sum tax implications;
- There are significantly different rules that apply for people in the age 65 to 70 age bracket.

The importance of advice

The strategy as outlined above has many variations, including where you: -

- Have a spouse and can split superannuation contributions to your spouse and/or have your spouse commence an allocated pension to replace the salary sacrificed;
- Are self employed (rather than employed);
- Are a lower income earner and may be eligible for the Government co-contribution.

The issues are complex, so advice from a licensed financial adviser is very important. In addition, advice is essential because the Australian Taxation Office has recently stated that: -

“(While) arrangements entered into in a straight forward way are consistent with the operation of the law and we do not see grounds for applying anti-avoidance rules...we would (only) be concerned where accessing the pension or undertaking the salary sacrifice may be artificial or contrived” (ATO Media Release – 2005/66).

However if the strategy is appropriate for you and executed correctly, it may assist in boosting your retirement savings and ultimately your living standards in retirement.

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