

TAKING SUPER ACCUMULATION TO THE EXTREME – TECHNICAL ADVISER NOV 2007

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# to the extreme

ANDREW McCLELLAND outlines the key super accumulation strategy that should be implemented to maximise superannuation savings and bridge your client's retirement savings gap.

With the removal of reasonable benefit limits (RBL) and the introduction of tax-free benefits from age 60, the status quo of superannuation in Australia has been flipped on its head.

Under the pre-July 1, 2007, regime, contributions were relatively unrestricted while benefits were restricted (by the operation of the RBLs).

Under the Simpler Super regime, from July 1, 2007, contributions are restricted through the new concessional contribution and non-concessional caps, but benefits are now uncapped and completely tax-free from age 60. Note: The figures and amounts that appear in this article have been reached by using calculations based on Midwinter's Reasonable Basis software.

**Finding the optimal contribution mix**

There will no doubt be some financial advisers

thinking, contribution mix? Don't worry if this is the case – this concept is yet to take off. However, with the new focus being accumulate, accumulate, accumulate, Midwinter believes that finding the optimal contribution mix will be an essential part of ensuring your client's (tax-free) retirement benefits are maximised. Let me explain.

There are two main types of contributions that can be made by individuals:

- Concessional contributions – formerly deductible contributions (includes Superannuation Guarantee (SG), salary sacrifice and self-employed deductible contributions); and

- Non-concessional contributions – formerly undeducted contributions (includes personal contributions and self-employed contributions for which a deduction has not been claimed).

In relation to contributing to super, current financial planning logic suggests the following:

- Where a client's total assessable income plus reportable fringe benefits are less than \$58,980 (i.e. the level at which the Government Co-Contribution kicks in), determine the maximum co-contribution and ensure the necessary non-concessional contribution is made to qualify for that maximum co-contribution. At these assessable income levels, a non-concessional contribution may provide a greater net contribution to super than a concessional contribution.

- Where a client's total assessable income plus reportable fringe benefits exceed \$58,980, make concessional contributions, either by salary sacrifice or deductible self-employed contributions. At these assessable income levels, concessional contributions provide greater net contributions to super. This is exacerbated where total assessable income exceeds \$75,000 or \$150,000, where marginal income tax rates increase to 40 per cent and 45 per cent respectively.

These are both positive measures. However, they do not provide the optimal solution where assessable income falls below \$58,980 (irrespective of whether concessional contributions were made to reduce this level).

Optimising net superannuation contributions can only be achieved through an understanding of the inverse relationship between concessional contributions and the government co-contribution. The maximum co-contribution is based on total assessable income plus reportable fringe benefits, and concessional contributions reduce total assessable income. This means, increasing concessional contributions lowers total assessable income, but increases the maximum co-contribution. However, to be eligible for the co-contribution net income requires the necessary non-concessional contribution.

“ Finding the optimal contribution mix will be an essential part of ensuring your client's retirement benefits are maximised. ”

To find this optimal contribution mix at a desired net income level, looped iteration is necessary where assessable income falls to \$58,980. This process involves replacing \$1 of gross concessional contribution with \$1 of gross non-concessional contribution until the maximum net contribution is determined.

Transition to retirement to the extreme

Since July 1, 2005 the transition to retirement (TTR) condition of release has existed to enable those who are aged 55 and still working access to their superannuation in the form of a non-

commutable pension.

There is no work test applied to access super benefits under the TTR condition of release. There is also no restriction on the amount of super benefits that can be used to commence the transition to retirement pension (TTRP).

**The tax benefits of implementing a TTR strategy**

1. Earnings within super are taxed at up to 15 per cent, but earnings and capital

gains in the pension environment are tax-free;

2. TTRP income drawn from 55 to 59 is eligible for the 15 per cent pension and annuity tax offset, and from age 60 any income drawn from the pension becomes tax free;

3. Drawing tax-effective TTRP income as opposed to taxable salary or business income means less assessable income is required to meet current net income levels – this could mean the eligible person falls into a lower marginal tax rate;

4. Excess salary or business income contributed back to super is taxed at a maximum of 15 per cent (up to contribution deduction limits) – as opposed to individual marginal tax rates of up to 46.5 per cent; and

5. Enhances the ability to qualify for additional tax offsets such as the mature age tax offset or low income tax offset, which are based on a person's level of net income from working (and not other

## Case study – What a difference an optimal super contribution makes

George, aged 45, and Pattie, aged 42, are married. George and Pattie are sole members of the Harrison self-managed super fund (SMSF). George has \$400,000 and Pattie has \$250,000 within the fund. The couple operate a small business and both declare income of \$75,000 to ensure their income tax rate does not exceed 30 per cent. The couple have determined that they require a combined net income of \$80,000.

If George and Pattie take a net income of \$40,000 each, they will both have \$16,775 of net income to invest. Using Midwinter's Contribution Uplift software based on gross income of \$75,000 and a net income requirement of \$40,000 provides the following optimal contribution mix: a concessional contribution of \$24,095 and non-concessional contribution of \$270, which provides a co-contribution payment of \$405. This optimal mix provides the maximum net superannuation contribution of \$21,115 in the first year.

If the couple implement this strategy over the next 10 years and with an earnings rate of 8 per cent before fees and tax and salary growth of 3 per cent per annum, George will have \$1,096,302 in super and Pattie will have \$806,699 in super. To put this in perspective, the Table 1 highlights the effectiveness of making an optimal net contribution to super versus investing the excess net income outside super or using it to pay off the family mortgage.

Table 1: Optimal super contribution v. paying off family mortgage or investment outside super

	Investment outside super	Paying off family mortgage	Optimal super contribution
George & Pattie (combined)	\$495,075	\$524,906	\$660,493

Assumptions - 8% earnings rate before tax, 8% lending rate, 3% salary inflation, Discounted capital gains and 31.5% tax rate applied.

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## Case study – taking TTR to the extreme

John and Yoko, both aged 55, are married. John earns \$150,000 and has \$500,000 in super and Yoko earns \$70,000 and has \$300,000 in super. The couple would like retire at age 65.

Implementing the TTR strategy for both John and Yoko, maintaining their current net income levels provides the following results:

	John		Yoko	
	No TTR strategy implemented	TTR strategy implemented	No TTR strategy implemented	TTR strategy implemented
Salary	\$150,000	\$150,000	\$70,000	\$70,000
Net Income	\$100,650	\$100,650	\$53,350	\$53,350
Accumulated Super	\$1,052,269	\$883,065	\$607,762	\$485,438
Residual TTRP	N/A	\$349,446	N/A	\$199,660
Total Super (age 65)	\$1,052,269	\$1,232,511	\$607,762	\$685,098
<b>Total Benefit Increase</b>	-	<b>\$179,882</b>	-	<b>\$77,336</b>
<b>Total Benefit Increase (%)</b>	-	<b>17.09%</b>	-	<b>12.72%</b>

John and Yoko have suggested they now require a combined net income of \$100,000 - less than their current combined net income of \$153,350. By implementing an optimal TTR strategy again, but this time setting their net income requirement at \$50,000 provides the following:

John & Yoko - combined	No TTR strategy implemented	TTR strategy implemented
Salaries	\$220,000	\$220,000
Net Income	\$154,000	\$100,000
Accumulated Super	\$1,660,031	\$2,035,102
Residual TTRP	N/A	\$850,098
Total Super (age 65)	\$1,660,031	\$2,885,200
<b>Total Benefit Increase</b>	-	<b>\$1,224,809</b>
<b>Total Benefit Increase (%)</b>	-	<b>73.77%</b>

This situation can be enhanced again where determining the optimal contribution mix back to superannuation which can add up to an additional 5 per cent. Implementing an annual pension commutation strategy can also add up to 5 per cent more in total benefits at age 65 (i.e., rolling the residual TTRP and accumulated super into a new pension each year to maximise tax-free earnings in pension phase).

➤ *Continued from page 5*

assessable income – such as pension income).

**What other opportunities exist?**

Other opportunities the TTR condition of release offers include:

1. Reducing desired net income can dramatically increase retirement benefits. This effectively allows more benefits to be retained in the tax-free pension environment and also allows greater contribution back to super;

2. Providing the self-employed with a consistent income stream. Drawing pension income smoothes out

income fluctuations and provides cash-flow certainty;

3. Combine TTR with contribution splitting. With large concessional contributions being contributed back to super under a TTR strategy, splitting contributions between spouses becomes far more effective;

4. Prolong workforce participation. Reducing work hours leading up to retirement and supplementing that reduced salary or self-employed income with TTRP income allows current lifestyle to be maintained and could prolong work life; and

5. Access to additional cash flow. This may be to renovate the family home,

pay for child education expenses, or to make additional personal contributions that qualify for the co-contribution.

**Common TTR misconceptions**

The following are classic TTR misconceptions that should be ignored:

1. TTR should only be implemented for high-net-worth clients;

2. TTR should not be implemented at certain income/benefit levels;

3. The optimal outcome is achieved where drawing the maximum 10 per cent pension income;

4. No benefit where salary sacrificing below \$30,000

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taxable income; and

5. No benefit if the client is already contributing up to their concessional contribution cap.

### Determining the optimal pension income level – pre and post July 1, 2012

There is an optimal pension income level when implementing the TTR strategy (between 4 per cent and 10 per cent) – the pension level that provides the highest increase in superannuation benefits over the period.

position from July 1, 2012, onwards.

### Using gap analysis to enhance accumulation strategy

When providing strategic recommendations (especially during accumulation), it is necessary to demonstrate to the client the impact that advice has made, not only on final retirement balances, but also on the client's net income, capital and social security position throughout retirement.

the optimal pension income level up to June 30, 2012, and then a different position from July 1, 2012, onwards. ”

Determining the optimal position is not a linear equation, as there are various different tax influences affecting the outcome at different times. These include tax scales, offsets, exemptions, incentives and caps.

The concessional contribution caps (CCCs) will significantly affect the outcome over the next few years. The transitional CCC of \$100,000 applies to those aged 50 up to July 2, 2012. From July 1, 2012, the universal CCC of \$50,000 (indexed at average weekly ordinary-time earnings in \$5,000 increments) will apply. It is important that advisers determine the optimal pension income level up to June 30, 2012, and then a different

Providing a retirement savings gap analysis enables the client to more readily identify the impact the strategy will have on net income as a primary objective, and capital and social security as secondary objectives. With the objective being, 'How much net income will you have in retirement?', the advice is put into a context clients can understand.

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## Case Study - Using gap analysis to increase accumulation strategy

Ringo is currently aged 45. He earns \$75,000 per annum in salary and currently salary sacrifices an additional \$5,000. He has \$200,000 in superannuation. Ringo has suggested that he would like to have a net income in retirement of \$60,000 to age 95. Assuming an annual earnings rate of 8.5 per cent, inflation rate of 3 per cent, and a total annual super fund fee of 1.6 per cent per annum, will Ringo's current contribution strategy achieve this goal?

Continuing to implement his current salary sacrifice of \$5,000 from age 45 to 55 and then implementing a TTR strategy from age 55 to 65, maintaining current net income, will provide Ringo with a superannuation balance at age 65 of \$1,096,269 in future value terms or \$815,727 in present value terms. Drawing \$60,000 per annum in net income will mean that Ringo exhausts his capital at age 92. Based on his capital at retirement, Ringo will only be able to draw a net income of \$57,883 per annum in retirement to age 95. This means he has a retirement income expectations gap of \$2,117. Understanding that current strategic advice is insufficient enables the adviser to introduce additional strategy to the client to ensure their retirement savings expectations are met.



**July 2007.** Hundreds of billions of dollars are wiped off the Dow Jones in a three day sell-off as the US Sub-Prime lending crisis worsens.

What might have helped the situation? See the back page.



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