

The budget's crackdown on salary-sacrificing into super mainly hits middle income earners, writes **Gillian Bullock**

THE move to treat salary-sacrificed super as income, announced in the budget, is more likely to hurt low to middle income earners than those on the top marginal tax rate.

The Government has announced plans to broaden the definition of income relating to benefits to include salary-sacrificed contributions to super from July 1 next year.

Under the proposed change, salary-sacrificing into super will no longer reduce your income to such a level that allows you to access government benefits such as the superannuation co-contribution.

Thankfully, the change does not affect your ability to reduce your assessable income for tax purposes through salary-sacrificing contributions to super. But all your income, whether salary-sacrificed or not, will be assessed for benefit purposes.

In the past it has been possible for some Australians to reduce their income to below the \$58,980 threshold prevailing in 2007-08 by salary-sacrificing in order to qualify for the Government's co-contribution scheme. By making an after-tax contribution to super of up to \$1000, you could qualify for a government co-contribution of up to \$1500.

The maximum payable is available for those with an assessable income of less than \$28,980 a year. This amount then reduces by 5c in the dollar up to the cut-off of \$58,980, which is the indexed level for 2007-08. As a result, there was a temptation for those on higher incomes to salary-sacrifice into super to bring income down below this \$58,980 threshold. The argument supporting this action was that the co-contribution was without doubt the

most tax-effective super concession. But it was never a scheme that suited those on high incomes — certainly not once the Howard government introduced the \$50,000 concessional contribution cap for those aged under 50 and \$100,000 cap a year until 2012 for those over 50. From July 1, 2012, there will be a universal cap of the current \$50,000 — although this is indexed, so it may well have moved up to \$60,000 by then. But as it stands now, if you were aged 45 and earning \$110,000 a year, then you couldn't have taken advantage of salary-sacrificing your income down to below \$58,980 without breaching your \$50,000 cap. The same would go for a 55-year-old on \$160,000 a year.

Matthew Esler, general manager of strategy and technical services at Midwinter Financial Services, says it is the middle income earners who will be most heavily hit by the budget clamp-down.

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Tax payoff: take winnings upfront

From Page 1

Using an example of somebody with a starting super balance of \$50,000 who salary-sacrifices into superannuation to achieve a net income level of \$35,000, Esler found that after 10 years it was the person on an original salary of \$100,000, not \$70,000, whose retirement benefits were affected the least.

Esler's figures show those on \$100,000 a year would find their super balance only 1.13 per cent lower after 10 years by not receiving the government co-contribution.

In contrast somebody on \$70,000 a year, the very heart of the working families the Rudd Government promised to help, would see their super at retirement fall by 2.12 per cent without the co-contribution.

In dollar terms, assuming a \$50,000 opening balance and a 7 per cent return after fees, if you were on a salary of \$70,000 before making the salary sacrifice, you would only have accumulated \$824,347 compared with \$842,180 if you had been able to enjoy co-contributions.

For those on \$100,000 before salary-sacrificing, the super balance after 10 years without a co-contribution would be \$1.41 million as opposed to \$1.43 million with the benefit of a co-contribution.

"This policy is counter to the Government's policy of bridging the retirement savings gap and actually makes it harder for low and middle income earners to generate additional retirement savings," says Esler.

Of course it's not a huge difference either way but there is an irony in that those at whom the change was targeted to help should in fact suffer most. Nevertheless many welcome the change, saying it removes the inequities between employees and the self-employed.

Col Lewis of Ipac Securities says an anomaly exists under the current rules where wage earners can reduce their assessable income through salary sacrifice and qualify for a co-contribution but the self-employed can't do the same with personal deductible contributions. This is because eligibility for the co-contribution is based on a total income equal to assessable income, plus reportable fringe benefits, minus deductible business expenses. For a self-employed person, a personal deductible contribution is not a business expense, so cannot reduce their income for co-contribution purposes. As a result the self-employed are disadvantaged.

It is a more level playing field now that nobody can use salary sacrifice or deductible contributions to increase their co-contribution entitlement, says Lewis.

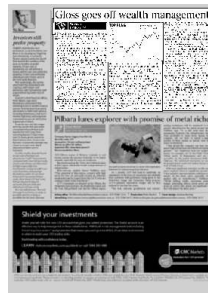
Canning the opportunity to enjoy co-contributions, however, is no reason to abandon salary sacrificing. Louise Biti, head of technical at Asteron, says that while co-contributions are the most tax-effective form of super saving, salary-sacrificing comes a close second.

By salary-sacrificing into super you only pay 15 per cent tax on your contributions (assuming you don't breach your caps) as opposed to your marginal tax rate. As a result you have more to invest than if you made a non-concessional contribution on income after tax.

"Anybody earning more than \$35,000 may get an advantage," says Biti. "You are paying less tax (than your marginal tax rate), so you have more money to invest and to build your account and then all your earnings in super are taxed at a lower level."

There appears to be little benefit in putting money into super when you are only paying 15 per cent tax when you can't access that money until you are 55 unless there are exceptional circumstances.

Of course if you are close to retirement, then maybe your aim is to bolster your super savings as they will be tax free once you turn 60. However, it might be smarter to pay your marginal tax rate on your income, then make a non-concessional contribution so you qualify for a co-contribution.



Gloss goes off wealth management



HOW fashions change: banks these days field nary a question about their wealth management operations when they front the market. Compare this lack of interest with the buzz of the early noughties, when banks clamoured to subsume companies such as Colonial and MLC.

Now banks are taking over other banks to find growth, as exemplified by Westpac's tilt at St George and the Bendigo Bank-Adelaide Bank union.

As well as falling out of vogue, the wealth management sector inevitably has come off the boil as a result of the share market decline. Yet the long-term drivers — compulsory super and generally higher financial literacy — remain compelling for investors with a counter-cyclical bent.

AMP, the biggest non-bank provider, recently acknowledged the deteriorating conditions, reporting a 6 per cent slide in funds under management for the April quarter.

"This is a more challenging environment for wealth management companies than we have experienced in a number of years," chief executive Craig Dunn told AMP's annual meeting this month.

Axa Asia-Pacific, which derives half of its earnings from Asia (Hong Kong), is similarly cautious. For every 10 per cent move in local and offshore share markets, Axa's net profit rises or shrinks by \$120 million, but Axa's earnings are also affected by bond values and currency fluctuations, some of which have been favourable, so the dynamics are more complex.

As with most downturns, not all stocks are affected to the same degree. Those skewed to advice, rather than asset management fees, are better placed to weather the downturn. **Australian Wealth Management (AUW)** — which recently expanded its distribution footprint with a 70 per cent stake in Ord Minnett — and **Count Group (COU)** are examples of small players with a strong advisory bent.

Trust Company (TRU), a much smaller operator, claims to have high immunity from market vicissitudes because 50 per cent of its managed fund revenues derive from cash management accounts. Trust also has earnings from trustee and estate planning services not reliant on market returns.

At the bigger end, Axa looks better placed relative to AMP, which earns 50 per cent of its revenues "from fees that are based on the value of the asset". Axa also has the advantage of a geographic spread of assets, although the important Hong Kong market has been heavy going.

The banks' acquired operations have laboured under a perception of underperformance, but are

emerging as more reliable performers than the lending operations.

According to KPMG, the wealth management operations of the big four banks increased their collective profits by 3.9 per cent in the first half, to \$937 million. That's still a drop in the overall profit bucket, but a resilient figure, given the headwinds.

As KPMG notes, the banks have enjoyed a revenue hedge because market volatility has spurred customers to transfer their savings from wealth management products into banking deposits. This positive impact will be felt in the second-half results.

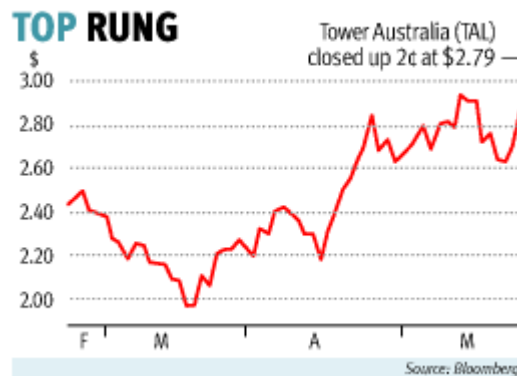
Tower Australia (TAL) presents an alternative investment story because of its dominant exposure to risk products such as life and income cover. According to broker EL&C Baillieu, the adverse market means good vibes for Tower Australia, one of the biggest providers of risk-style products.

The broker says financial advisers have renewed their focus on selling such products because clients have lost interest in investment products. There's also some evidence that high personal debt and increasing job insecurity are prompting sales growth.

As for the most vulnerable stocks, we nominate the pure asset managers such as Westpac spin-off **BT Investment Management (BTT)**, the offshore-focused **Platinum Asset Management (PTM)** and **K2 Asset Management (KAM)**. To be fair, these shares have been discounted already and could be tempting to those convinced the recent share market improvement is more than half-hearted.

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SUPER GAIN WORTH THE SACRIFICE

Salt away your hard-earned before the taxman can get at it

IF you are on the top marginal tax rate, it may end up working in your favour to breach the concessional contribution caps to superannuation.

For people under 50, the concessional cap is \$50,000 a year, while those over 50 can contribute up to \$100,000 until 2011-12.

If you breach these caps, it is deemed an excess concessional contribution and you have to pay an additional 31.5 per cent contributions tax on top of the 15 per cent you have already paid. This brings your total tax exposure on the excess amount equal to the top marginal tax rate of 46.5 per cent.

But that may not be such a bad thing if you are on that top marginal tax rate.

Deborah Wixted, a senior technical manager at Colonial First State, cites the case of Oscar, 45, who has a salary of \$350,000 and is eligible to receive a bonus of \$125,000 in July.

Oscar wants to put all his bonus into super. However, mindful of his \$50,000 concessional cap, he thinks he should just salary-sacrifice up to this amount and put the rest into super as a non-concessional contribution.

But what if he were to ignore the cap and salary-sacrifice the whole \$125,000 bonus? Would he actually be better off?

By doing so, he would pay 15 per cent contributions tax on the \$125,000 (\$18,750) and excess contributions tax of \$23,625, leaving a net contribution of \$82,650.

But the excess tax is not due straight away — indeed in some cases it might be more than a year later, but certainly long after the end of the financial year. As a result, he has \$106,250 (\$125,000 less the \$18,750) sitting in his super account for quite some time.

In addition, he does not even have to pay the excess tax out of his super money and can pay it from his private income, thus maintaining the higher balance he has in super. In fact, if he had money invested in a term deposit outside super, then using that may prove more effective.



Gillian Bullock

According to Wixted's calculations, if he had money invested in a diversified portfolio with an after-tax return of 6.86 per cent (equivalent to 8.5 per cent net in super) both in and outside super, he would be \$1422 better off after five years by paying the excess contributions tax from his investment portfolio, rather than his super.

And of course that money in super is only attracting 15 per cent tax on its earnings, as opposed to his top tax rate, and once he gets to 60 the money and earnings will all be tax free. If Oscar had chosen to stay within the concessional contributions cap, he would make the \$50,000 salary sacrifice into super and then a personal non-concessional contribution.

(For simplicity's sake, this example ignores any money that might be put into super through his 9 per cent superannuation guarantee.)

As a result, after paying 15 per cent contributions tax on the \$50,000, he would have a combined super contribution of \$82,625, compared with the initial super contribution under the other scenario of \$106,250.

Because of the timing advantage where he has \$106,250 earning income from day one, his super balance one year later would be \$115,281 versus \$89,648 by honouring the cap.

By the time his excess contributions tax is due, the two amounts move more into line, but two years after making the initial contribution he is \$3370 ahead. But this is only if he has taken the money out of his super to pay his excess concessional tax.

Five years out he is \$4300 better off by breaching the cap in the first case. While this is not a king's ransom, if he were to do that with his bonus every year, the differences would soon mount up.

Of course, if you are not paying the top rate of tax, it would be foolish to breach your concessional cap as you would end up paying more tax than if you just took the money as salary. And any money that you pay over and above the concessional cap



will count towards your non-concessional contributions cap and here you may find yourself paying up to 90 per cent tax if you breach the \$450,000 cap over a three-year period.

Clearly not a clever move.

Further, the responsibility rests with you, the employee. It is up to you to keep track of just how much money is going into your super through salary sacrifice.

Salary-sacrificing your bonus can be tricky as you can only do it on a prospective basis.

AMP's John Perri says you can only salary-sacrifice bonuses if an agreement is in place before you have earned the entitlement to that bonus.

"You must make the election first," says Perri. "If it is a performance-based bonus then you must not have met that performance before you elect to salary-sacrifice that money."

For example, say Rob's employer, XYZ, made a decision on whether or not to pay employees every March. If Rob elects to salary sacrifice some or all of this bonus, he must enter into an effective salary-sacrifice agreement before March to meet the Australian Tax Office's guidelines.

Salary-sacrificing bonuses is one thing, salary-sacrificing your actual salary is another, because your employer's treatment of your salary sacrificing can affect other parts of your remuneration.

If you were to salary-sacrifice \$30,000 of your \$180,000 salary, you may enjoy a lower tax bracket on your income, but your employer may choose not to bother making the 9 per cent superannuation guarantee payment as they see your salary sacrifice as fulfilling their obligation.

Similarly, if you have any remuneration that is based on a percentage of your salary, your employer may calculate these entitlements on the amount you earn after salary sacrificing. This could affect your long-service leave or even bonuses.

Unless you are paying more than 15 per cent in tax, there is little point in salary sacrificing, particularly if there are a fair few years before you can access the money.

From July 1, you need to be earning at least \$35,862 before salary sacrificing is viable. If you are earning less, it is more tax effective to make a non-concessional contribution of \$1000 and enjoy the Government's co-contribution scheme.

Aside from using bonuses to salary sacrifice, you may also consider applying your long-service leave or even your annual leave.

Say, for instance, you had worked for eight years with your company and were entitled to long-service leave once you had 10 years under your belt.

If you were to elect now to salary-sacrifice your long-service leave into super before the 10-year

qualifying period is completed, this too would fit in with ATO guidelines.

Salary sacrificing is also a clever way to make the most of your super once you have turned 55. By employing a transition to retirement strategy, you can accelerate the growth in your super in the lead-up to your retirement. A TTR strategy allows you to draw down an income from a TTR pension while directing your salary back into your super through salary sacrificing.

Macquarie Wealth Management associate director Doug Webber says it is like having a free kick at building your super. The more you have already accumulated in super, the better this tends to work.

Under transitional rules applying until July 1, 2012, those aged over 50 could potentially salary-sacrifice a total of \$340,000 into super net of the 15 per cent contributions tax. That's \$100,000 pre-tax each financial year. After that date, regardless of age, you will be limited to concessional contributions of \$50,000 a year, although this will be indexed and increase by increments of \$5000.

"In the majority of modelling we have done for those on the top marginal tax rate, TTR will see a greater combination of super and pension balance than not using this strategy," Webber says.

Midwinter Financial Services' general manager of strategy Matthew Esler agrees. He says all high-net-worth individuals aged 55 and still working should be implementing an optimised TTR strategy, even when they are set to exceed or are already exceeding the concessional contribution cap.

"High-income earners should implement the strategy for the tax-free earnings available within the pension phase and where you know you will exceed the concessional contribution caps, make a tax-free non-concessional contribution. You still pay 46.5 per cent tax but it will be treated as tax-free within the fund."

He cites the example of 55-year-old Peter, who is earning \$300,000 a year, has a current super balance of \$500,000 and is contributing \$100,000 a year.

If Peter uses an optimised TTR strategy over a 10-year period and maintains his current net income level, his final super balance will have increased by more than \$86,000, from \$1.84 million to \$2.06 million. This assumes an earnings rate of 7 per cent. In addition, the tax-free component within the fund would have accumulated to \$406,729 through the additional non-concessional contributions.

Salary sacrificing for high-income earners makes sense and for those over 55 with the opportunity to implement a TTR strategy, it's a no-brainer.



A case study: why you should divert more of your pre-tax salary

SALARY sacrifice is a strategy where your employer contributes to a super fund on your behalf instead of paying you the equivalent in salary. Super contributions via salary sacrifice are generally taxed at 15 per cent, which is a lot less than the income tax generally paid before investing in other investments.

Investors find it highly tax effective as his total tax is much less than if set at his marginal tax rate. And that's not counting the investment earnings of his super fund.

In Oscar's case, he's earning \$350,000 and in July is eligible for a bonus of \$125,000.

He thinks the best option for him would be to salary-sacrifice \$50,000 of his bonus and contribute the after-tax amount of the remainder as a non-concessional contribution. But he could be wrong and may benefit by making an excess

concessional contribution. This is because the contribution of \$125,000 receives investment earnings from day one and the excess contributions tax is not deducted until well after the end of the financial year.

If Oscar salary-sacrifices the full \$125,000 he will pay contributions tax of \$18,750 and excess contributions tax of \$23,625, leaving a net contribution of \$82,650. His net income will be \$207,650.

By salary-sacrificing \$50,000, Oscar pays just \$7500 in contributions tax and no excess contributions tax. He could then contribute \$40,125 as a non-concessional contribution. This leaves him with a net super contribution of \$82,650 and net income of \$207,650.

Once his excess contributions tax is paid, Oscar is \$3370 ahead by salary-sacrificing over his cap and after five years he is \$4300 ahead.

HOW IT WORKS

	Salary-sacrifice full bonus	Salary-sacrifice up to concessional cap and personal contribution of remainder
Salary-sacrifice contribution	\$125,000	\$50,000
Personal contribution	Nil	\$40,125
Contributions tax	\$18,750	\$7500
Excess contributions tax	\$23,625	Nil
Income tax	\$142,350	\$177,225
Total taxes	\$184,725	\$184,725
Net super contribution	\$82,625	\$82,625
Net income	\$207,650	\$207,650
July 2008 – Initial net contribution	\$106,250	\$82,625
July 2009 – Balance	\$115,281	\$89,648
February 2010 – Balance after excess contributions tax paid	\$97,275	\$97,268
July 2010 – Balance	\$100,638	\$97,268
July 2013 (five years later) – Balance	\$128,544	\$124,240

Assumptions: contributions tax of 15% is deducted from the contribution at the time it is made; earning rate of 8.5% after tax and fees; concessional contributions cap is \$50,000; excess contributions tax is paid in February after the end of the financial year in which the contribution was made.

Source: Colonial First State



Transition: Matthew Esler says wealthy 55-year-olds still working need an optimised TTR strategy

HEADLINE: Get up to speed on the humps in gearing into loans

AUTHOR: John Wasiliev

Finance firm Portfolio Planning Solutions said it had expected some restrictions on self-managed super funds (SMSF) at the recent federal budget. However, property investment firm Calliva Group said it was confident that super borrowing strategies for SMSF's were permanent following recent Australian Taxation Office clarifications on the issue. Macquarie Bank said his firms Property Lever, allowing DIY funds to borrow up to 55 percent of the value of residential investment property, was within current tax rules. However, geared property investing is being looked at in Superannuation Minister Nick Sherry's current SMSF review. Law firm DBA Butler warned that not all the products and arrangements offered by financial institutions comply with the current legislation.

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MENTIONS: Portfolio Planning Solutions, Calliva Group, Australian Taxation Office, Macquarie Bank, Property Lever, Superannuation Minister Nick Sherry, DBA Butler



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EDITORIAL



Champagne must still be flowing down the offices of IFSA following the Budget announcement. The association, which represents financial service providers responsible for over \$1 trillion of assets, scored a major coup when the government proposed new rules regarding withholding tax on foreign sourced investments. IFSA has long lobbied for the 30 per cent rate to be lowered and this month – with the rate falling to 7.5 per cent – they got the answer they wanted.

The government's ruling was a major victory for IFSA and a big step for the industry. What is interesting is that the industry is full of non-profit associations such as ASFA, FPA, SPAA, AFA, AIST and ICA that have solidly worked in the background to get the financial services industry to where it is today. Lobbying for fundamental changes to benefit a wider community base is often a thankless task so I tip my hat to them.

Besides a feature on the Budget

and what it means to the industry (page 22), this edition also features a special report on life insurance (page 15). Think of all the views you have about life insurance works and scratch it. As the article reveals, life insurance is getting a major revamp thanks to new insurance technologies and consumer demand for ultra-flexible, affordable and so-called "lifecycle" insurance.

Last but not least, a leading investment research expert opined that over time, the allocation to

alternatives is likely to continue to rise and reach 20 per cent or more of a typical portfolio. Read his article (page 20) on what this means for a super fund and why traditional asset classes are steadily giving way to non-traditional asset classes.

As always, we welcome your feedback.

Michelle Baltazar
Editor