Strategy Paper: Pre–Retirement Pensions

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Overview

- If you're at least age 55 you can access your super in the form of a pre–retirement pension (also known as a 'transition to retirement' or "TtR" pension) whilst you are still working
- A TtR pension allows you to convert your super into a regular pension, but doesn't allow you to make lump sum withdrawals until you're fully retired
- If you haven't fully retired, you should be able to continue adding to your super:
  - Your employer should continue making compulsory 9.5% Superannuation Guarantee contributions
- You can also make your own salary sacrifice or after-tax contributions:
  - If you do, you may be able to receive enough income from your pre–retirement pension so that your after-tax income is maintained
  - This can be an excellent and tax–effective retirement savings strategy
- This is one of the aspects of a TtR strategy that makes it so flexible:
  - You can start to draw down on your super to supplement your other income while adding to your retirement savings, ready for your eventual retirement
- As you can see, TtR pensions provide you with a range of retirement options, including the ability to phase into full retirement and the option to restructure how you receive your income to maximise your retirement savings:
  - A pre–retirement pension can be incorporated into your retirement strategy in a number of ways, depending on your needs and circumstances
- This Strategy Paper helps to explain how TtR pensions work, what strategy options they provide and their benefits

What are pre–retirement pensions?

If you're at least age 55 you can access your super in the form of a TtR pension whilst you are still working

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To allow access to your superannuation benefits, a pre–retirement pension includes a pension that:

- Allows total income payments each financial year of a maximum of 10% of the pension account balance at the start of the year
- Ensures that the pension cannot be withdrawn as a lump sum unless:
    - You are cashing unrestricted non preserved benefits which were used to commence the pension
    - You have satisfied a condition of release:
        - Such as turning 65
    - The withdrawal is to pay super contributions surcharge, make a payment split to a non–member spouse in accordance with the family law and super rules or to give effect to a release authority

There are no work tests to start a pre–retirement pension – you may be working part time or full time and start a pre–retirement pension.

There are also no limits on the amount of super that can be invested in a pre–retirement pension (other than product provider minimums). You may decide to invest your whole super balance into a pension, or invest only part if you don't require as much income.

Other issues which could limit your ability to properly execute a TtR strategy and which you should consider include:

- Having insufficient super savings to generate the required level of pension income; or
- Having an employer that does not allow salary sacrifice

What is salary sacrifice?

Salary sacrificing involves sacrificing part of your cash salary for the provision of other benefits. The most common benefit is additional super contributions.

The benefits of salary sacrificing are two–fold.

Firstly, salary sacrificing to super can reduce your income tax liability. Secondly, you are increasing the level of savings within your super account.

Complying super funds are taxed at a maximum rate of 15 per cent. Compare this to your own marginal tax rate, which could be considerably higher. It makes sense to put additional money into super, ensuring a higher level of savings to draw on when you're ready to retire.

Limitations and other considerations

From 1 July 2014, $30,000 is the maximum concessional super contribution allowable for the current Financial Year: For individuals aged 49 years and over at 30 June 2014, the concessional contributions cap is $35,000 per annum.

These limits also include any compulsory Superannuation Guarantee (SG) contributions your employer is required to pay. It is also important to realise that if your level of concessional contributions exceeds the relevant cap, the excess amount will be taxed at an additional 31.5%.

While you don't have to pay income tax personally on any amount sacrificed to super, the amount sacrificed will be taxed at 15 per cent within the super fund. However, you should compare this to the tax you would personally have paid if you'd taken the same amount as salary. Also note that you cannot access the contributions until you are eligible to access your super savings.

Who benefits from salary sacrificing to super?

This strategy is available for any employee whose employer offers salary packaging arrangements. If you're unsure if this is available to you, contact your employer's Human Resources department to see what salary packaging arrangements are available and what (if any) rules are in place regarding the arrangements.

From 1 July 2009, salary sacrifice superannuation contributions count as income for the following measures:

- Centrelink income–tested payments under Age Pension age
- Government co–contribution
- Selected tax offsets
- Baby bonus
- Family Tax Benefit Part A & B
- Personal concessional contributions to super
- Medicare levy surcharge liability

Plain Vanilla: What Transition to Retirement was intended for…

The TtR initiative was intended to allow older Australians approaching retirement to reduce their working week while accessing their superannuation as a retirement pension to top up any drop in salary.

Case Study

Joe is an accountant aged 57 with a salary of $105,000 per annum and accumulated superannuation benefits of $450,000, all of which is taxable component. Joe wants to spend more time with his family and wants to reduce his working week from five to three days. He is concerned about the drop in income due to reduced employment.

Joe estimates he requires at least $60,000 net income for his family to maintain an adequate lifestyle.

Using 2014/15 tax rates, the following would be Joe's comparative income position if he reduced his working hours, and his employer reduced his salary proportionately:

	Continue Full Time Work	Reduced Work
Salary (net of SG)	$105,000.00	$63,000.00
Tax Payable	$26,797.00	$12,022.00
Medicare Levy	$2,100.00	$1,260.00
Low Income Rebate	$ -	$55.00
Net Disposable Income	$76,103.00	$49,773.00

Due to a reduction in work hours, Joe's net disposal income has fallen well below his required $60,000.

Joe commences a TtR pension using $130,000 of his superannuation benefits, drawing $13,000 as a pension. The following table provides a comparative overview of Joe's income situation for the 2014/15 Financial Year.

	Continue Full Time Work	Reduced Work with No Pension	Reduced Work with Pension
Salary	$105,000.00	$63,000.00	$63,000.00
Annual Pension Income	$ -	$ -	$13,000.00
Assessable Income	$105,000.00	$63,000.00	$76,000.00
Tax Payable	$26,797.00	12,022.00	$16,247.00
Medicare Levy	$2,100.00	$1,260.00	$1,520.00
Pension Rebate	$ -	$ -	$1,950.00
Low Income Rebate	$ -	$55.00	$ -
Net Income	$76,103.00	$49,773.00	$60,183.00
Excess/(Shortfall) Over Required Net Income	$ -	-$10,277.00	$183.00

By using a TtR pension, Joe has been able to maintain his net income at the required level.

Taking it further, Joe could transfer more to increase his pension amount and salary sacrifice some of his salary which would otherwise be taxed at 32.5% plus Medicare Levy and a loss of the Low Income Rebate, in effect combining the 'Plain Vanilla' strategy with elements of the salary sacrificing ideas.

But what happens when Joe reaches 60 given that currently pension payments to persons aged 60 or over are tax free?

Joe's net income at 60 would increase to $62,718 due to no tax being payable on the pension amount, which is $2,718 more than his required net income of $60,000.

As such, it may be prudent at this stage for Joe's to either reduce the pension amount being withdrawn (if possible given the minimum annual pension required) or salary sacrifice (while increasing the pension payment) to bring his net income down to the required level.

Given that pension income is tax free, but his salary is taxed, the optimal approach would likely be a combination of increased pension payment and salary sacrifice.

Taking Transition to Retirement further...

As with any government policy, it is advisable to look beyond its obvious practical intention. A TtR strategy is no exception, particularly after the ATO provided written notification that certain TtR strategies were not deemed to be tax avoidance.

Salary sacrificing to higher retirement benefits

The reasons for commencing a TtR pension are not restricted to people that wish to reduce their working hours. Indeed, the biggest benefit is for people who do not wish to reduce their working hours.

Currently there are 5 reasons why an employed person aged 55 and over will generally benefit from combining a TtR pension with a salary sacrifice strategy:

- Salary sacrificing comes from pre–tax dollars which may otherwise get taxed at up to 46.5%:
    - o Salary sacrificed contributions on the other hand are only taxed at 15%
- Retirement income streams from age 60 are completely tax free
- Retirement income streams have a 15% tax offset up to age 60
- Retirement income streams will have a tax free portion of pension payment under 60 where some tax free component exists at purchase
- Pension balances are exempt from tax on earnings, compared to the 15% tax applied in accumulation phase

Similar advantages are available to self–employed persons by claiming tax deductions on their personal contributions to reduce their taxable income.

The whole purpose of combining a salary sacrifice arrangement with a TtR pension should be to maximise retirement benefits without net income falling below required levels.

Case Study 1

Age 55 to 59

Katie is 55. Her gross salary is $85,308.36 p.a., which equates to $64,091.10 p.a. after tax, as detailed below:

Gross Salary	**$85,308.36**
Tax on First $18,200	$ -
Tax on $18,200 to $37,000	$3,572.00
Tax on $37,001 to $80,000	$13,975.00
Tax on $80,000+	$1,964.09
Medicare Levy	$1,706.17
Total Tax Payable	**$21,217.26**
After Tax Income	**$64,091.10**

Katie has $539,683.61 in superannuation assets (no untaxed component).

She is considering making use of a pre–retirement pension, the income from which will give her a 15% tax offset that her ordinary employment income doesn't. She can then salary sacrifice part of her salary to superannuation to offset the reduction in retirement savings from the pension payments. However, she wants her level of after tax income to remain unchanged.

Gross Salary	$85,308.36
Salary Sacrifice	$26,895.71
Net Employment Income	**$58,412.66**
Minimum Pension Payment	$21,587.34
Assessable Income	**$80,000.00**
Tax on Assessable Income	$19,147.00
Pension Rebate	$3,238.00
Net Tax Payable	**$15,908.90**
After Tax Income	**$64,091.10**

It is important to note that Katie is salary sacrificing the maximum amount she possibly can into the superannuation environment. In this situation, her employer is making 9.5% superannuation guarantee contributions on his gross salary of $85,308.36 which equates to an amount of $8,104.29. When this is added to the amount she is salary sacrificing of $26,895.71, she is at the $35,000 p.a. concessional contributions limit.

The net benefit in the first year to Katie can be summarised as follows:

Additional Deductible Super Contributions	$26,895.71
Contributions Tax	$4,034.36
Net Contributions	**$22,861.35**
Pension Payment	$21,587.34
Net Benefit	**$1,274.01**

The benefit to Katie is in the form of getting a further $1,274.01 into superannuation while maintaining exactly the same level of after tax income.

It is very important to note that the table above ignores the value of moving Katie's $539,683.61 in superannuation assets from the accumulation phase to the tax free pension phase.

The table below summarises the benefit of moving to the pension phase, based on a total return of 8.50% p.a., comprising income of 4.75% p.a. (of which 30% is fully franked), capital growth of 3.75% p.a. as well as indicative superannuation fund costs of 1.10% p.a.:

	Accumulation	Pension
Income Return	4.750%	4.750%
Franking Credits	0.611%	0.611%
Costs	**-1.100%**	**-1.100%**
Tax Payable	0.639%	0.000%
Less Franking Credits	0.611%	0.611%
Net Income Return	3.622%	4.261%
Capital Growth	3.750%	3.750%
Total After Tax Return	**7.372%**	**8.011%**

As can be seen, there is a return differential of 0.639% p.a. simply by moving Katie's superannuation assets from the accumulation to the pension phase.

On an asset base of some $539,683.61, such a return differential is equal to an amount of $3,448.58 in the first year. In addition to the benefit of $1,274.01 calculated earlier, the total value of the strategy to be implemented in the first year is an amount of $4,722.58.

In this case study, more of the benefit of the strategy stems from moving Katie's superannuation assets from the accumulation to pension phase.

It is important to note that the calculation above ignores any possible saving on capital gains tax. On the assumption that all of the capital growth is long term in nature (e.g. the assets were held for longer than 12 months), a tax rate of 10% applies in the accumulation phase, an amount of 0.375%. In the pension phase, no capital gains tax liability would arise, which is a further saving of 0.375% p.a

Case Study 2

Aged 60 to 75

Tom is 60. His gross salary is $50,956.06 p.a., which equates to $42,319.66 p.a. after tax, as detailed below:

Gross Salary	**$50,956.06**
Tax on First $18,200	$ -
Tax on $18,200 to $37,000	$3,572.00
Tax on $37,001+	$4,535.72
Medicare Levy	$764.34
Less: Low Income Rebate	$235.66
Net Tax Payable	**$8,636.40**
After Tax Income	**$42,319.66**

Tom has $552,142.12 in superannuation assets. Like Katie, he is considering making use of a pre–retirement pension but he also wants his level of after tax income to remain unchanged.

Gross Salary	$50,956.06
Salary Sacrifice	$30,413.95
Net Employment Income	**$20,542.11**
Minimum Pension Payment	$22,085.68
Assessable Income	**$20,542.11**
Tax on Assessable Income	$445.00
Less: Low Income Rebate	$445.00
Net Tax Payable	**$ -**
Plus: Medicare Levy	$308.13
Total Tax Liability	**$308.13**
After Tax Income	**$42,319.66**

Amazingly, Tom will pay no personal income tax in his personal name however he does pay a very small amount of Medicare Levy. The Low Income Rebate fully offsets the tax levied on Tom's assessable income.

The net benefit to Tom in the first year can be summarised as follows. We have used the same set of return assumptions as we did in the previous case study with Katie when calculating the benefit of being in the pension phase:

Additional Deductible Super Contributions	$30,413.95
Contributions Tax	$4,562.09
Net Contributions	**$25,851.86**
Pension Payment	$22,085.68
Sub Total:	**$3,766.18**
Benefit of Being in Pension Phase	$3,528.19
Total Benefit	**$7,294.36**

A total benefit of $7,294.36 is extracted in the first year by implementing all of the strategies recommended.

Alternative Uses and Variations of the Transition to Retirement Strategy

Whilst the "standard" TtR remains the foundation of most strategies, subtle variations, such as those contained below, may assist achieve other financial objectives and/or boost the taxation benefits of the strategy.

TtR spouse variation

Certain individuals who are members of a couple may benefit from varying the standard TtR, so that one member salary sacrifices and the other commences a TtR income stream.

Using funds outside super boost the TTR strategy

Individuals may benefit from using funds outside super to increase the benefits of a TtR strategy. This can be performed by either:-

1. Drawing down on assets outside super to fund increased salary sacrifice
2. 2Injecting the funds outside super as a non-concessional contribution prior to commencing the TtR:
   a. The higher TtR purchase price allows more income to be drawn (under the 10% maximum rule), which can be used to replace increased salary sacrifice.

It is important to note that performing this strategy may trigger a capital gains tax liability, and any proceeds contributed to super are subject to the normal preservation rules.

Using a TtR to facilitate the acceleration of a debt reduction strategy

Those over the age of 60 may benefit from using a TtR income stream to assist in servicing loan repayments or accelerate debt reduction. This is obviously because pension payments are tax free.

Alternatively, those aged 55 to 59 with superannuation interests mainly composed of tax-free component can also utilise the strategy.

Paying interest only on a home loan and using the spare cash flow to increase salary sacrifice

Some may benefit from 'delaying' capital payments on a home loan and using the spare cash flow to increase salary sacrifice as part of their TtR strategy.

By doing so, individuals may increase their retirement savings in a tax effective manner with a view to repay the capital of the loan by making a lump sum withdrawal from their super when they retire (or at age 65).

Re-contribution for tax purposes

Those aged 55 to 60 whose superannuation contains 'unrestricted non-preserved' funds may benefit from performing a re-contribution strategy prior to commencing a TtR.

Whilst performing a re-contribution strategy will change the preservation status of these monies to preserved, some may accept this disadvantage in order to increase the tax effectiveness of the income from their TtR pension.

TtR strategy, non-concessional variation

Low-income earning individuals who do not generate enough income for salary sacrifice to be tax effective, may still benefit from implementing a TtR strategy by replacing the TtR pension income with non-concessional contributions.

Taking more than the maximum upon attaining age 65

Those undertaking a TtR strategy who continue to work may benefit from increasing the amount they draw from their account based pension upon attaining age 65.

The strategy is valid because the 10% maximum draw down percentage is lifted once the account holder attains age 65 (as this is a superannuation condition of release regardless of work status).

This strategy can be especially beneficial for those with lower super balances.

Strategy considerations

With any potential strategies, you should consider any drawbacks that may arise. The following are some areas that should be considered when assessing the potential to use any of the ideas discussed in this Strategy Paper.

Net income requirements and accumulated superannuation benefits

Your net income requirement will be the key determinant of how beneficial a TtR strategy will be. The lower the annual net income required (assuming a constant salary), the better the outcome. However, this will be compromised by the amount of superannuation benefits accumulated at 55. The lower the super benefits, the lower the amount of pension income that can be drawn, due to a 10% maximum, which means a lower salary sacrifice amount.

Centrelink

Superannuation accumulation assets are exempt from means testing until age pension age. Converting superannuation to pension will result in superannuation losing its status as being exempt from means testing for Social Security purposes. As such, any implementation of a TtR strategy should be assessed with regards to any possible impacts it may have on your current or any possible future social security entitlement although the pension can always be commuted back to accumulation phase if required.

Investment earnings

The benefits of a TtR strategy are likely to be amplified as investment earnings performance increase due to the nil tax environment on earnings in the pension phase. Conversely, lower investment earnings may result in lower benefits or even a detrimental outcome from the strategy.

Capital gains tax ('CGT')

Before using a TtR strategy, your current super fund needs to be assessed to determine whether it allows transfer of superannuation assets to pension phase without triggering a CGT event. However, where you are in a unitised fund this is not a consideration as CGT is already accounted for in the unit price. That is, there are no further CGT implications since it has already been effectively paid.

Life Insurance

If you have life insurance cover as part of your accumulation benefits, it needs to be ensures that there is no loss of such coverage when benefits are transferred to the pension phase.

Salary Sacrificing Arrangements

Before commencing any pension, you should check with your employer to ensure that they are willing to enter into the required salary sacrifice arrangement. You also need to avoid the breaching the concessional contribution cap.

When entering into a salary sacrifice arrangement it is also important to check with your employer on how they intend to finance the 9.5% Superannuation Guarantee. Some employers will continue to pay superannuation contributions as if no salary sacrifice arrangement was made. Other employers will only pay superannuation guarantee in addition to salary sacrifice.