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Case Study

The Cost of Not Getting Good Financial Advice

SMSF Specialists
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The Cost of Not Getting Good Financial Advice

Michael and Glenys (not their real names) were referred to our firm recently as Michael was about to turn 55. They were both financially “savvy” enough to understand that once Michael reached 55 there may be tax advantages available to him through his superannuation as they had previously spoken to friends about Transition to Retirement (TtR) pensions.

Michael and Glenys had owned a very successful small business for a number of years but recently sold out of it. Through conscientious saving and the successful sale of their business, Michael had just under \$1,900,000 in his private super fund of which \$380,000 was unrestricted non-preserved and \$950,000 was a “tax free” component. They carried no debt, had savings in Glenys’s name of about \$400,000 outside superannuation in regular bank accounts and Michael worked on a part time contract basis for the company that purchased their business on a package of \$115,000 per annum, inclusive of the 9.5% superannuation guarantee.

It was immediately clear that Michael and Glenys had built sufficient assets to meet their retirement income needs of \$75,000 per annum. This meeting was not a question of longevity of funds accumulated for retirement, rather to see if we could assist to explore their planning opportunities now that Michael was about to reach 55. Michael planned to work for the next five years to age 60 whilst Glenys was enjoying being the home bearer after working very hard in the business.

We explained to Michael and Glenys there was a range of strategies they should consider including:

Strategy 1

- **That Michael start to salary sacrifice some of his income into superannuation to reduce personal income tax**

For any income above \$80,000 that Michael salary sacrifices, the “tax arbitrage” for salary sacrificing is 38.21%. Put another way, by taking this part of his salary as pay, Michael is 38.21% worse off, excluding the small amount of interest that Michael and Glenys earn for these funds in the bank. It is a no brainer.

The concessional contributions cap is \$35,000. We recommended to Michael that he promptly arrange for this amount to go into his private super fund this year.

In short, between age 55 and 59 the personal tax saving of Michael’s salary sacrifice was going to be \$34,687.08 (based on only paying 15% tax on the salary sacrifice contributions rather than his marginal tax rate).

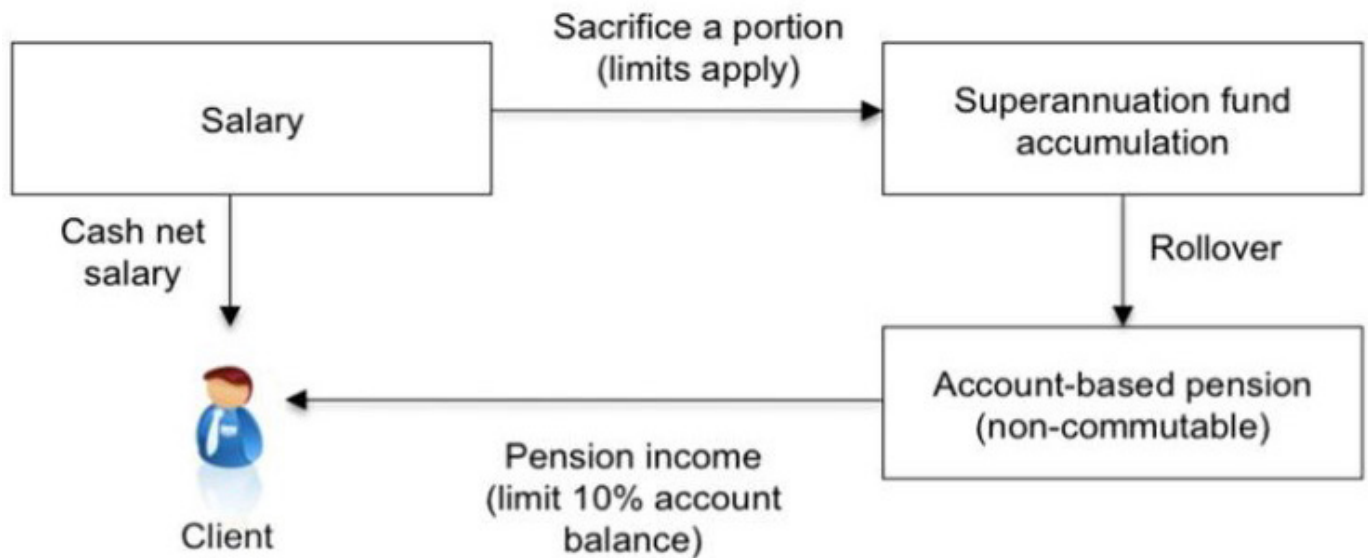
Strategy 2

- **At age 55 converting Michael’s super into a Transition to Retirement Pension (TtR)**

As Michael and Glenys quite rightly pointed out, they still need to live and by making the maximum concessional contribution this financial year from his income, they would not have enough income to live. To allay these fears we developed a strategy to ensure they still have the same level of disposable income as before the salary sacrifice arrangement commenced.

Many understand the value of starting a TtR pension in that there is limited access to tax advantaged pension payments. Michael has access, should he wish, to between 4% and 10% of the member value each year whilst having a TtR pension.

In 95% of cases these TtR Strategies are a recycling of funds as below. We ask individuals to salary sacrifice aggressively whilst at the same time drawing tax advantaged pension payments. The individual ends up with exactly the same level of cash flow in their back pocket but through the tax savings of salary sacrifice they end up with extra in super.



In Michael and Glenys' case however, it was not quite that simple. Based on a super value of \$1,900,000, at a minimum pension drawdown of 4%, Michael would be required to draw down \$76,000 as a minimum pension payment, much more than he needs. Worse than that, as Michael was not yet 60, these pension payments whilst tax advantaged, still attracted tax that would detract from the benefit of the salary sacrifice strategy. In fact, we were able to calculate that Michael's personal income tax would be \$9,120 on the minimum pension payment in the first year.

This combined tax on pension payments of \$9,120 was a major detraction for Michael and Glenys as they could see no sense in drawing these payments. They did not need them to live, he could just use cash held outside super. What they were unaware of is that in the accumulation phase super fund earnings are taxed at up to 15%, whilst in the pension phase the tax on earnings is zero.

Through some rather sophisticated numbers we were able to work out that the difference in tax on his super fund earnings by being in the pension phase rather than the accumulation phase would be \$12,141.

Naturally Michael and Glenys could see the sense in his super being in the pension phase.

But it gets better than that....

One item that Michael and Glenys were not aware of was that Michael had unrestricted non preserved benefits in his super fund of just over \$380,000. As Michael was about to reach age 55, withdrawal of his unrestricted non preserved benefits after 55 would attract zero (0%) tax. So in short, instead of taking the minimum taxable pension payment each year, we simply recommended that Michael take his

annual minimum pension payment as a lump sum withdrawal of his unrestricted non preserved benefit which also sufficed as a pension payment.

It could not get any better for Michael and Glenys. **By being in the pension phase his super fund investments attracted no tax, but better than that, the minimum 4% drawdown could now be taken tax free, rather than the \$9,120 in tax on pension payments being paid.**

The table below illustrates the aggregate benefit in tax savings that we were able extract for Michael and Glenys in the first year alone:

Tax Saved on Pension Payments	\$ 9,120.00
Tax Saving on Salary Sacrifice	\$ 6,937.42
Tax Saving on being in the Pension Phase	\$ 12,141.00
Total Saving	\$ 28,198.42

Strategy 3

- **That Michael and Glenys draw their cash flow shortfall from their savings outside super rather, from their super pension payments, and they re-contribute all their pension payments back into superannuation**

As mentioned earlier Michael was now going to salary sacrifice to reach the concessional contributions cap of \$35,000 this Financial Year. Michael and Glenys required Michael's entire \$115,000 remuneration package to live so our salary sacrifice recommendation was going to put a hole in their cash flow.

In order to ensure the same cash flow prior to commencing the salary sacrifice arrangement, we recommended that Michael and Glenys draw on their tax free savings outside of super to make up the cash flow loss rather from their pension payments.

Simply, as the minimum pension payments Michael will be taking are significantly higher than the amount they are salary sacrificing, by taking these pension payments and re-contributing back into super, we were not depleting Michael's super value. Michael and Glenys's aim was to preserve what they had built in super.

Whilst complex, this example of Michael and Glenys was a perfect example of the potential cost of not getting good advice. Naturally, they were very pleased.

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