Colonial First State

TTR strategies, determining the optimum pension balance

FirstTech Strategic Update

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It is widely acknowledged that a transition to retirement and salary sacrifice strategy is a prudent course of action for a number of our clients working beyond preservation age.

For clients aged 60 or over, an optimal TTR strategy could involve converting all of their super to a TTR pension. For clients aged 55 to 59, however, a more beneficial outcome could occur by converting only a certain amount of their super balance to a TTR pension and leaving the remainder in accumulation phase. The trick, and what this article focuses on, is trying to find that amount.

Note: This article assumes that all clients are members of taxed super funds.

Background – how the TTR strategy provides benefits

A basic transition to retirement and salary sacrifice strategy (TTR strategy) commonly involves a client maintaining their existing level of net income by:

1. converting part or all of their super balance into a TTR pension, then
2. drawing an appropriate pension payment (provides additional after tax income), then
3. making salary sacrifice contributions (removes the additional after tax income).

The TTR strategy allows two distinct types of tax savings leading to a higher overall super balance when the client does retire. Let's call these the Earnings Tax Benefit and the Personal Tax Benefit.

The Earnings Tax Benefit occurs because earnings on assets in a TTR pension are tax free, compared with being taxed at up to 15% while in accumulation phase. For example, a client with a $500,000 super balance earning 8% pa could allow their super fund to save up to $6,000 pa in tax by commencing a TTR pension. Note that in practice, this tax saving would often be lower firstly because of tax deductions available to the fund and secondly because earnings often consist partially of unrealised capital gains.

The Personal Tax Benefit calculates a client's income tax saving by implementing the TTR strategy, after allowing for any increase in contributions tax. In practice, it looks at whether the net amount being contributed to super is greater than the amount coming out (ie, pension payments). It is often a complex calculation that depends on a number of factors, including:

- the client's marginal tax rate
- whether the client is over 60
- what the tax free proportion of the client's TTR pension is (if under 60)
- how much further salary sacrifice contributions the client can make (after allowing for super guarantee and any existing concessional contributions).

Because the Earnings Tax Benefit will always be greater as more money is converted to a TTR pension, the Personal Tax Benefit is the important calculation to focus on when looking at the optimum amount of super with which to commence a TTR pension, because it may decrease, or become negative, as a greater proportion of super is converted to a TTR pension.

Clients aged 60 or over, 100% to the TTR pension is normally the way to go

Clients aged 60 or over may be the main beneficiaries from a TTR strategy by converting all of their super balance to a TTR pension.[1] As well as the Earnings Tax Benefit being maximised, this approach may assist in maximising the client's salary sacrifice contributions while replacing them with tax free pension payments. The Personal Tax Benefit is therefore also maximised – provided we assume that the client's salary sacrifice contributions (and SG) do not exceed their concessional contributions cap.

Below are some illustrative examples only and in each case you will need to consider the individual needs of the client and what is in their best interests.

Example 1: Bill not reaching concessional cap

Bill (age 60) is employed full-time on a salary of $120,000 and receives SG of $11,100. He has a current super balance of $360,000.

Table 1 calculates Bill's Personal Tax Benefit in a range of possible TTR scenarios.

TABLE 1: BILL'S PERSONAL TAX BENEFIT

	$180,000 TTR pension	$270,000 TTR pension	$360,000 TTR pension
Min. TTR pension payment	$7,200*	$10,800*	$14,400*
Pre-tax salary sacrifice equivalent (assumes 38.5% MTR including Medicare levy)	$11,707	$17,561	$23,415
Net super contribution after contributions tax of 15%	$9,951	$14,927	$19,902
Personal Tax Benefit	$2,751	$4,127	$5,502

Assumptions: concessional cap of $35,000 applies, concessional contributions are taxed at 15%, super guarantee is 9.25% of the lower of the Bill's salary or the SG maximum earnings base for 2013–14 of $192,160, and no further existing concessional contributions are being made. Super balance consists of 100% taxable component. Bill is subject to 2013–14 MTRs on his salary (personal tax offsets are ignored). Medicare levy of 1.5% pa applies.

* Bill may look to further optimise the effectiveness of his TTR strategy by electing to increase both pension payments and salary sacrifice. However, for the purposes of working out the ideal maximum TTR pension balance, we have assumed that the minimum TTR pension payment is taken.

We can see that Bill's Personal Tax Benefit, is maximised by converting 100% of his super to a TTR pension. As his Earnings Tax Benefit will also be maximised in this situation, clearly the '100% TTR pension' option is his optimum TTR strategy. But would this also be the case for a client who will fully utilise their concessional cap and still have income to spare under such a strategy?

Example 2: Betty reaches her concessional cap then switches to after tax contributions

Betty (age 60) is employed full-time on a salary of $150,000. She receives SG of $13,875 and her concessional cap is $35,000. She has a current super balance of $600,000. Under any TTR strategy, Betty will make up to $21,125 of salary sacrifice contributions (up to her cap) then make any further contributions as after tax.

Table 2 calculates Betty's Personal Tax Benefit in a range of possible TTR scenarios.

TABLE 2: BETTY'S PERSONAL TAX BENEFIT

	$300,000 TTR pension	$450,000 TTR pension	$600,000 TTR pension
Min. TTR pension payment	$12,000*	$18,000	$24,000
Gross salary sacrifice (assumes 38.5% MTR including Medicare levy)	$19,512	$21,125	$21,125
After tax contributions	–	$5,008	$11,008
Net total super contributions after contributions tax of 15% on salary sacrifice	$16,585	$22,964	$28,964
Personal Tax Benefit	$4,585	$4,964	$4,964

Assumptions: concessional cap of $35,000 applies, concessional contributions are taxed at 15%, super guarantee is 9.25% of the lower of the Betty's salary or the SG maximum earnings base for 2013–14 of $192,160, and no further existing concessional contributions are being made. Super balance consists of 100% taxable component. Betty is subject to 2013–14 MTRs on her salary (personal tax offsets are ignored). Medicare levy of 1.5% pa applies.

* Betty may look to further optimise the effectiveness of her TTR strategy by electing to increase both pension payments and salary sacrifice. However, for the purposes of working out the ideal maximum TTR pension balance, we have assumed that the minimum TTR pension payment is taken.

We can see that Betty's Personal Tax Benefit is maximised to a point by converting more of her super balance to a TTR pension. However, from that point any additional TTR pension commenced and subsequent minimum pension payment received can only be directed back to super as after tax contributions which receive no further personal tax saving – but importantly do not reduce the Personal Tax Benefit.

This means that as more of Betty's super balance is used to commence a TTR pension, the Earnings Tax Benefit is increasing, while the Personal Tax Benefit is either increasing or at least remaining the same. The optimum result for Betty would therefore be to use 100% of her super balance to commence a TTR pension.

Important: the above analysis assumes that all after tax/non-concessional contributions are within Betty's non-concessional contributions cap. Where a client undertakes a TTR strategy that involves making contributions that breach their non-concessional cap, significant tax penalties will likely apply.

1 From a practical perspective, it will generally be best to leave a small nominal amount in accumulation phase to keep the account open until further contributions are made. This is particularly important where insurance is held within the account as the balance will need to cover the cost of insurance premiums.

Clients between preservation age and 59, ideal maximum TTR pension amount is capped

Unlike clients aged over 60 for whom pension payments are tax free, clients between preservation age and 59 are assessed on the taxable component of any pension payments, less a 15% pension tax offset. This means that if such a client undertook a TTR strategy involving salary sacrifice that fully utilised their concessional cap (allowing for SG) any further pension payment received and subsequent after tax contributions made, may decrease their Personal Tax Benefit and likely their overall TTR strategy benefit.

Example 3: Chris reaches his concessional cap then switches to after tax contributions

On 1 July 2014[2], Chris (age 55) is employed full-time on a salary of $150,000. He receives SG of $13,875 and his concessional cap is $35,000. He has a current super balance of $600,000, which is all taxable component. Under any TTR strategy, Chris will make up to $21,125 of salary sacrifice contributions (up to his cap) then make any further contributions as after tax.

Table 3 calculates Chris's Personal Tax Benefit in a range of possible TTR scenarios.

TABLE 3: CHRIS'S PERSONAL TAX BENEFIT

	$300,000 TTR pension	$450,000 TTR pension	$600,000 TTR pension
Min. TTR pension payment	$12,000*	$18,000	$24,000
Net min. TTR pension payment (assumes 39% MTR including Medicare levy, and 15% pension tax offset)	$9,120	$13,680	$18,240
Gross salary sacrifice (assumes 39% MTR including Medicare levy)	$14,951	$21,125	$21,125
After tax contributions	–	$794	$5,354
Net total super contributions after contributions tax of 15% on salary sacrifice	$12,708	$18,750	$23,310
Personal Tax Benefit	$708	$750	-$690

Assumptions: calculation applies on 1 July 2014 assuming a concessional cap of $35,000. Concessional contributions are taxed at 15%, super guarantee is 9.25% of the lower of Chris's salary or the SG maximum earnings base for 2013–14 of $192,160, and no further existing concessional contributions are being made. Super balance consists of 100% taxable component. Chris is subject to 2014–15 MTRs on his salary and pension payments (pension payments also receive a 15% tax offset, but other personal tax offsets are ignored). Medicare levy of 2.0% pa applies.

* Chris may look to further optimise the effectiveness of his TTR strategy by electing to increase both pension payments and salary sacrifice. However, for the purposes of working out the ideal maximum TTR pension balance, we have assumed that the minimum TTR pension payment is taken.

We can see that Chris's Personal Tax Benefit is maximised to a point by converting more of his super balance to a TTR pension. However, from that point any additional TTR pension balance, resulting minimum payment and subsequent after tax contribution lead to Chris paying more income tax – reducing his Personal Tax Benefit.

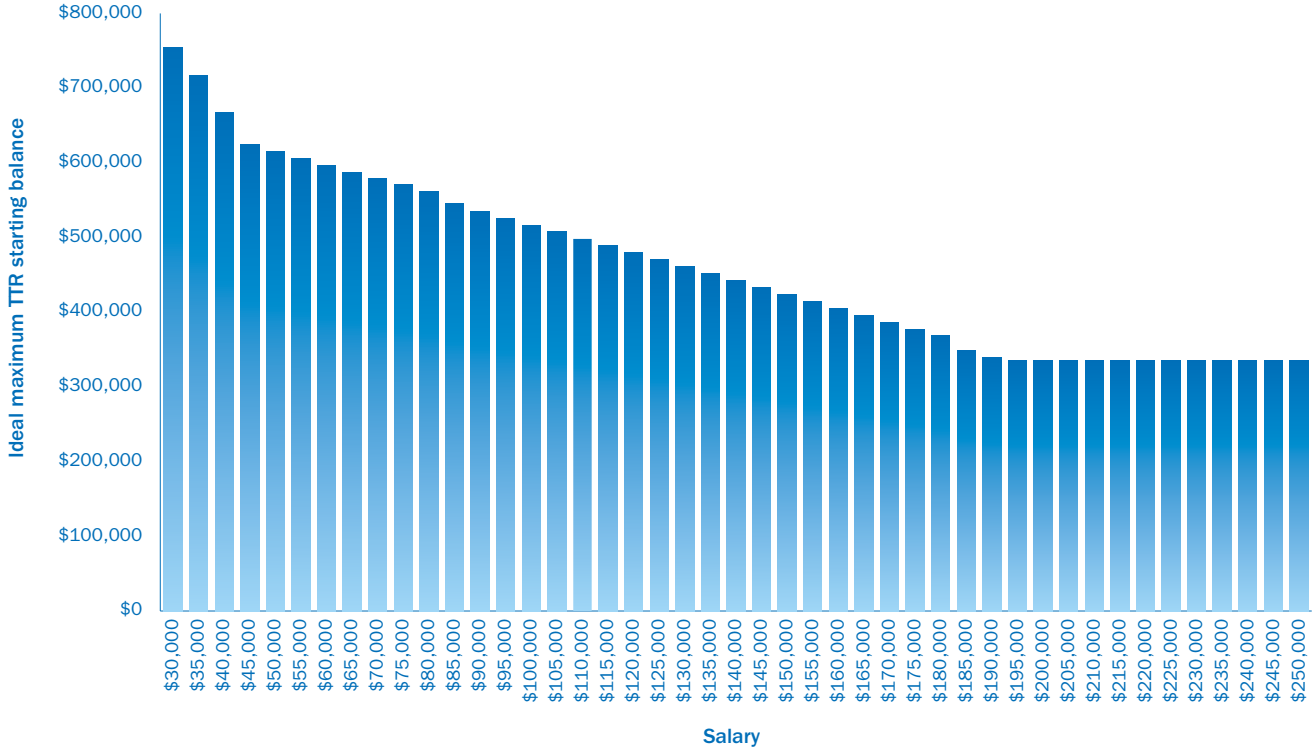
Based on the above information, we would say that Chris should convert approximately $450,000 to a TTR pension to optimise his TTR strategy. But can we be more specific about the ideal TTR pension balance, not only for Chris but for clients on other income levels?

2 This example has been moved to next financial year to enable Chris to have a $35,000 concessional cap and provide a like-for-like comparison with Example 2.

Determining the ideal maximum TTR starting balance for clients aged 55 to 59

For clients aged 55 to 59 with a super balance consisting wholly or mostly of taxable component, the ideal maximum TTR balance will normally occur when the Personal Tax Benefit is maximised. As discussed already, this occurs when the pension balance produces a minimum pension payment that allows the client to fully use their concessional cap, but not have to make further (after tax) contributions. Graph 1 shows the ideal maximum TTR balance for clients on different salaries – assuming a start date of 1 July 2014 and a concessional cap of $35,000.

GRAPH 1: MAXIMUM TTR BALANCE (100% TAXABLE COMPONENT)



Assumptions: calculation applies on 1 July 2014 assuming a concessional cap of $35,000. Concessional contributions are taxed at 15%, super guarantee is 9.25% of the lower of the client's salary or the SG maximum earnings base for 2013–14 of $192,160, and no further existing concessional contributions are being made. Super balance consists of 100% taxable component. The client is subject to 2014–15 MTRs on their salary and pension payments (pension payments also receive a 15% tax offset). The low income tax offset applies where the client is eligible. Medicare levy of 2.0% pa applies.

Graph 1 shows that the ideal maximum TTR balance decreases as a client's salary increases. This is because as salary increases, their SG means that they have less concessional cap free to allow for salary sacrifice contributions under their TTR strategy.

For example, where a client aged 55 has a super balance of $500,000 and a salary of $80,000, their ideal TTR pension balance will be their entire balance (as any TTR pension balance up to approximately $561,000 would increase their Personal Tax Benefit). However, if the same client was receiving a salary of $150,000, they may be best limiting their initial TTR pension balance to around $424,000.

Graph 1 also highlights the impact of the SG maximum earnings base, which means that once a client earns $192,160 or over, their ideal maximum TTR pension balance is fixed at around $336,000. Note that this assumes the client's employer limits their employer contributions to 9.25% of the maximum earnings base.

Won't the additional Earnings Tax Benefit more than compensate for lost Personal Tax Benefit?

While Graph 1 is concerned only with determining the ideal maximum TTR pension balance in order to maximise a client's Personal Tax Benefit under the TTR strategy, it is important to consider what happens to the Earnings Tax Benefit where further money is directed to the TTR pension balance, to see whether it will more than offset the lost Personal Tax Benefit.

For example, Sally is aged 55 and earning a salary of $100,000. She is considering directing $516,694 (the ideal maximum according to Graph 1) to a TTR pension. For every additional $25 in TTR pension commenced, she would receive an extra $1 of minimum pension payment.

Assuming 2014–15 tax and Medicare levy rates, Sally needs to pay tax of 24 cents on her $1 of minimum pension payment (taxed at 39% MTR less 15% offset). If we assume her TTR pension earns 8% (with earnings consisting of 50% income and 50% capital), she can save tax on earnings of up to 15 cents ($25 × 8% × 50% × 15%) by having an additional $25 in her TTR pension.

It is clear that Sally is worse off overall by undertaking a TTR strategy that involves a TTR balance higher than the ideal maximum TTR balance in Table 1.

Table 4 compares the tax consequences of directing an additional $25 (above the ideal maximum TTR balance) to a TTR pension for clients between preservation age and 59.

TABLE 4: EFFECT OF INCREASING TTR BALANCE BY $25

Client's MTR (inc. Medicare levy)	Personal Tax Benefit lost	Earnings Tax Benefit gained	Overall disadvantage
21%	6 cents	15 cents	-9 cents
34.5%	19.5 cents	15 cents	4.5 cents
39%	24 cents	15 cents	9 cents
47%	32 cents	15 cents	17 cents

Assumptions: 2014–15 MTRs apply (pension payments also receive a 15% tax offset) including 2.0% Medicare levy. Other personal tax offsets (eg, low income tax offset) are ignored. Super balance consists of 100% taxable component. TTR pension earns 8% pa, assuming half income (taxed at 15%) and half unrealised gain (not taxed).

With the exception of clients subject to a MTR of 21% or less (see 'best course of action for lower income earning clients' section below), as a general rule we can say that further money (beyond the ideal maximum TTR balances in Graph 1) generally doesn't increase the overall benefit of a TTR strategy. While the Earnings Tax Benefit varies depending on earnings and capital growth/income assumptions, the additional tax paid (less offset) on any extra minimum pension payment (ie, the lost Personal Tax Benefit) normally easily exceeds any additional Earnings Tax Benefit gained.

This is highlighted if we consider the earning rate which would be needed in order to make it worthwhile commencing a pension with a balance in excess of the ideal maximum TTR balance. Leaving aside the 21% MTR, a client's super balance would need to earn[3] at least 10.4% pa (34.5% MTR), 12.8% pa (39% MTR) or 17.1% pa (47% MTR) for this to occur.

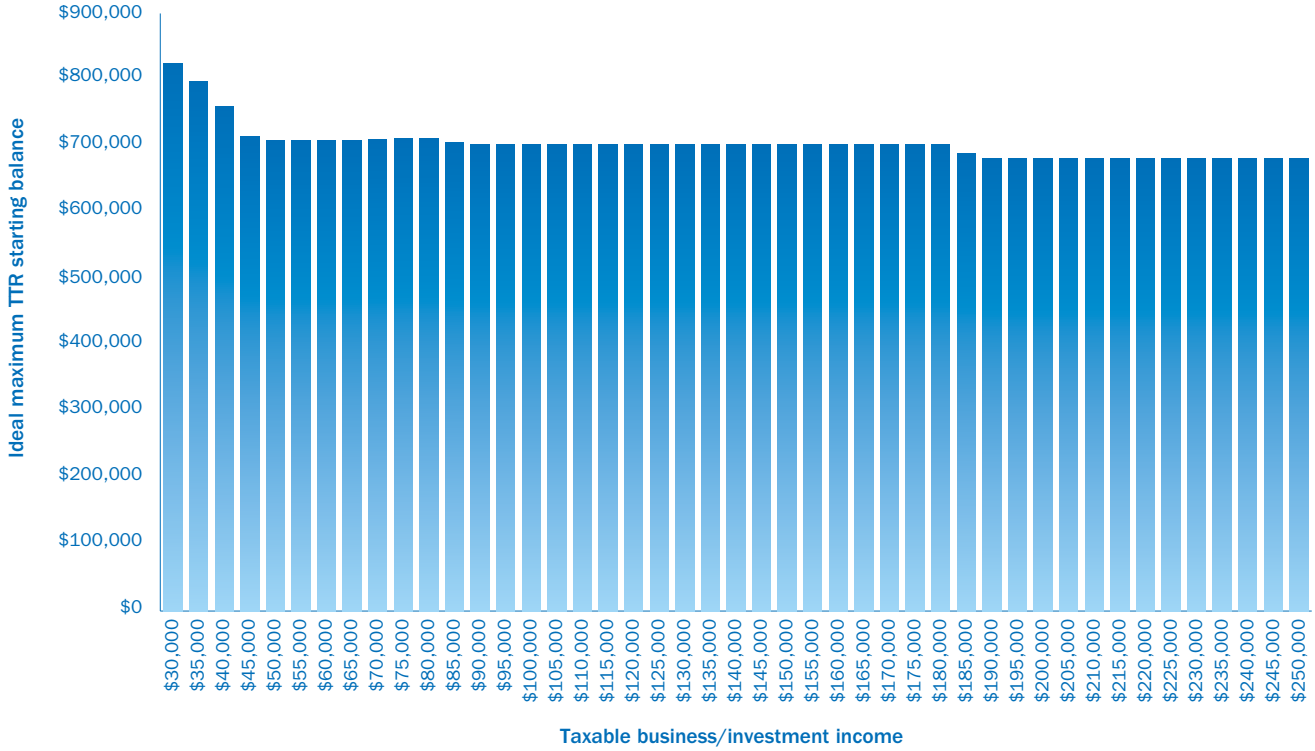
Other considerations for clients between preservation age and 59

Clients earning business or passive income instead of salary

Where a client is earning income only from business (eg, as a sole trader) or passive sources (eg, rent, interest) instead of salary, they are not entitled to SG and assuming no existing personal concessional contributions, will have a full $35,000 concessional cap available.

In this situation, Graph 2 shows that their ideal TTR pension balance will be higher than a client earning a comparable income as salary, and will decrease relatively slowly as the client's taxable income increases.

GRAPH 2: MAXIMUM TTR BALANCE FOR CLIENT WHO RECEIVES NO SG SUPPORT



Assumptions: calculation applies on 1 July 2014 assuming a concessional cap of $35,000. Concessional contributions are taxed at 15%, no existing concessional contributions are being made. Super balance consists of 100% taxable component. The client is subject to 2014–15 MTRs on their salary and pension payments (pension payments also receive a 15% tax offset). The low income tax offset applies where the client is eligible. Medicare levy of 2.0% pa applies.

3 Earnings are assumed to consist of half income (taxed at 15%) and half unrealised gain (not taxed).

Alternative course of action for lower income earning clients

In practice, most clients earning relatively low levels of taxable income will be best undertaking a TTR strategy that converts their entire super balance to a TTR pension. As shown in Graph 1, a client earning a salary of $35,000 (with a MTR of 21% including Medicare levy) in 2014–15 would have to have a total super balance of more than $717,000 before needing to consider whether it is better to convert less than all of their super balance to a TTR pension. In these rare situations, it is important to analyse the client's specific situation to determine whether any additional TTR pension balance would allow an Earnings Tax Benefit that would exceed the loss of Personal Tax Benefit (if any).

When recommending TTR strategies to clients earning relatively low levels of taxable income, it is also important to consider the ideal mix of contributions for an optimal strategy. This consideration is important whether the client is between preservation age and 59, or aged 60 or over. For example, a client aged 60 with a taxable income of $30,000 might make salary sacrifice contributions of $9,458 (to reduce their taxable income to the effective tax free threshold of $20,542) then make any further contributions as after tax.

Employee clients earning less than $48,516 could also look to target the maximum Government Co-contribution for their situation by making after tax contributions of up to $1,000 (depending on their level of income) as part of their TTR strategy. Clients earning $37,000 or less should also ensure they are taking advantage of the low income super contribution of up to $500 that applies when concessional contributions of up to $3,333 are made.

What about clients earning over $300,000?

From 1 July 2012, clients are required to pay an additional 15% tax on any non-excessive concessional contributions which, along with income, exceed $300,000. In this case, the definition of income is taxable income, reportable fringe benefits and total net investment loss.

While the effectiveness of a TTR strategy varies depending on a client's particular circumstances, a TTR strategy can still provide a benefit (although reduced) both for clients, both aged over 60 or between preservation age and 59. One trap to be very careful of though is to ensure that a client who is currently only paying 15% tax on their concessional contributions does not become liable for the additional tax because of undertaking a TTR strategy.

For example, Jason (age 55) receives a salary of $280,000 plus super guarantee of $17,775. He has a super balance of $800,000 (all taxable component). Without a TTR strategy his concessional contributions and salary do not exceed $300,000. If Jason were to start a $335,638 TTR pension (the ideal maximum according to Chart 1) and draw a minimum pension payment of $13,426, his 'income and concessional contributions' would rise to $311,201. By commencing the TTR strategy, Jason would therefore pay an additional tax of 15% on $11,201 of his concessional contributions, or $1,680 extra tax.

A detailed look at the effectiveness of the TTR strategy for clients earning over $300,000 will be the subject to a separate article by FirstTech in the near future.

Conclusion

For many clients looking to start 'transitioning to retirement' while under age 60, an optimum TTR strategy may initially involve using only part of their super balance to commence a TTR pension. This will more readily occur where a client has a high super balance, high income or both.

But for these clients in particular, TTR is not a set and forget strategy. Upon reaching age 60 (and pension payments becoming tax free) an optimal TTR strategy outcome may often be achieved by restarting the strategy at that time with all of the client's super balance in pension phase.