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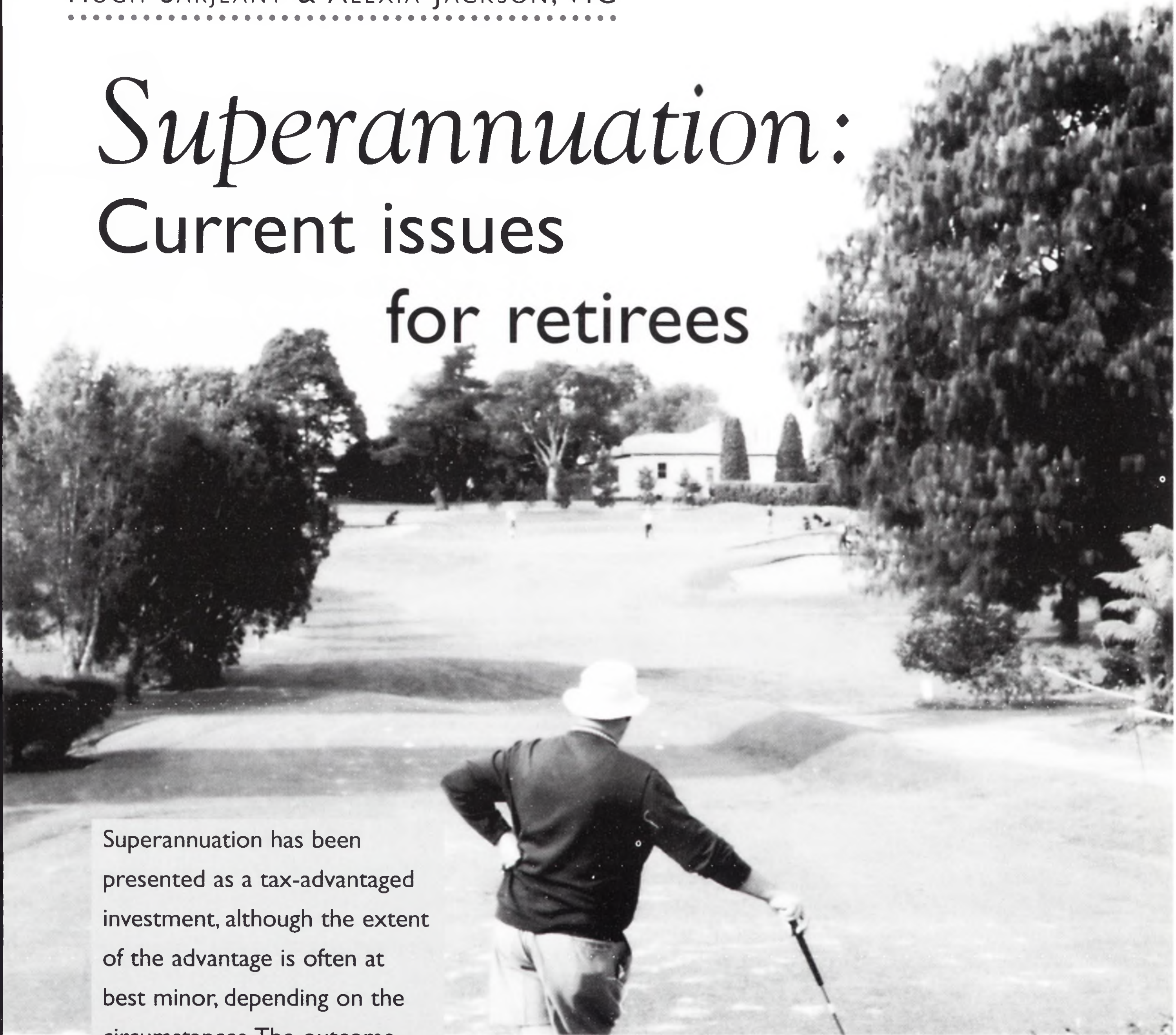
Superannuation: Current issues for retirees



Superannuation has been presented as a tax-advantaged investment, although the extent of the advantage is often at best minor, depending on the circumstances. The outcome differs according to the income, assets and lifestyle of the participants. Hugh Sarjeant and Alexia Jackson look at some of the constraints, the choices that can be made, and ways to alter the outcomes.

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The Legal Framework Governing Superannuation

The quantity of government documentation required for a complete knowledge of superannuation is vast, and the structures are ridiculously complicated. Some key pieces of legislation are:

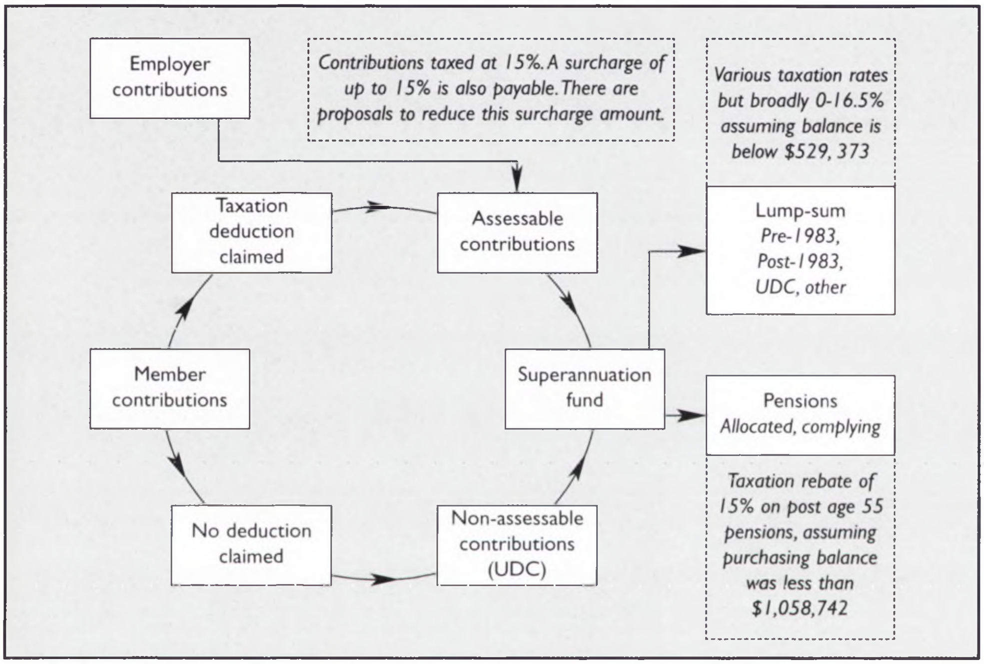
- *Income Tax Assessment Act* 1936
  Part III Division 2 AA taxation of benefit payments
  Part IX taxation of superannuation business and related business
- *Superannuation Industry (Supervision) Act* 1993
  Known as 'the SIS Act', it deals largely with the management and supervision of Superannuation funds
- *Superannuation Guarantee Charge Act* 1992
  Sets out minimum levels of employer support

- *Social Security Act* 1991 (Cth)
  Social security payments are regulated by Federal Government Acts of Parliament. Policy and practice is governed by the *Guide to the Administration of the Social Security Act* which can be viewed on the Department of Family and Community Services website.

Owing to the complexities, individual advice is needed to address specific objectives or needs.

Tax Aspects of Superannuation

Taxation of superannuation applies potentially at all stages of membership, as shown below.



The majority of employers are required to make contributions on behalf of their employees at superannuation guarantee rates. These are currently eight per cent, and due to increase to nine per cent from 1 July 2002. Self-employed individuals can also make contributions and receive a taxation deduction. Contributions made from both of these sources are assessable income.

Contributions assessable to the superannuation fund are taxed at 15 per cent. This taxation rate is increased by a surcharge if the member has an Adjusted Taxable Income (ATI) over $85,242. ATI includes all of an individual's income, including salary, employer-sponsored superannuation contributions, investment income and fringe benefits. The maximum rate at present for the surcharge tax is 15 per cent, making the total contributions tax 30 per cent where ATI exceeds $85,242. The government has proposed to reduce the surcharge tax rate.

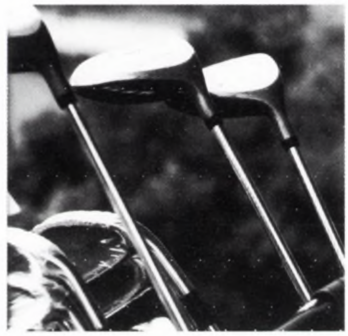
A contribution made by an individual from after-tax income is classified as an Undeducted Contribution (UDC). These contributions are not taxable to the superannuation fund, no contributions tax applies, and no tax deduction is applicable to the member.

Superannuation funds are taxed annually on investment income at the rate of 15 per cent, not allowing for imputation offsets. Capital gains are taxed at 10 per cent, allowing for the one-third of capital gains exempted from tax.

When lump sum benefits are paid, the amount is split into components as:

- Undeducted contributions (UDC, see above)
- Pre-83: relating to service before 1 July 1983
- Post-83: the remainder.

Other components apply in some circumstances.



The taxation basis of benefits cashed at retirement is as follows:

- UDC have already been taxed in the hands of the individual, and so they are not assessable to the superannuation fund, and therefore not taxed. On withdrawal the UDC do not count towards the Reasonable Benefit Limit (RBL).
- Five per cent of the Pre-83 component is added to assessable income for the year and taxed at marginal rates. This concessional treatment means that it is important to preserve any superannuation entitlements which relate to service before July 1983.
- Tax on the Post-83 component for an individual aged 55 years or over is levied in 2001-02 as:

Benefit	Taxation Treatment
Less than $105,843	No tax payable
Between $105,843 and $529,373	16.5% payable on the excess over $105,843 (includes Medicare levy)
Between $529,373 and $1,058,742	48.5% payable on the excess over the lump sum RBL of $529,373 (includes Medicare levy), unless one-half of the benefit is taken as a complying pension

Planning for Retirement

For many employees who may have only small fund balances, superannuation may not form a significant part of retirement planning. On retirement no tax will be paid on the benefit, and it may be used for holidays, home improvements or other discretionary spending.

Other employees will want to have funds available long-term, to provide options for income long into the future. These employees will want to consider how much they should have in superannuation at retirement, what options will then exist, and how to evaluate them.

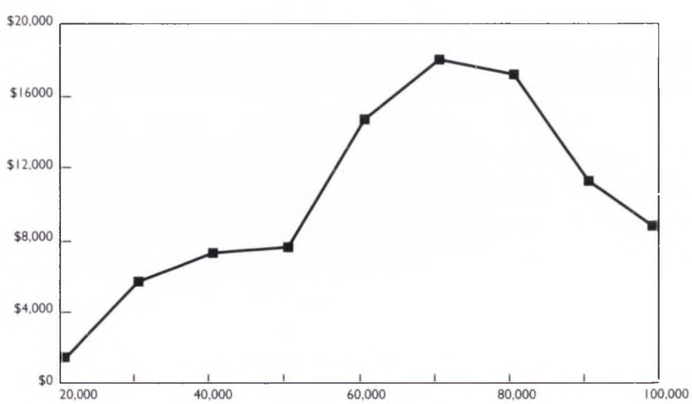
One option may be to consider salary sacrifice, where part of an employee's salary is paid into a superannuation fund instead of being taken in cash. The take-home pay is obviously reduced, but if the reduction can be sustained the increased superannuation benefit may make the sacrifice worthwhile.

Whether or not this will be beneficial will depend on a number of factors, including age, current superannuation entitlements, and salary. For example, for an employee currently aged 55 years with a superannuation balance of $25,000, taking a retirement benefit at age 65 as a lump sum, the comparison would be as below. A balance like $25,000 might be realistic for a member whose entitlements began with the SGC legislation in 1992.

Gross salary	50,000
Value of additional superannuation, as a result of salary sacrifice of 10% of salary to age 65	46,763
Value of accumulated equivalent investment made outside superannuation	39,217
Net value of salary sacrifice	**7,546**

The decision on whether or not to make the salary sacrifice will need to be made recognising the possibility that taxation and investment changes may make the calculations invalid, and in view of the constraints on access to superannuation (see below).

Net benefit of 10% salary sacrifice age 55 to 65



Some Common Terms

Adjusted Taxable Income (ATI) - the income used to assess the surcharge rate an individual pays on superannuation contributions. The ATI is calculated as:

- individual's taxable income as shown in their taxation return
- less ETPs taken in cash
- less any unused leave payouts made
- plus taxpayer's surchargeable contributions in the year
- plus the taxpayer's reportable fringe benefits

Do-It-Yourself Superannuation Fund (DIY) - a fund that an individual sets up and manages. These funds have a limited membership (fewer than five), and are excluded from some of the regulations imposed on other of funds. They are also known as Self-Managed Superannuation Funds (SMSF).

Eligible Service Period (ESP) - is dependent on the fund type. For employer sponsored superannuation funds, it starts when the individual commences employment. For a personal superannuation fund, ESP generally starts with fund membership.

Eligible Termination Payment (ETP) - superannuation payments and some employer termination payments which receive concessional tax treatment. They are defined in the *Income Tax Assessment Act* 1936 (ITAA36) (Cth).

Reasonable Benefit Limit (RBL) - maximum amount of concessionally taxed superannuation benefits a person is permitted to receive over their lifetime.

Residual Capital Value (RCV) - the amount returned at the end of a pension or annuity contract.

Undeducted Contribution (UDC) - amounts contributed to a superannuation fund in the period from 1 July 1983 for which a tax deduction has not been claimed.

The value of salary sacrifice depends on salary level. At the mid-salary levels, the effect of the high marginal tax rates is apparent. At high salaries, the superannuation surcharge depresses the net gain.

Estate Planning

There are a range of complications that can arise with split-families and divorce proceedings. A few considerations when reviewing the use of superannuation and income streams as investment vehicles are discussed below.

A will does not control all financial assets on death. Assets are separated into estate and non-estate assets. Non-estate assets are those assets which the client does not legally own and are passed to beneficiaries by methods other than the execution of a will. There are many assets that are non-estate assets, examples of which are superannuation benefits, pensions and annuities.

For many individuals a major part of their estate value is attributed to their superannuation benefit. Under s62 of the SIS Act, death benefits in the form of a lump sum, and the remainder of the guaranteed portion of a complying or other pension can be paid to:

- the estate of the fund member;
- any one or more of the fund member's dependents; or
- a superannuation death benefits trust established exclusively for dependents.

The SIS Act defines dependents. The date for determining dependency is the date of death. 'Child of any age' means that an adult child is considered dependent.

The trustee of the superannuation fund has discretion as to whom the death benefit will be paid. Whilst individuals may nominate their preferred beneficiary, this nomination is not binding on the trustee. The trustee has to act in accordance with the SIS Act and the preferred beneficiary may not be within the guidelines the trustee has to follow. An individual can make a binding nomination providing the superannuation fund trust deed allows it.

There are tax implications if the benefit is paid as a lump sum from accumulation phase, or from the pension phase. When paid as a lump sum to:

- dependents under the age of 18, the payment is tax free up to the Pension RBL of $1,058,742;
- non-dependents or dependents over 18, the payment is taxed as an Eligible Termination Payment (ETP) based on the deceased's eligible service period, with the following changes:

ETP Component	Taxation Treatment
Pre-1983	5% assessable at marginal tax rates
Post-1983	No tax free threshold. The whole component is taxed at 16.5% (taxed source such as superannuation fund), or 31.5% (untaxed source such as insurance payment)
Undeducted contributions	Tax free
Excessive component (amount over deceased's pension RBL of $1,058,742)	Taxed at 48.5%

"The Commonwealth Government has ...signalled its concern with the ageing of the population..."

- the member's estate, the payment is taxed by the methods above to the extent that the Taxation Commission is satisfied that the recipient will be a dependent.

Similar rules (with slight modifications) apply to pension commutations (conversion of pension to lump sum) and Residual Capital Value (RCV) payments.

Some income stream products provide the annuitant with the option of a reversionary benefit. On death of the member, a surviving spouse will be able to continue to receive the deceased member's pension at a reduced rate, for example, two-thirds of the current pension.

Individuals need to be aware that by investing money into the superannuation environment they are increasing the risk of unintended beneficiaries. In particular, if an individual wants a beneficiary to be someone other than a spouse, child or dependent, superannuation may be an inappropriate investment vehicle for estate planning reasons. ▶

Assumptions and Data

Most outcomes are affected by economic variables such as investment earnings, rates of inflation and rates of wage increases. Where illustrations are provided, values assumed are:

Net rate of return on share investments	8.0%
Gross earning rate on fixed interest investments	5.0%
Inflation	3.0%
Wage growth	4.0%
Administration and insurance charges (% contributions)	2.6%
Administration (% assets, for pensions)	1.5%

Values for the various regulated items, for example tax rates and thresholds, are assumed to be constant in real value over time. In view of recent government practice, the assumption that tax scales will be updated in line with inflation is an optimistic one.

Some factors that affect superannuation arrangements in 2001-02 are:

Superannuation surcharge rates	
Lower threshold	$85,242
Upper threshold	$103,507

RBL limits	
Lump sum	$529,373
Pension	$1,058,742

ETP lump sum tax rates - Post '83 component	Taxed	Untaxed
Age up to 55	21.5%	31.5%
Age 55 & over up to $105,843	Nil	16.5%
Excess over $105,843	16.5%	31.5%

Note: these rates include the Medicare levy

Superannuation Guarantee (SG) rates	
Percentage rate	8%
Maximum employee earning base per quarter	$27,510

Access to Superannuation

SIS Regulations for the preservation, portability and payment of a member's benefits (the 'payment standards') apply.

In general, from 1 July 1999, all contributions to superannuation funds are 'preserved'. That is, unavailable until the later of retirement and a given age. This includes all contributions made by, or on behalf of, an individual, including contributions made out of after-tax income (UDC). All fund earnings are also preserved. The age depends on year of birth, and is 55 years for current retirees. In future years this age will increase to 60 for persons born after 30 June 1964. These requirements may be relaxed if there is financial hardship, or on compassionate grounds.

Benefits must be taken in cash or in some approved form when the member is aged between 65 and 70 and is employed less than 10 hours per week. If aged 70 or over, the benefits must be taken if the member is employed less than 30 hours per week. This is to ensure that people are not using the taxation concessions in the superannuation environment for unintended purposes, such as building up wealth for their heirs.

On withdrawing funds from the superannuation environment a member has a number of options, two of which are:

1. take as cash (lump sum)
2. invest into an income stream

There are taxation advantages of purchasing an income stream. However, this depends on the components of the eligible termination payment, and whether the overall balance exceeds the taxation free threshold of $105,843 or the lump sum RBL of $529,373 (2001-02 rates).

Income Streams in Retirement

Two pension options are:

1. *Allocated Pensions* In this option, the maximum and minimum amounts drawn each year are specified, but there are otherwise few constraints. For example, for a superannuation balance of $100,000, a 65-year-old may draw between $6,370 and $12,350 in the current year.[1] Investment earnings on funds backing pensions in payment are tax-free, and the pension payment itself is taxed as income but with an allowance for any return of capital. This option is relatively simple in concept and operation, but does not entitle the superannuation fund member to the higher RBL, and is counted as an asset for Centrelink purposes. Not all the superannuant's assets need be converted to pension form. Some may remain just as available funds, to be drawn on as required. For those other funds, the tax advantages do not apply.
2. *Complying Pensions* These are of two forms: life pensions and life-expectancy pensions. Both forms meet the requirements for the higher RBL, and have the same tax-free status in respect of earnings on assets. However there are more compliance requirements.

Both forms may be purchased from a life office or other approved supplier, or can be provided through a Do-It-Yourself (DIY) fund. For a life pension purchased from a life office, there is generally total loss on death, and the purchase price may seem unattractive. In a DIY fund, a wide range of asset mixes may be chosen at the discretion of the member, however there are a number of administration and compliance charges to be met.

OTHER ASSETS	Pension Fund Assets 100,000	150,000	200,000	250,000	300,000	350,000
50,000				9,000	18,000	25,000
100,000			11,000	20,000	26,000	29,000
150,000	2,000	14,000	22,000	27,000	30,000	31,000
200,000	15,000	23,000	28,000	31,000	32,000	31,000
250,000	1,000	19,000	23,000	25,000	27,000	25,000
300,000	2,000	7,000	10,000	13,000	15,000	13,000

Total net gain available to a single home-owner.

Impact on Government Pensions

Investments backing a complying life time pension are excluded from the assets test by Centrelink, and so for some members it may be worth the expense and inconvenience to convert some portion of superannuation assets into this form of pension. The assessment will be different from that used by members seeking the higher pension RBL, and the various tax and income components are complicated. The outcome will depend on the size of the investment and the characteristics of the investor.

Entitlement to the age pension is limited by both the income and the assets test. Only that part of the complying pension in excess of an assumed portion, being a return of capital, is counted as income for income-test purposes. Maximum age pensions from Centrelink depend on whether the recipient is single or not, as do the reductions in those maximum pensions for each extra dollar of income or asset above various thresholds. The asset test is affected by whether the individual is a home-owner.

Typically, for an individual for whom this arrangement is likely to be advantageous, there is significant extra savings in early years, with those savings being reduced over time and eventually disappearing. The perception will generally be that the early gains, provided in times of greater physical activity, outweigh any later deterioration in the position. Some illustration of the total net gain available to a single home-owner is set out in the table above.

The illustration is based on a pension payable for the life expectancy of the member. Additional benefits may be achieved from a life-time pension, but the payment period will be longer. Those additional benefits might be of the order of a 10 per cent increase, but again, the end result will depend on a range of assumptions and options chosen.

Conclusion

The superannuation environment in Australia has changed greatly over the period since 1983 when taxation was first introduced. Indications are that the superannuation industry would welcome a clean-up of the mess that has been created. However, the government has now a substantial and rapidly growing source of revenue, and must be expected to retain an interest in that income. The Commonwealth Government has also signalled its concern with the ageing of the population, and increased incentives to take benefits in pension form seem likely.

Options exist, both for current employees and those retired, to change the benefit they ultimately receive from their superannuation fund. The quantum of that changed outcome depends, of course, on their individual circumstances. PL

Footnote:

See table of pension valuation factors from schedule 1A of SIS Regulations.

Sources www.dva.gov.au/pensions/mainpe.htm
www.centrelink.gov.au
www.facs.gov.au/