CASE STUDY: INVESTING FOR RETIREMENT – NON-SUPER v SUPER – HIGHER INCOME

[including Salary Sacrifice, Tax-Deductible Personal Contributions & Non-Concessional Contributions to super]

Investing for retirement using available cash flow

What is super?

Superannuation is an ownership structure specifically designed for investing for retirement purposes. Super is not an investment itself; it is a means for owning assets and investments which generally lowers the tax payable on the returns from those investments. Broadly speaking, you can invest in most of the same investments within super than you can invest in outside super.

Investments owned by super receive significant tax advantages both prior to and throughout retirement.

During your working life (or otherwise prior to age 65), it is possible to direct some of your salary, *before income tax is deducted*, to super by sacrificing some of your salary to super as Concessional Contributions and, from July 2017, it is also now possible for anyone under age 65 to pay a contribution to super and claim a tax deduction for that super contribution. These tax incentives mean that it is possible for you to add more to your super after tax than the reduction to your after-tax income. That is, effectively, the government adds to your super for you. For instance, if you had a marginal tax rate including the Medicare levy of 47% and you were saving $10,000 per annum from your after-tax income, you could instead contribute $18,867 to super via salary sacrifice or personal super contributions for which you claim a tax deduction, which would be tax instead at the super tax rate of up to 15%. This would then add $16,037 to your super balance after tax, which is an increase of $6,037 or over 60% more than you were saving from your after-tax income.

Once assets are owned by super, returns on investments held within super are taxed at up to 15% during 'accumulation phase' (i.e. prior to retirement) and at 0% during 'retirement phase' (i.e. after a certain age and when drawing an income from retirement) which compares to those returns being taxed at up to 47% if held outside super. Once you're eligible to access your super due to an age or retirement related condition, it is possible to transfer super-owned assets into a retirement phase super pension up to a limit known as the Pension Transfer Balance Cap (which is $1.6m for the 2019 financial year) and pay no tax on any investment income (eg interest, rent, dividends) or any realised capital gain generated by those investments. This includes those assets that may be sold to

Concessional Contributions

'Concessional Contributions' is the financial jargon for super contributions for which the payer claims a tax deduction. Concessional Contributions are taxed at up to 15% within your super fund, and include super guarantee, salary sacrifice, additional employer and personal contributions for which a tax deduction has been claimed.

Concessional Contributions Cap

An annual cap on Concessional Contributions applies each financial year and contributions exceeding this amount will be exposed to additional tax. For the 2018/19 financial year the Concessional Contributions Cap is:

- **$25,000 per annum per person**

The contribution caps mean that there are now limits to the ability to accumulate non-super wealth and make large contributions to super just before retirement, especially tax effectively; it is therefore now more advantageous to make smaller contributions throughout our working lives. There has always been a benefit to doing so however the contribution caps reinforce this benefit. Salary sacrifice contributions or personal contributions for which a tax deduction is claimed can be an ideal way of making such contributions

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provide you with the regular super pension income payments that a super pension pays to you.

Furthermore, under current rules, any franking credits that Australian share investments held in a super pension generate are received by the super fund as a cash refund. We note that the Australian Labor Party has proposed a removal of cash refunds for excess franking credits for many people which may become law if they win the next Federal election and proceed with implementing this proposed change to the law. If this were to become law, this would not affect the other tax concessions available to super referred to above.

Furthermore, in retirement (subject to certain criteria being met), you can also draw a regular income from a super pension to meet your living expenses, which can be readily adjusted this as your circumstances change (above a minimum level), and draw lump sum additional amounts without any tax being applied to those income payments or lump sum withdrawals.

That is, if you hold all your investment assets via a super pension in retirement, you can pay no tax in relation to your investment assets at all.

This contrasts to most other asset ownership structures, where almost every dollar of investment income and realised capital gain is taxable income. For assets owned personally, the taxable income generated by the investments is added to other taxable income (which we note includes the Age Pension for retirees) and taxed against the progressive tax scales. This may mean that relatively low levels of taxable income may be able to be received without tax being payable, for instance due to the tax free threshold and other tax offsets, however we often find that this is only a temporary position in retirement as the taxable income grows over time, and due to the need to sell investments to provide a regular income which realises capital gains in an environment where those amounts are taxable income.

Please refer to our Strategic Concept Summary – Super for more details relating to the specific rules regarding accessing super and other aspects of our superannuation system.

Please also refer to our Strategic Concept Summary – Asset Ownership for an outline of the various types of entities via which

Non-Concessional Contributions

'Non-Concessional Contributions' is the financial jargon for super contributions for which the payer does not claim a tax deduction. Concessional Contributions are not taxed when they are paid to super.

Non-Concessional Contributions Cap

An annual cap on Non-Concessional Contributions applies each financial year and contributions exceeding this amount will be exposed to additional tax. For the 2018/19 financial year the Concessional Contributions Cap is:

» **$100,000 per annum per person**

Those under age 65 are also able to 'bring-forward' two years of their Non-Concessional Contributions Cap and contribute **up to $300,000** in a single year or in any combination within a three financial year period. Please note that the super work test needs to be satisfied in each financial year in which a contribution is paid in you're over 65 at the time of the contribution,

[Please note that transitional limits apply to those who triggered their 'bring-forward' rule prior to 30/06/2017. Please contact us for details if this affects you]

Please refer to our Strategic Concept Summary – Super for details relating to other types of contributions to super.

Super – reduce tax; build more wealth; achieve your retirement objectives

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assets may be owned and the taxes applicable to the returns from those assets.

In conclusion, once over age 65 and drawing a pension, investments held in super can be totally tax free (provided that the super pension commenced with a balance equal to or lower than the Pension Transfer Balance Cap applicable at the date the pension commenced). Therefore, the same level of assets owned via super ownership, will most likely be able to provide the same level of income for a longer period in retirement or a higher level of income for the same period in retirement, or both, than the same level of assets owned in personal names or via almost any other type of ownership structure.

In our opinion, this means that for the majority of people, it can be highly advantageous to own as much of their assets via super as possible in retirement.

The question then becomes, how do you maximise the assets available to provide your income in retirement? How do you change the ownership of assets from personal or other asset ownership to super ownership in order to access the benefits super ownership provides?

This Case Study seeks to provide those answers as well as to illustrate the benefits of considering the ownership of your assets, and of considering after-tax outcomes over the long term.

Super salary sacrifice at a glance
Salary sacrifice is an arrangement between you and your employer where you request that part of your employment salary is sacrificed directly into superannuation rather than being paid to you as ordinary salary or wages.

The amount that is sacrificed to super is no longer taxed at your marginal tax rate of up to 47% that applies to employment income, but rather it is taxed as a super contribution at up to 15% upon entry to the super fund (or up to 30% for those with income over $250,000 for the 2019 financial year – a discount of up to the tax applicable to salary received as salary). If your marginal income tax rate is above 15% you can therefore invest more by salary sacrificing to super than you can by investing after tax cash flow.

Also, your employer may agree to pay your salary sacrifice contributions regularly so salary sacrifice provides a convenient savings plan and also reduces your risk of investment at the wrong time ('timing risk') by spreading your investment across many different periods. It provides a natural Dollar Cost Averaging plan. All with the convenience of automatic deduction from your salary so that once set up many don't notice the impact on their personal cash flow.

Tax Deductible Personal Super Contributions at a glance
From July 2017, it is possible for anyone who is eligible to contribute to super up to age 74 to pay a personal contribution and claim a tax deduction for that contribution. Prior to June 2017, this was only permissible for those that satisfied a substantially self-employed test. This now means that in effect anyone, whether they are working or not prior if they're under age 65, and those who satisfy a super work test if they're between age 65 and 74, can now lower the tax they pay on their personal taxable income while at the same time increasing their super balance (and then benefiting from the significant tax

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concessions that owning assets provides potentially for the remainder of their lives). This has a result that is virtually identical to the outcome from salary sacrificing to super.

This therefore means that those whose employers do not offer salary sacrifice contributions to super, those who do not know how much they could afford to contribute to super before they earn their income (as it is a key requirement of any salary sacrifice arrangement that only salary that is yet to be earned is able to be salary sacrificed to super) or those that have a larger-than-usual taxable income in a given financial year, are now achieve a tax effective outcome by paying a personal contribution to super and claiming a tax deduction for it. This then allows those with a marginal tax rate above 15% to contribute more to super than the amount by which their after-tax income reduces (see the earlier calculation in the "What is super?" section)

In addition to those who simply wish to reduce tax and increase the assets available to provide income in retirement, this measure is also likely to be highly advantageous for those who sell an investment and realise a capital gain, or who receive a bonus or incentive payment, or a payment for unused leave in one financial year. They could pay a contribution to super and claim a tax deduction for it which would mean they retain a greater portion of the additional income they have received for their benefit and pay relatively less of that amount in tax.

Catch up Concessional Contributions

Furthermore, from July 2018 those with a Total Superannuation Balance of less than $500,000 just before the beginning of the financial year will be able to carry forward the amount of their Concessional Contribution Cap from the previous five (5) financial years. We note that it is only unused Concessional Contribution Cap amounts from 01/07/2018 that are able to be carried forward, and therefore the first financial year in which a full five years of unused Concessional Contribution Cap amounts are able to be carried forward will be the 2024 financial year (which commences on 01/07/2023).

By way of a simple example, if the Concessional Contribution Cap for the 2024 financial year was still $25,000, and you had paid, or had paid for you, Concessional Contributions totalling $10,000 per annum in each of the preceding five financial years, then you would able to pay a Concessional Contribution of up to $75,000 in the 2024 financial year (five times $15,000).

Who can benefit from a salary sacrifice strategy or tax deductible personal super contribution strategy?

Salary sacrifice and tax deductible personal super contributions can work effectively if you:

» Want (i.e. need!) to grow your retirement savings and/or have a comfortable retirement
» Are under age 75
» Are eligible to contribute to super, including everyone under age 65

What are the catches?

» Super generally cannot be accessed until retirement age. You may therefore wish to have some non-super savings or investments as well as your super that you can access if required. We note that this 'cost' reduces as you get close to retirement age
» Salary sacrifice only: You should check whether sacrificing some of your salary to super adversely affects your employee entitlements, including whether your super guarantee or employer contributions would be reduced

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- Have a marginal tax rate above 15% (in 2018/19, taxable income over $18,200 pa). Higher income earners receive higher benefits
- Can afford to reduce your take home pay. Even a small reduction in take home pay can result in a meaningful super contribution and additional investments at retirement. ***We would ask: can you afford not to make additional super contributions?***
- Have received a larger-than-usual taxable income as a result of such things as selling an investment and realising a capital gain, a bonus or incentive payment, or a payment of unused leave, among many other circumstances

- Salary sacrifice only: Ideally have a written agreement/request with your employer
- Salary sacrifice only: If you wish to salary sacrifice a bonus, you should have the instruction/agreement in place prior to earning the bonus (i.e. completing the work that entitles you to the bonus). Generally you cannot provide a salary sacrifice instruction once your bonus has been confirmed or paid
- Ensure your total Concessional Contributions are within the Contributions Cap
- If you're eligible for the government co-contribution (i.e. a lower income), it may be preferable to use cash flow to make a Non-Concessional Contribution to qualify for that payment as Salary Sacrifice and personal contributions for which you claim a tax deduction do not make you eligible

Case Study: Salary Sacrifice versus investing after-tax income

Meet Judy: Judy is 45, earns $180,000 pa plus super guarantee; that is, a total salary package of $197,100 pa in 2018/19. Judy's marginal tax rate is therefore 47% including the Medicare levy. Judy characterises herself as a ***'motivated wealth accumulator'*** as she wants to live a free and active life in retirement, with plenty of choice regarding where and how she lives. Judy also realises that if she waits until she has paid off her mortgage in full (in 5-10 years!) before she starts saving for retirement she will have left it too late. While Judy realises that she will need to make sacrifices now if she is to provide herself with options in retirement, she enjoys life and would therefore like to limit the impact of those sacrifices. Judy has realised that taking action sooner rather than later will limit the impact of the sacrifices she has to make...as well as teaching her good habits which will provide a foundation for further improvements to her financial strategy over time.

Judy has some non-super investments that she has held for some years which are currently valued at $50,000 and a cost base for CGT purposes of $25,000. Judy has recently completed a budget and, after making a few cutbacks, thinks she has about $20,000 per annum available from her salary that she could save or invest towards achieving her retirement goals. Judy also has built up a cash reserve outside super that she can access to provide for unforeseen expenses. Accordingly, she does not require access to these excess cash flow that she's considering investing.

Judy was intending to invest this in her own name, by adding to her existing non-super investments, however she has become aware that there may be a better way, so she contacts Mammoth Financial.

Throughout their discussions, Mammoth Financial discusses the following options with Judy:

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1. **Non-Super Investment & Regular Investment Plan** – maintain the existing non-super investment and establish a regular investment plan to add $20,000 pa to the investments increasing each year at 2% which allows her cash flow to increase, after tax, at a rate that is similar yet somewhat higher than it is in the super contribution scenario.
2. **Super Investment & Super Contributions** – establish a salary sacrifice plan directing her employer to salary sacrifice up to the Concessional Contributions Cap each year - $25,000 in 2018/19. We note that this could equally have been achieved by Judy paying personal contributions to super for which a personal tax deduction is claimed. As Judy's income increases, and the super guarantee rate increases, her employer's super guarantee contributions will increase and her salary sacrifice contributions will need to adjust each year to remain within the Concessional Contributions Cap. In 2018/19 Judy's super guarantee contributions are $17,100 and therefore her salary sacrifice is $7,900. As this does not utilise the available after-tax cash flow that Judy has available of $20,000 per annum, Judy also pays personal contributions to super for which she does not claim a tax deduction (Non-Concessional Contributions) with the remaining amount of her cash flow. In the first year, these Non-Concessional Contributions are $15,813. That is, immediately Judy is able to contribute an additional $23,713 per annum and her cash flow is the same as it is if she were adding $20,000 per annum to the non-super investment. Furthermore, the addition to her super balance after-tax is $22,528 – ***an increase in the after-tax addition to her investments of $2,528 or over 12.6%, in the first year*** - due to the lower tax applied to the Concessional Contribution amount. This additional net investment increases in future years, and after the contribution to super, compounds within super each year after. Furthermore, due to the tax benefits this super strategy provides, the ongoing Non-Concessional Contributions are estimated to be able to increase at 5% per annum (rather than the 2% increase to her regular investment plan in the Non-Super scenario) and result in a cash flow that is similar to Judy's cash flow in the Non-Super Investment & Regular investment Plan scenario above. Judy also sells her existing personally owned investment for $50,000, pays the capital gains tax which is estimated to be $5,875, and uses the net sale proceeds to pay a one-off Non-Concessional Contribution of $44,125 immediately. This amount is then owned by super and earns its investment returns in an environment where the taxes applicable to those returns never exceed 15% (rather than her personal marginal tax rate of 47% including Medicare)

We note that the comparison provided below doesn't include the capital gains tax that Judy would need to pay in the Non-Super Investment & Regular Investment Plan scenario if she sold the personally owned investments at retirement in order to contribute them to super in order to then be able to hold those assets (or a meaningful proportion of them) in a tax free environment for the remainder of her life from that time forward.

Assumptions:

- Timeframe: 20 years as Judy wants to retire at age 65
- Salary increases: 3.5% per annum
- Inflation: 2.3% per annum
- Current legislation
- Super Balance - $150,000
- Non-Super Investment Balance - $50,000; cost base $25,000
- Investment returns (after fees) for both super and non-super – Balanced Growth profile:

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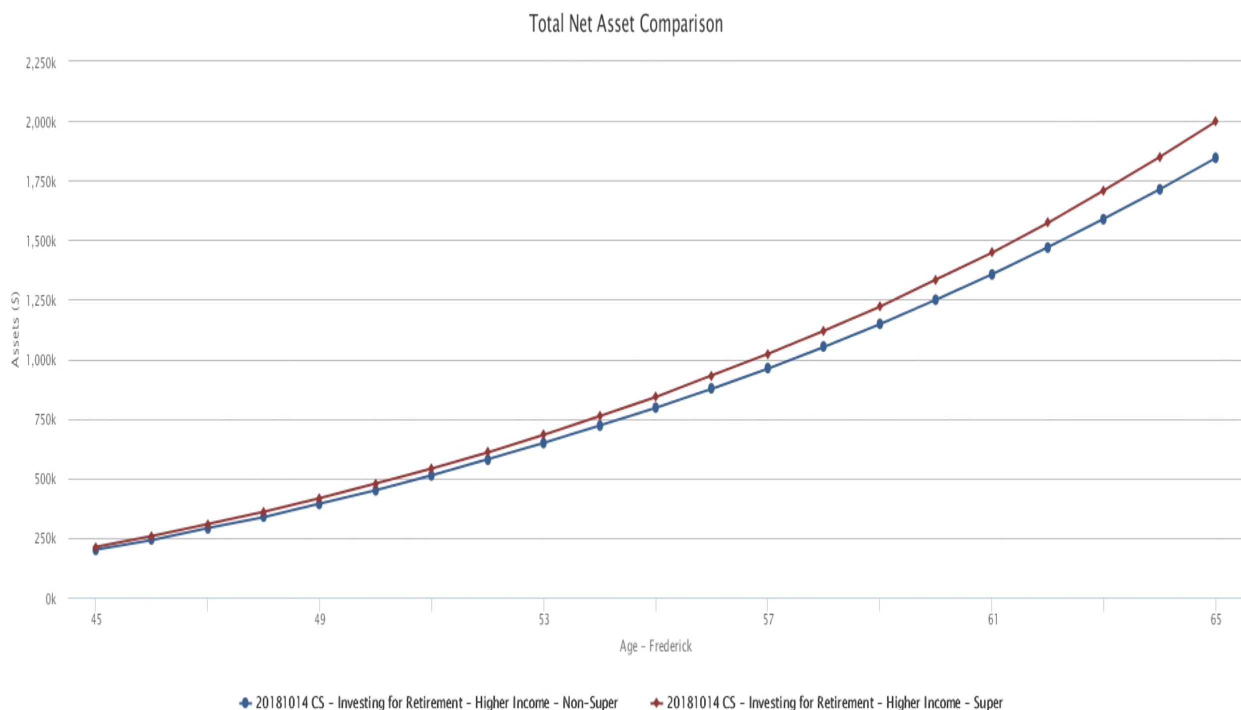
- » Super Guarantee Contribution – according to the currently legislated scale increasing from 9.50% in 2014/15 to 12% in 2025/26
- » Non-Super Investment – capital gains tax at retirement has been ignored. Therefore the outcomes from that scenario are over-stated and the benefit of salary sacrifice consequently understated
- » Judy has and maintains private health insurance
- » Higher Income Earners Contributions (Division 293) Tax – applies in both scenarios
  - Income: 3.79% pa (Franking: 18.07%)
  - Growth: 2.71% pa
  - Total: 6.50% pa
  - Investment Costs (ICR) – 1.00%
  - Adviser Fees – 1.0%
  - These fees are examples only; they are generously estimated to be conservative
- » All investment income is reinvested (less tax)
- » All individual investments are held for longer than 12 months and therefore receive the capital gains tax discount

Important note: as noted above, it is essentially possible to hold the same investments in super as you can hold outside super (certain exceptions apply) and therefore the assumed investment returns are the same for the super and non-super investments. This is entirely reasonable. This case study, like Mammoth's strategic advice, is focused on the ***strategy*** as the primary generator of wealth rather than the individual investments selected

How is Judy better off?

The graph below shows the value of Judy's investment assets (super and non-super) over time to age 65 where the **blue line** is the non-super strategy and the **red line** is the salary sacrifice strategy:



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The table below summarises the benefits provided by the salary sacrifice strategy relative to the non-super strategy:

	Non-Super Strategy	Salary Sacrifice Strategy	Benefit of Salary Sacrifice Strategy
Available after-tax income (excess cash flow)	$20,000	$20,000	$0
After-Tax Amount Invested – Year 1	$20,000	$22,528	+$2,528 or 12.6%
Net Investments at Age 65	$1,845,521	$1,998,864	**+$153,343 / +8.3%**

Judy decides to establish a salary sacrifice plan and looks forward to being **$153,343** better off at age 65, ***from the same cash flow,*** even before considering the capital gains tax that would apply in the Non-Super Investment & Regular Investment Plan scenario if Judy wished to transfer her personally owned investment assets into super ownership to access tax free investment returns throughout retirement. Judy is also pleased that at age 65 she will already have a large portion of her wealth invested in super where it will benefit from concessional tax treatment throughout retirement and she won't be restricted by the contribution caps that would otherwise limit her ability to contribute her non-super investments to super at retirement.

Why does the strategy add value?

At Mammoth we appreciate that understanding why strategies add value increases the opportunities for you to benefit from them so we have provided the list below summarising what makes the strategy work:

» Lower tax on employment income – tax of up to 15% on salary sacrifice contributions relative to tax of 47% for Judy if paid as salary results in a higher initial investment when salary is sacrificed to super than when paid as salary and the after-tax amount is invested outside super

» Lower tax on investment returns – tax on investment returns in accumulation super are at a maximum rate of 15% relative to non-super investment returns taxable at 47% for Judy results in more of each dollar of investment return being retained

» Compound investment returns – the magic of compound investment returns operates in both scenarios however due to the lower tax rates discussed above, there is a larger investment in the salary sacrifice scenario to benefit from this magic

» Lower tax in retirement – at age 60, if Judy wishes to retire, she already has a significant investment in super which can be invested tax free for the rest of her life

» Concessional Contributions Cap – just because Judy utilises the full amount of the Concessional Contributions Cap before she exhausts her available cash flow, doesn't mean that salary sacrifice in combination with Non-Concessional Contributions doesn't add value

Specialist financial planning advice will help you ensure that you maximise the benefits provided by any salary sacrifice arrangement, not to mention the wide array of other opportunities available to you. In our experience, we note that a similar shaped outcome can broadly be expected at any level of income above $37,000 per annum, although the actual size of the benefit will differ.

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Need more information?

If you wish to discuss how this strategy can apply to your situation & potentially increase your ability to achieve your objectives, please feel welcome to contact Mammoth Financial on:

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