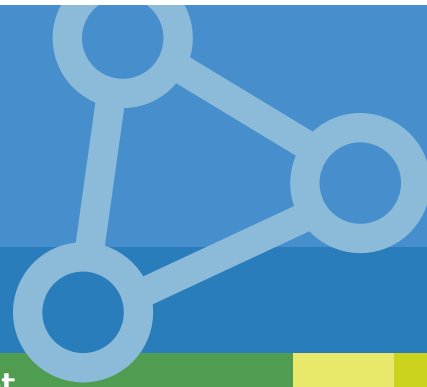


FirstTech

Strategic Update

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Contents

Salary sacrifice to superannuation	1
Transition to retirement salary sacrifice strategy	4
Making large contributions prior to retirement	5
Double deduction strategy	6
Employer ETPs	7
Dual allocated pension strategy	8
Using a term allocated pension (TAP) and an allocated pension to access the pension RBL	8
Excessive death benefit pension strategy	9
Reversionary pension strategy	9
Re-contribution strategy	10
Superannuation splitting strategy	10
Social Security changes and complying pensions	11
Aged care and entry fee opportunities	12
Glossary	13

2006 Federal Budget – what to do now!

How the Budget proposals will impact 12 of the most popular financial planning strategies

On 9 May 2006, the Treasurer announced a plan to ‘simplify and streamline’ the superannuation system in Australia. Although the plan is not law it is expected that many of the announced changes will become law in the near future.

It is not our intention to provide a complete summary of the Budget proposals. Instead we have identified some of the key strategic considerations that have arisen from the Budget announcements. If you would like more detail please refer to ‘A Plan to Simplify and Streamline Superannuation – Detailed Outline May 2006’ which is available on the Treasury website www.simplersuper.treasury.gov.au.

Salary sacrifice to superannuation

Salary sacrifice involves an employee foregoing future gross salary in return for non-salary benefits. An example of this is salary sacrifice into super. Here, the employee will forego salary or wages (which would be taxed at their marginal rate of tax) in return for super contributions (which are taxed concessionaly). The benefits of salary sacrifice may include:

- reduction in assessable income and personal income tax
- tax on super contributions may be less than income tax that would otherwise be payable if the amount was received as salary
- the super contribution earns income in a concessionaly taxed environment that allows earnings to compound at a greater rate.

Contributions to super are subject to tax in the super fund when made by an individual’s employer, including salary sacrifice contributions. Employer contributions are taxed at 15%.

Relevant Budget proposals

The following Federal Budget proposals, if made law, will impact salary sacrifice to super.

Personal income tax rate reductions* effective from 1 July 2006

2005/06		2006/07	
Tax rate*	Threshold	Tax rate*	Threshold
0%	\$0 – \$6,000	0%	\$0 – \$6,000
15%	\$6,001 – \$21,600	15%	\$6,001 – \$25,000
30%	\$21,601 – \$63,000	30%	\$25,001 – \$75,000
42%	\$63,001 – \$95,000	40%	\$75,001 – \$150,000
47%	\$95,001 +	45%	\$150,001 +

* Tax Laws Amendment (Personal Tax Reduction and Improved Depreciation Arrangements) Act 2006 contains these amendments.

* Tax rates exclude Medicare.

Changes to taxation of employer contributions from 1 July 2007

Under the proposed arrangements, a limit on concessional deductible contributions of \$50,000 per person per annum would apply. Contributions up to \$50,000 would continue to be taxed upon contribution at 15%. Where the ATO identifies that a person's deductible contributions have exceeded \$50,000 in a financial year, the amount in excess of \$50,000 would be taxed at the top marginal tax rate at the fund level (proposed to be 45%).

A transitional period for people aged 50 and over is proposed.

People aged 50 and over during the transitional period (1 July 2007 to 30 June 2012) would be able to continue to have deductible contributions up to \$100,000 taxed at the concessional rate of 15%.

Changes to deductibility of employer contributions from 1 July 2007

It is proposed that age-based deduction limits be abolished from 1 July 2007.

While there is a proposed \$50,000 limit on contributions that may be concessional tax within the fund upon contribution, this will not cap the *deductibility* of contributions for employers.

It is also proposed to extend the deductibility of contributions to age 75. The employer will receive a tax deduction on all contributions to super funds made on behalf of their employees under age 75.

Currently mandated employer contributions (such as SG or contributions under an industrial instrument) may be made at any age, however, voluntary employer contributions such as salary sacrifice are not permitted after age 70. Consequently salary sacrifice is currently limited to those people under the age of 70.

While there is no specific proposal to amend the contribution rules, the proposal to extend deductibility of all employer contributions made on behalf of employees up to age 75 will require the contribution rules to be amended to allow employers to make non-mandated contributions after the age of 70.

Potential impact on strategy

The following table illustrates* how the three proposals above may impact existing salary sacrifice arrangements. Please refer to page 3 for the assumptions used in the examples below.

Client	Total package \$	Year 1 (2005/06) before salary sacrifice			Year 1 (2005/06) after salary sacrifice		Continued salary sacrifice	
		Taxable income before salary sacrifice \$	Net benefit \$ Year 1	Salary sacrifice amount \$	Taxable income after salary sacrifice \$	Net benefit \$ Year 1	Net benefit \$ Year 2	Net benefit \$ Year 3
		2005/06			2005/06		2006/07	2007/08
Jeff 44	280,000	254,800	169,092	40,560	239,440	174,238	182,226	182,226
Jeff 44	280,000	254,800	177,400	50,000	n/a	n/a	185,200	185,200
Jeff 44	280,000	254,800	200,850	120,000	n/a	n/a	207,250	186,250
Jeff 50	280,000	254,800	169,092	100,587	179,413	194,347	201,135	200,959
Jeff 50	280,000	254,800	169,092	100,000	180,000	194,150	200,950	200,950
Gavin 44	200,000	182,000	125,480	40,560	159,440	133,038	139,426	139,426
Gavin 50	200,000	182,000	125,480	100,587	99,413	153,147	155,806	155,629
Gavin 50	200,000	182,000	125,480	100,000	100,000	152,950	155,650	155,650
Dean 50	106,000	96,460	74,236	60,000	46,000	86,650	87,160	87,160
Dean 50	106,000	96,460	74,236	50,000	56,000	85,000	85,510	85,510
Gina 44	84,000	76,440	61,315	40,560	43,440	68,372	68,882	68,882
Barb 44	71,000	64,610	53,636	40,560	30,440	59,467	59,977	59,977
William 44	25,000	22,750	21,636	10,000	15,000	22,150	22,150	22,150
Stacey 44	12,000	12,000	11,100	10,000	2,000	10,500	10,500	10,500

* The examples used are for illustration only.

Assumptions

In the examples in the table on page 2:

- each employee is paid a constant package value regardless of the salary sacrifice amount
- Superannuation Guarantee is 9% of package value
- 2005/06 Medicare rates have been applied to all years
- proposed personal tax rates have been applied to 2006/07 and 2007/08
- proposed 45% contributions tax has been applied to contributions in excess of \$50,000 or \$100,000 (dependent on employee age) in 2007/08
- 2005/06 age-based deduction limit for a 44 year old is \$40,560 and for a 50 year old is \$100,587.

These results are discussed in detail below.

Can any rules of thumb be drawn?

No – the outcome of a salary sacrifice strategy before and after the Budget proposals depends on the individual's circumstances (eg marginal tax bracket, level of salary sacrifice and age).

Impact of reduced personal tax rate

From 1 July 2006, the reduced personal tax rates will increase the net benefit of salary sacrifice to super for many employees. In the table on page 2, all the employees except for Barb, William and Stacey (those on the lower marginal tax brackets) will have a more effective salary sacrifice arrangement in 2006/07 than in 2005/06.

Impact of amended taxation of employer contributions

Salary sacrifice strategies will be less effective from 1 July 2007 due to the higher taxation of contributions for employees who are salary sacrificing beyond the thresholds. Examples:

- employees under the age of 50 who are salary sacrificing beyond \$50,000 per year. For a person to be in this position an employer would be allowing salary sacrifice beyond the age-based limits in 2005/06 and 2006/07. In the table on page 2, when Jeff aged 44 salary sacrifices \$120,000 (above his current age-based limit), his net benefit will decrease from \$207,250 to \$186,250 from 1 July 2007
- employees over the age of 50 who are salary sacrificing beyond \$100,000 in the transitional period. In the table on page 2, at age 50 Jeff and Gavin salary sacrifice \$100,587 (the 2005/06 age-based limit). The net benefit of salary sacrifice will drop between the years 2006/07 and 2007/08. It may be appropriate to review the amount of salary sacrifice for Jeff and Gavin.

Impact of deductibility changes

Employers may currently limit salary sacrifice to age-based limits since they do not receive a tax deduction for contributions beyond those limits. From 1 July 2007, some employers may relax any imposed limits since they will be able to claim a tax deduction for all employer contributions.

For example, Jeff may have been limited to his age-based limit of \$40,560 for salary sacrifice arrangements. Under the new rules, his employer may be willing to let him salary sacrifice beyond that amount.



Example

Gina is 44 and on a package of **\$84,000**. She is able to live off the income of her partner, and in 2005/06 salary sacrifices \$40,560 per year into super. This strategy increases her net benefit from \$61,315 to **\$68,372** since her taxable income has been reduced from \$76,440 to \$43,440.

In 2006/07 her net benefit increases to **\$68,882** due to the changes in personal marginal tax rate thresholds moving her down into the 30% tax bracket from the 42% tax bracket.

In 2007/08 Gina's net benefit remains unchanged. This is because she is still salary sacrificing within the new \$50,000 cap, so none of her contributions will be subject to the higher contributions tax. Now that there are no age-based limits, Gina may wish to increase her salary sacrifice up to the \$50,000 cap.

→ Is a higher amount of salary sacrifice always better?

Under the current rules, for people in marginal tax brackets of 30% or above, higher levels of salary sacrifice always achieve higher net benefits provided they are within their respective age-based deduction limits. However, if the proposed changes to the taxation of contributions are introduced, higher salary sacrifice will not always mean higher net benefits.

For example, in the table on page 2, Gavin is age 50 and will receive transitional treatment. He is on a package of \$200,000 and is looking at salary sacrificing either his age-based limit of \$100,587 or just a flat \$100,000. Prior to 1 July 2007 he is better off salary sacrificing \$100,587 since he will reduce his assessable income from \$182,000 to \$99,413, with the added bonus of a drop in his marginal tax rate from 47% to 40% after 1 July 2006.

From 1 July 2007, with the new tax on excessive contributions, Gavin would have a \$21 higher net benefit if he only salary sacrifices \$100,000 rather than \$100,587. While Gavin would pay \$244 more in income tax, the fund would pay \$264 less in contributions tax if he only salary sacrifices \$100,000 rather than \$100,587. This is a marginal case, but for clients who are able to salary sacrifice beyond age-based limits, there may be a substantial benefit to them to reduce their salary sacrifice after 1 July 2007.

A planner may want to schedule a 1 July 2007 review for any clients implementing salary sacrifice strategies today that are beyond the proposed \$50,000/\$100,000 caps.

What is the relevance now of changes scheduled for 1 July 2007?

The examples in the table on page 2 illustrate how the Budget proposals will potentially increase or decrease the net benefit of a salary sacrifice strategy that is in place today. You may consider making a note now of clients who are salary sacrificing. A review of their salary sacrifice arrangements may be appropriate should the proposals become law.

Additionally, some clients may not be permitted by their employers to salary sacrifice beyond age-based deduction limits now. Some of these employers may be willing to allow employees to salary sacrifice larger amounts after 1 July 2007. Another potential reason to review salary sacrifice arrangements after 1 July 2007.

Transition to retirement salary sacrifice strategy

A recent strategy development after the introduction of pre-retirement pensions is for clients over age 55 to enter into a salary sacrifice arrangement with their employer and then to replace any lost income with a pre-retirement pension. The strategy works by allowing clients to contribute more via salary sacrifice than they are drawing in the form of a pension due to the effect of the 15% pension offset. The advantage of this strategy is that it allows clients to increase their net superannuation savings without having to forego any after tax 'in the hand' income.

Relevant Budget proposals from 1 July 2007

- All benefits taken in the form of a lump sum or income stream will be tax free from age 60.
- Limit the total amount of concessional taxed superannuation contributions to \$50,000 per person each year. Deductible contributions made in excess of \$50,000 per year would be taxed at 45%. A transitional period is proposed to allow clients over 50 to make concessional contributions of up to \$100,000 up until 30 June 2012.
- RBLs will be abolished.
- A maximum of 10% of the account balance (at the start of each year) of a pre-retirement pension can be drawn as income in a financial year.

Potential impact on strategy

The announcement of the removal of tax after age 60 could make this strategy even more advantageous as it may mean that clients over 60 who would have otherwise had to pay tax on their pension may need to draw less income to replace their after tax salary. This would result in a higher net contribution to super and increased super savings. The announcement of the abolition of RBLs would also remove the potential RBL problems that extra super savings could cause some clients. Another flow-on benefit is that pensioners will still be able to take advantage of the zero tax pension phase sooner.

The new maximum 10% income payment rule for pre-retirement allocated pensions will allow greater draw-down amounts from 1 July 2007 compared to what is permitted under the current factors for allocated pensions.

However, the announcement impacting the taxation of deductible employer contributions over the concessional limit could reduce the benefits of this strategy for high income earners. For example, where a high income earner wished to salary sacrifice amounts over their concessional limit the contributions in excess of the limit would be taxed at 45% instead of 15%. This would result in lower net contributions and reduce the benefits of this strategy.

Making large contributions prior to retirement

This strategy involves clients making large personal contributions to super in the lead-up to retirement to maximise the amount of benefits that can be rolled over to commence a retirement income stream, such as an allocated pension.

This strategy assists clients to boost their retirement income by allowing them to access the generous tax concessions available to pensions and annuities, such as the 15% tax offset and zero tax rate on earnings. Clients using this strategy include:

- self-employed people who have planned to fund their retirement with the proceeds from the sale of their business
- people with some employer funded super that have large investments outside super
- people with little or no super receiving an inheritance or other windfall.

Depending on age and eligibility criteria, contributions to super can either be made in the form of an after tax undeducted contribution or as a pre-tax deductible contribution. Undeducted contributions are not subject to tax and are included in the calculation of deductible amount for a super pension or annuity. Deductible contributions are subject to tax in the fund, however, any deduction claimed on the contribution will reduce the client's taxable income. Deductions for personal contributions are limited to 100% of the first \$5,000 plus 75% of the balance over \$5,000 of the contribution up to an age-based limit.

Relevant Budget proposals

- From 9 May 2006 – to limit personal undeducted contributions to \$150,000 per person each year. There will be the ability to average this over three years – allowing a \$450,000 undeducted contribution to be made in any one financial year (refer to the Glossary for more details). Contributions in excess of this amount would be required to be refunded to the member and any growth taxed at 45%.
- From 1 July 2007 – to abolish age-based deduction limits (allowing a full deduction for contributions to super) whilst limiting the 15% concessional tax rate on deductible contributions to \$50,000. Deductible contributions made in excess of \$50,000 per year will be taxed at 45%. A transitional period is proposed to allow clients over 50 to make concessional contributions of up to \$100,000 until 30 June 2012.

Potential impact on strategy

These proposals, if adopted, will limit the ability of clients wanting to make large undeducted contributions to super after 9 May 2006. Clients wanting to contribute amounts in excess of the proposed limits may need to consider making undeducted contributions over a number of years. However, for some clients this may not always be possible. For example, a 64 year old client who is about to retire wanting to contribute \$650,000 from the sale of an investment property. In this situation, the client could contribute \$450,000 in the first year (assuming there is no yearly work test that needs to be satisfied)* but could not contribute the balance in later years as they would not be eligible to contribute at that time.

These proposals will also impact clients wanting to make deductible contributions to their super fund. Although the abolition of age-based deduction limits will allow a client to claim a full deduction for their contribution the new limit on concessional taxed super contributions will effectively limit their contributions to \$50,000 or \$100,000 (under the transitional period) unless they are already on the top tax rate.

For example, where a client wanted to claim a tax deduction on their contribution to offset any realised capital gains on the sale of an asset they may be better off limiting their deductible contribution to \$50,000 or less. The aim is to reduce their overall income to no more than \$150,000, ie the threshold where the marginal rate goes from 45% down to 40%. This is because any contribution made above \$50,000 is to be taxed at a flat 45%, while any capital gain included in taxable income less than \$150,000 would only be taxed at 40% or less.

Although a transitional provision will allow clients over age 50 from 1 July 2007 to make concessional taxed contributions of up to \$100,000 this will expire on 30 June 2012. In addition this amount is less than the current age-based limit of \$105,113 (2006/07) and will make up a progressively smaller proportion of what is currently allowed unless the concessional limit is indexed as are age-based limits. However, it's not all bad news – the proposals would actually increase the amount of deductible contributions that could be made by clients under 50 as the \$50,000 limit is larger than the current age-based limits that apply to clients between age 35 and 50.

* Refer to glossary on Undeducted Contribution Cap and the work test on page 13.

Double deduction strategy

The double deduction strategy allows clients to double their super tax deductions as well as maximising tax-effective super contributions in the lead-up to retirement. The double deduction strategy relies on a client claiming a deduction for a personal contribution under the 10% eligible person test whilst also having their employer contribute on their behalf. Under the current rules both the client and their employer are subject to a separate age-based limit. In this case, a client over 50 and their employer could both make a super contribution and each claim a tax deduction up to the age-based limit. This effectively doubles the allowable deductions as well the total deductible contributions.

Relevant Budget proposals from 1 July 2007

- Age-based deduction limits will be abolished.
- A limit will apply to the total amount of concessional taxed superannuation contributions to \$50,000 per person each year. Deductible contributions made in excess of \$50,000 per year would be taxed at 45%. A transitional period is proposed to allow clients over 50 to make concessional contributions of up to \$100,000 until 30 June 2012.

Potential impact on strategy

The proposals would effectively make the double deduction strategy redundant by limiting the amount of concessional taxed deductible contributions at the fund level. Therefore, it would no longer matter that both a client and their employer were making deductible contributions. Where the total level of deductible contributions exceeds the concessional limit the excess contributions will be taxed at 45%. In most circumstances this would result in a client limiting their personal deductible contributions to the difference between what their employer will contribute and their concessional limit. However, under the current proposals, it appears that there would be no disincentive to high income earners on the top marginal rate making personal deductible contributions over the concessional rate, as the client will be paying the top marginal rate in either case. A client could actually save the Medicare levy by contributing pre-tax income to super rather than receiving it as income.

It is also important to note that these rules may impact someone who receives employer SG contributions as well as making salary sacrifice contributions. See the salary sacrifice strategy for more detail.

Employer ETPs

Currently employer ETPs are taxed according to the components shown in the left hand column of the table below. It is proposed that the taxation of employer ETPs be simplified into two components – exempt and taxable as shown in the right hand column of the table below.

Current 2006/07 component	Tax treatment	Proposed component (unknown start date)	Tax treatment
Post-June 1994 invalidity	Not assessable	Exempt	Not assessable
Pre-July 1983	5% taxed at marginal tax rates		
Post-June 1983 untaxed		Taxable	
→ Under age 55	30%	→ Under age 55	
		Up to \$140,000	30%
		\$140,000+	45%
→ Age 55 and over		→ Age 55 and over	
Up to \$135,590	15%	Up to \$140,000	15%
Over \$135,590	30%	\$140,000+	45%
Excessive component*	38% to 45%	Abolished	

Note: Medicare of 1.5% also applies to assessable portion of components.

It is also proposed that employees will no longer be permitted to roll employer ETPs into superannuation.

Effective date

There is currently no proposed effective date for these changes.

Potential impact on strategy

For clients that cash out the post-June 1983 untaxed component after the proposals become law, the following changes will apply.

Clients under age 55

- ETP below \$140,000 – no change
- ETP between \$140,000 and \$678,149 – higher tax under proposed rules
- ETP in excess* of \$678,149 – higher or lower tax under proposed rules

Clients age 55 and over

- ETP below \$135,590 – no change
- ETP between \$135,590 and \$140,000 – lower tax under proposed rules
- ETP between \$140,000 and \$678,149 – higher tax under proposed rules
- ETP in excess* of \$678,149 – higher or lower tax under proposed rules

Pre-July 1983 component

Clients with significant pre-July 1983 service will not be taxed on this component under the new rules. Someone with \$100,000 pre-component, on the highest marginal tax rate would save \$2,425 if receiving an ETP after the proposals become law. It is proposed that pre-1983 components be frozen as at a yet unspecified date.

Excessive component

Essentially the excessive component, taxed at 47% plus Medicare, will be reduced to 45% plus Medicare, in line with the reduction of the top personal marginal tax rate.

Conclusions

As can be seen from the variations above, depending on the size of the employer ETP and the age of an employee, a recipient of an employer ETP may receive a comparatively higher or lower net payment if the ETP is cashed before or after the proposed changes.

The inability to roll over employer ETPs will not have a big impact for those clients under age 65, or over 65 and still working at least part-time, if they are subject to relatively small amounts of tax upon cashing the employer ETP. They will be able to contribute the net amount back into superannuation (subject to undeducted contribution caps).

However, clients receiving employer ETPs subject to higher tax under the new rules, combined with an inability to contribute to super after the employer ETP is paid, will be disadvantaged, as they will have lost the opportunity to have this amount invested in the concessional tax environment of super.

* From 1 July 2002, the notional post-1983 excessive benefit is taxed at 38% plus Medicare. The remaining part of the excess benefit remains taxed at 45% plus Medicare. For more detail refer to the Taxation Laws Amendment Act (No 5) 2003.

Dual allocated pension strategy

This strategy is used when a person has superannuation benefits in excess of the lump sum RBL and uses two allocated pensions (AP), to isolate the excessive portion in the second pension.

The first AP is commenced up to the person's lump sum RBL, then a second AP is commenced with the excess.

The benefit of doing this is that commutations made from the fully rebatable pension would be subject to a maximum ETP tax rate of 16.5% on the post-1983 component. If only one partially rebatable pension was commenced then commutations would be subject to a proportionate amount of excess benefits tax (38% to 45% plus Medicare).

Relevant Budget proposals

- RBLs will be abolished from 1 July 2007.
- All benefits taken in the form of a lump sum or pension will be tax free from age 60.

Potential impact on strategy

With the abolition of RBLs the concept of a partially rebatable pension will no longer apply. Therefore only one pension needs to be commenced after 30 June 2007. Pension payments for those under 60 will be taxable (dependent on the proportion of proposed new taxable and exempt ETP components – see Glossary page 13). The full superannuation pension rebate of 15% will apply to all pensions paid from a taxed fund to those over 55 and under 60 years of age. For those over 60 pension income payments will be tax free.

Using a term allocated pension (TAP) and an allocated pension to access the pension RBL

This strategy is used when a client has super benefits that exceed their lump sum or pension RBL.

This can be achieved by placing the required amount in a complying pension and the balance in an AP. The required amount is satisfied by purchasing a complying pension such as a TAP with at least the lesser of:

- 50% of the qualifying portion of their total superannuation benefits, or
- 50% of their pension RBL.

The benefit of this strategy is that it allows clients to maximise both the 15% pension offset and potential investment returns. This has the dual effect of increasing their after tax income while also allowing the pension payments to grow.

Relevant Budget proposals from 1 July 2007

- RBLs will be abolished.
- All benefits taken in the form of a lump sum or pension will be tax free from age 60.

Potential impact on strategy

With the abolition of RBLs the concept of a partially rebatable pension will no longer apply. Therefore, only one pension needs to be commenced after 30 June 2007. Complying pensions will no longer be needed for this purpose. Tax treatment of pension payments is the same as the previous strategy.

Excessive death benefit pension strategy

The maximum lump sum that may be paid to a dependant tax free from the accumulation phase of super is the equivalent of the deceased's pension RBL.

Any lump sum paid beyond that limit is taxed at 38% to 45% (plus Medicare). The 'excessive death benefit strategy' involves a member arranging for their death benefit to be paid to their beneficiaries as a combination of lump sums and pensions. Death benefits paid as pensions are fully rebatable to minor children. The advantage of this strategy is that it allows a death benefit to be paid out without excess benefits tax applying. This will benefit clients with minor children and who currently have benefits in excess of the pension RBL on death whether fully funded or due to the proceeds of life insurance.

Relevant Budget proposals

- RBLs will be abolished from 1 July 2007.
- Under proposed arrangements all lump sum death benefit payments would be tax free if paid to a dependant (no commencement date has been announced at the time of writing).

Potential impact on strategy

From 1 July 2007 benefits paid from a super fund will not be assessed against a member's pension RBL as they will no longer apply from this date. This means that there is no limit to the amount of benefit, whether funded by contributions and investments or by life insurance that can be paid on the death of a member.

Lump sums of any size will potentially be able to be paid directly to the spouse and/or minor children tax free. Treatment of income streams in these circumstances is not clear at this stage (other than reversionary pensions). Whether the income tax or SIS definition of a dependant will apply is yet to be determined.

Reversionary pension strategy

People who commence pensions can ensure their benefit continues to be paid as a pension to nominated dependant(s) as defined in the SIS Act as a pension (this includes adult children – refer to Glossary on page 13 for dependant definitions).

This has the dual benefits of:

- asset protection with surety on death, and
- ensures the beneficiary inherits the concessional tax treatment enjoyed by the primary beneficiary (if the original pension was fully rebatable).

Relevant Budget proposals

The Government has not announced a commencement date for these proposals (at the time of writing):

- A pension would not be able to revert to a tax non-dependant on death (eg adult children). Death benefit payments to tax non-dependants would have to be made as a lump sum.
- Lump sum payments to tax non-dependants (irrespective of their age) would be taxed in the same manner as other super fund payments to those under age 60. That is, the entire taxable component would be taxed at 15% (this currently applies to the post-1983 taxed element component).

- A reversionary pension would be exempt from tax if the primary beneficiary was aged over 60 at the time of death.
- A reversionary pension would be taxed at the beneficiary's marginal tax rate (less any deductible amount and pension rebate) if the primary beneficiary was under age 60 at the time of death. If the reversionary beneficiary was over 60 it would be tax exempt.

Potential impact on strategy

The ability to revert pensions to dependants (under SIS) who are non-dependants for tax purposes may be eliminated. This would exclude such persons as adult children.

Re-contribution strategy

The portion of pension income that may be taxed each year is reduced by the annual deductible amount which is calculated at the commencement of the pension.

The deductible amount of a pension purchased today is the sum of undeducted contributions plus the CGT exempt component and the post-June 1994 invalidity component. Increasing the proportion of undeducted contributions in super prior to purchasing a pension, increases the deductible amount and reduces tax paid on pension income for the life of the pension.

The re-contribution strategy is used to increase the proportion of undeducted contributions in super prior to commencing a pension. This is generally achieved by withdrawing up to the low-rate threshold (\$135,590 for 2006/07) of post-June 1983 component and re-contributing the same amount, which as a result becomes an undeducted contribution.

Using a re-contribution strategy your client can increase the undeducted contributions component in their super fund before starting a pension, without the need for additional contributions and as a result increase the tax-free portion of a pension.

Superannuation splitting strategy

Super splitting allows one spouse to split up to 100% of undeducted contributions and up to 85% of taxable contributions (ie SG contributions, salary sacrifice and personal deductible contributions).

This applies to those contributions made on or after 1 January 2006. If the receiving spouse is between 55 and 65, they must declare that they are not retired at the time of the split.

Relevant Budget proposals from 1 July 2007

- RBLs will be abolished.
- All benefits taken in the form of a lump sum or income stream will be tax free from age 60.

Potential impact on strategy

The application of superannuation splitting as a strategy after the Budget announcements may seem irrelevant at first glance, since its two main purposes would be left without effect should the proposal go ahead. However, this strategy may still have some valid application.

Super splitting could offer a window of opportunity for those clients wishing to retire between the ages of 55 and 60, as lump sum ETPs for people within this age bracket will continue to be taxed (under a more simplified system, see Glossary page 13).

Relevant Budget proposal

From 1 July 2007, all benefits taken in the form of a lump sum or income stream will be tax free from age 60.

Potential impact on strategy

For people retiring in the 2006/07 financial year there is still a benefit in cashing out the post-1983 component up to the low rate threshold and re-contributing the proceeds back to super. This will maximise the undeducted purchase price for these pensions. This strategy will still remain valid in future years for clients under age 60 who plan to purchase pensions prior to age 60. This is because the undeducted purchase price will be the new exempt component (see Glossary on page 13) which includes undeducted contributions by persons between 55 and 60 years of age.

Case study

John (50) and Jane (48) are planning to retire at age 55. John has accumulated \$600,000 in super while Jane's super balance is only \$40,000. As John is a high income earner, he is able to salary sacrifice a large portion of his income and still be able to meet their living expenses. For the next five financial years, John is able to salary sacrifice up to \$100,000 pa and split this contribution to Jane's super. At the end of the term, their superannuation balances will be much closer, allowing them to access two post-1983 tax-free (low rate under the Proposal) thresholds and achieve income splitting, providing opportunities to attain some tax savings on pension payments received during the taxable period of their income streams.

A potential use of this strategy could be for a couple who hold a large amount of cash in the bank resulting from the sale of an investment property. As both of them will be subject to contribution caps (\$150,000 of undeducted contributions and \$50,000 or \$100,000 depending on their age), super splitting may offer them the possibility to manage these limits to suit their circumstances.

Social Security changes and complying pensions

Clients may consider investing in complying income streams prior to 20 September 2007 to reduce assessable assets to qualify for or maximise Centrelink entitlements.

Relevant Budget proposals from 20 September 2007

- The pension assets test taper rate is to be halved. The taper rate is to be reduced from \$3.00 to \$1.50 for every \$1,000 of assets above the relative threshold.
- The current 50% assets test exemption for purchased complying income streams will be removed. Purchased complying income streams commenced prior to 20 September 2007 will retain their respective assets test exemptions.

Potential impact on strategy

The increase in the assets test cut-off point to \$494,000 for a single homeowner, or \$793,500 for a couple homeowner may mean that clients currently ineligible for a pension could now become eligible or those who are receiving a pension would now receive an increased amount. These clients could further benefit through the use of complying income streams (if purchased prior to 20 September 2007).

Here are two examples*: the first one shows us why purchasing a complying income stream prior to 20 September 2007 will increase Harry's pension entitlement. The second example shows us how Alan and Joyce can qualify for a part pension by doing nothing and waiting for the Budget changes to take effect.



Example 1

Harry is a 66 year old single homeowner who is currently receiving a part Age Pension. His only asset apart from his home is \$300,000 in a term deposit. In light of the above mentioned changes Harry has approached his financial adviser to see if it is better to keep his assets in their current format or cash some of his term deposit to purchase a TAP for \$200,000 prior to 20 September 2007.

Keeping money in term deposit

This will result in an estimated Age Pension entitlement of \$70.70 per fortnight under the current assets test and \$285 per fortnight if the assets test taper was reduced to \$1.50.

Investing in a complying pension

If Harry cashed some of his term deposit to purchase a TAP for \$200,000 prior to 20 September 2007 his entitlement would be \$370.70 per fortnight and \$435.20 after the introduction of the reduced taper rate.

In either scenario, the reduced taper rate will benefit Harry. If Harry purchases a TAP with \$200,000 prior to 20 September 2007 it will result in him receiving an extra \$150 per fortnight (ie \$435 less \$285).



Example 2

Alan and Joyce currently have \$770,000 in assessable assets. They would like to claim some Age Pension this year – just enough to get a Seniors' Health Care Card.

Currently, the value of Alan and Joyce's assets exceed the couple's threshold which precludes them from receiving any Age Pension. If they invested \$540,000 in a complying pension, they could receive \$3.40 per fortnight in Age Pension.

If Alan and Joyce were content to not receive the Health Care Card this year, they could avoid tying up their funds in a complying pension for their life expectancy. Under the proposed rules from 20 September 2007, with \$770,000 in assessable assets, they would receive \$13.90 per fortnight in Age Pension. They would have investment flexibility for their assets, as well as receiving their Health Care Card.

* Example 1 and example 2 exclude the pharmaceutical allowance and are based on Age Pension rates as at 20 March 2006. The income test is more generous and results in a lesser reduction which does not affect the results.

With the increased assets test limit, there could be greater scope for higher net worth clients to target at least a \$1 of Centrelink benefit purely to receive the concession card. This would grant them various concessions including concessional rate prescriptions listed on the pharmaceutical benefits scheme and concessional state-based benefits, eg reduced council and utilities rates.

Clients with existing complying income streams which have gained the 50% or 100% assets test exemption should ensure that they do not commute and restart after 20 September 2007 to avoid losing their concessional assets test treatment.

Aged care and entry fee opportunities

Current rules

For Centrelink/DVA purposes, complying income streams purchased prior to 20 September 2004 would qualify for a 100% assets test exemption while those purchased after this date would qualify for only a 50% assets test exemption. However, for Aged Care Assets Testing purposes, Centrelink/DVA are presently allowing 100% of the purchased amount to be exempt from the assets test, potentially limiting the recipient's accommodation bond or accommodation charge.

Relevant Budget proposal

This anomaly will be removed so that from 1 January 2007 the current assets test rules will apply to both Centrelink and DVA clients when assessing pension entitlements and aged care fees. This change will not affect existing residents unless they change aged care facilities.

Potential impact

A limited opportunity has arisen for those entering aged care accommodation to purchase complying income streams before 1 January 2007 to remove 100% of this asset from Aged Care Asset Testing when Centrelink/DVA calculates an accommodation bond or an accommodation charge.

Glossary

Proposed ETP component comparison for under 60s

Current ETP component	Current tax treatment	Proposed ETP component	Proposed tax treatment 2007/08
Pre-July 1983 Concessional Undeducted contributions	5% taxed at marginal tax rates Nil	Exempt	Nil
Post-June 1994 invalidity CGT exempt	Nil		
Post-June 1983 taxed	Under 55 – 20% Age 55 and over up to LRT* – Nil		
Non-qualifying	Age 55 and over above LRT* – 15%		
Excessive	38% or 45%	Abolished	n/a

* LRT: Low-rate threshold for 2006/07 is \$135,590.

ATO: Australian Taxation Office.

Averaging provision for undeducted contributions:

(refer to Treasurer's press release 'A plan to simplify and streamline superannuation' – Transitional issues that apply immediately, dated 14 June 2006): The proposed averaging provisions will enable a person to contribute \$450,000 of undeducted contributions between 10 May and 30 June 2006. This means that a member will be able to utilise their full 2005/06 entitlement and bring forward their 2006/07 and 2007/08 entitlements. Further undeducted contributions could not be made until 1 July 2008.

If a member contributed \$150,000 between 10 May and 30 June 2006 a further \$450,000 could then be contributed between 1 July 2006 and 30 June 2007. This would result in the full entitlement being used up (comprising of the 2006/07 entitlement and the bringing forward of the 2007/08 and 2008/09 entitlements). In this scenario no further contributions could be made until 1 July 2009.

CGT: Capital Gains Tax.

DVA: Department of Veteran Affairs.

Dependant definitions (current):

→ Superannuation Industry (Supervision) Act 1993 (SIS):

includes a spouse, any child of the deceased, anyone financially dependent on the member and a person in an interdependency relationship with the member.

→ Income Tax Assessment Act 1936 (Tax):

a spouse or ex-spouse (including defacto spouse), child under the age of 18, anyone financially dependent on the member and a person in an interdependency relationship with the member.

ETP: Eligible Termination Payment.

Pre-retirement pension: is a type of pension that allows a client who has reached their preservation age to draw preserved and restricted non-preserved benefits as an income stream, but which limits their ability to make lump sum withdrawals until they are fully retired. Examples of these include pre-retirement allocated pensions, term allocated pensions and lifetime pensions.

Purchased complying income stream: an income stream that has an identifiable account balance, eg term allocated pensions. A non-purchased pension does not have an identifiable account balance, eg a defined benefit fund.

RBL: Reasonable Benefit Limit – the maximum amount of concessional superannuation benefits that an individual can receive in their lifetime.

Superannuation Guarantee (SG): legislation requiring employers to provide a minimum level of superannuation support for employees.

Undeducted Contribution Cap and the work test: An

excerpt from the Fact Sheet 'Post-tax contributions' released on the 26 June 2006 from Treasury discusses how the averaging of the personal undeducted contribution cap would work:

'How would the work test rule for people aged 65 and above apply to the averaging provisions?'

When a person reaches age 65 they can only make post-tax superannuation contributions during a financial year if they work at least 40 hours during a 30 day period. [Personal] Superannuation contributions cannot be made once a person reaches age 75.

The proposed averaging arrangements would allow a person to bring-forward their entitlement to make \$150,000 in the next two years. For example, a person who is age 64 would be able to take advantage of the averaging arrangements provided they satisfied the work test in the following years. A person who makes a \$300,000 contribution at age 64 would need to satisfy the work test at age 65. If the person did not satisfy the work test at age 65 the contributions would be returned to them and the earnings on the excess contributions would be effectively taxed at the top marginal tax rate.

A person aged 74 and above would not be able to take advantage of the averaging arrangements as they do not have an entitlement to make contributions from age 75'.

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