

CASE STUDY: TRANSITION TO RETIREMENT



Build wealth for retirement

Transition to Retirement at a glance

Transition to retirement is a strategy available to those who have reached their 'preservation age' but who have yet to retire permanently, and who wish to either reduce their working hours and supplement their employment income or build their wealth for retirement. The TTR Wealth Creation strategy works by replacing taxable employment income with concessional tax or tax free pension income.

Until 2005, super benefits could only be accessed prior to age 65 upon total retirement after reaching 'preservation age'. This meant that it was difficult for those who wished to 'transition to retirement' to reduce their working hours and maintain their income. The rules were therefore changed to allow those who had reached their preservation age but not yet retired to access their super via a non-commutable retirement income stream.

What's in it for me?

If you are thinking of reducing your working hours gradually prior to permanent retirement, a Transition to Retirement (TTR) strategy can provide additional income to replace the employment income forgone due to your reduced working hours.

Alternately, a TTR strategy can be used to build your wealth between preservation age and retirement, with the benefits continuing to flow through retirement. It is this TTR as a wealth creation strategy that is the focus of this Case Study.

How does the TTR wealth creation strategy work?

The wealth accumulation benefits of a TTR strategy are substantially the result of various taxation benefits. Income from employment or self employment is taxed at a marginal tax rate of up to 46.5%. Whereas income received from a superannuation pension is either:

- » Age 55-59 – taxed at your marginal tax rate but receives a 15% tax offset that reduces the effective tax rate
- » Age 60+ - tax free

Investments held in accumulation super ('super') have their earnings taxed at up to 15% whereas investments held in super pensions ('pensions') are tax free. Furthermore, if those investments held in a pension pay franking or other tax credits, a

Preservation Age

If your date of birth is:	Your Preservation Age is:
Before 01/07/1960	55
01/07/60 – 30/06/61	56
01/07/61 – 30/06/62	57
01/07/62 – 30/06/63	58
01/07/63 – 30/07/64	59
After 30/06/1964	60

What is a Non-Commutable Retirement Income Stream?

A non-commutable retirement income stream is one from which lump sum withdrawals cannot be made; capital can be accessed only via income payments. Income payments are limited to a **maximum of 10%** of the account balance either at commencement or at 1 July each year. The most common type of retirement income stream used for a TTR strategy is an Account Based Pension.

What is an Account Based Pension?

An Account Based Pension (ABP) is one which has an account balance, generally offers a wide range of investment options and provides the ability to vary the income payments. Except in the case of a Non-Commutable ABP for a TTR strategy, there is no maximum income level. Income each year must only exceed the minimum income based on age:

Age	Pension Min	Age	Pension Min
<65	4%	85-89	9%
65-74	5%	90-94	11%
75-79	6%	>95	14%
80-84	7%		

CASE STUDY: TRANSITION TO RETIREMENT



refund may be received which can reduce other tax payable by the fund (particularly beneficial within a Self Managed Super Fund SMSF).

The TTR Wealth Creation strategy involves the following steps:

- » Rollover most (but not all) of your super into a TTR pension (usually an Account Based Pension)
- » Commence a pension and receive income
- » Salary sacrifice employment income to super – being mindful not to exceed the Concessional Contributions Caps
- » Balance the pension income and remaining employment income to provide your desired take home pay
- » Regularly review the strategy to ensure it continues to meet your requirements, takes account of any legislative changes and that you do not incur unnecessary taxes

As noted above, the income paid from the pension may be taxed at a lower rate than your employment income. This allows you to draw down less from the pension than you are contributing to super via salary sacrifice contributions. Thereby increasing your wealth over time.

Please note that specialist advice is required when considering a TTR strategy to ensure the strategy adds value in your circumstances.

Who can benefit from a TTR Wealth Creation Strategy?

TTR can work effectively if you:

- » Want to grow your retirement savings and/or have a comfortable retirement
- » Have reached preservation age
- » Are eligible to contribute to super, including anyone under age 65
- » Have a marginal tax rate above 15% (in 2009/10, taxable income over \$35,000 pa). Higher income earners receive higher benefits
- » Do not use your Concessional Contributions Cap
- » Have an employer who is willing to salary sacrifice
- » Have a reasonable super balance

What are Concessional Contributions?

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

Concessional Contributions Cap

An annual cap on Concessional Contributions applies each financial year and contributions exceeding the amount will be exposed to additional tax. For the 2009/10 financial year the Concessional Contributions Cap is:

- » \$25,000 if under age 50 at 30/06/2010, or
- » \$50,000 if over age 50 at 30/06/2010

The contribution caps mean that we can no longer accumulate non-super wealth and make large contribution to super just before retirement; we now need to make smaller contributions throughout our working lives. There has always been a benefit to doing so however the contribution caps reinforce the benefit. Salary sacrifice contributions are an ideal way of making such contributions

What are the catches?

- » Excess Contributions Tax – exceeding the Concessional Contributions Cap will result in additional tax that will substantially reduce the benefits of the strategy
- » 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
- » Ideally have a written agreement/request with your employer for the salary sacrifice arrangement

CASE STUDY: TRANSITION TO RETIREMENT



Case Study: Transition to Retirement (TTR) Wealth Creation

Meet Jackson: Jackson is 55, earns \$80,000 pa plus super. Jackson characterises himself as a *'pre-retiree'* as he has started to think about what his life in retirement will look like. Jackson currently intends to work until age 65 however he anticipates that he may wish to reduce his working hours before then. Jackson also realises that as he hasn't had super throughout his full working life and has previously focused on repaying his mortgage, he has some ground to make up if he wants to have options in retirement.

Jackson wishes to build his wealth however he requires the same take home pay to meet his day-to-day living expenses. He was therefore finding it difficult to see how he could add to his wealth prior to retirement. However Jackson decided to speak with Mammoth Financial to see if there was a better way.

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

- 1. No Transition to Retirement Strategy** – continue with the existing arrangements whereby his super is maintained unaltered and super guarantee contributions continue.
- 2. Transition to Retirement Strategy** – rollover \$290,000 of his \$300,000 of super into a TTR pension; elect to receive the maximum pension payment of 10% (i.e. \$29,000); salary sacrifice \$35,000 to super; super guarantee contributions continue; review this arrangement on an ongoing basis.

Initially Jackson benefits from the higher Concessional Contribution Cap of \$50,000 as he is over 50 years old, however this is currently legislated to reduce back to \$25,000 from 01/07/2012. At this time Jackson will need to adjust the TTR strategy by reducing his salary sacrifice to around \$16,000 to ensure that the combination of his super guarantee contributions and these salary sacrifice contributions are below the Concessional Contributions Cap. Jackson can increase his salary sacrifice contributions when the Concessional Contributions Cap indexation increases the cap to \$30,000.

To ensure that Jackson is not receiving excess income following the reduction to the salary sacrifice amount, Jackson reduces his pension income from the maximum to the minimum from 01/07/2012 (\$10,866).

Jackson's take home income is the approximately the same in both scenarios.

Assumptions:

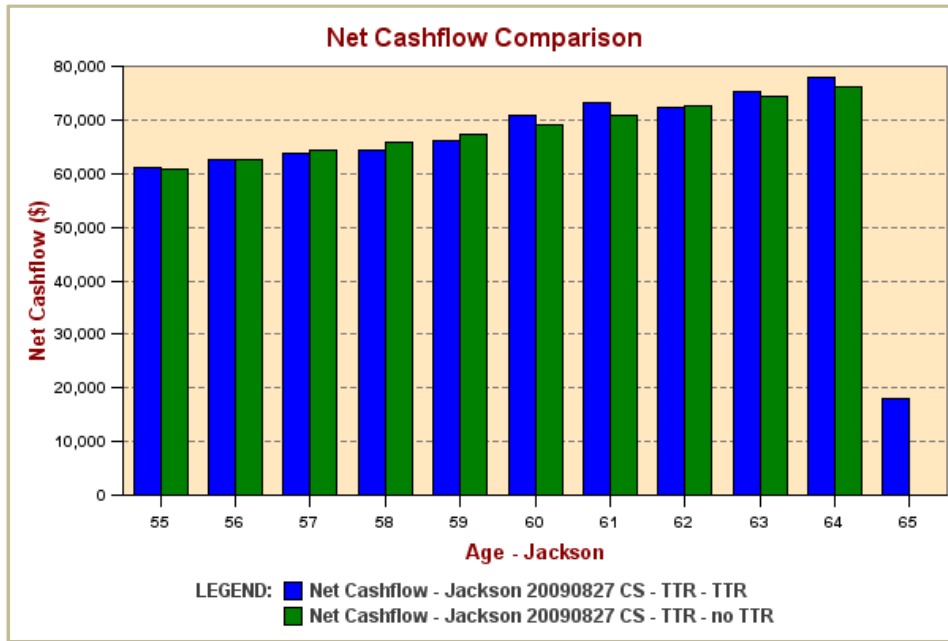
- » Timeframe: 10 years to age 65
- » Inflation: 2.5%
- » Salary increases: 3% per annum
- » Super Guarantee Contribution: 9% - not reduced by salary sacrifice contributions
- » Existing super - \$300,000
- » Investment returns (after fees) for both super and pension:
 - Income: 3% pa (Franking: 20%)
 - Growth: 5% pa
- » Jackson has and maintains private health insurance
- » Current legislation

CASE STUDY: TRANSITION TO RETIREMENT



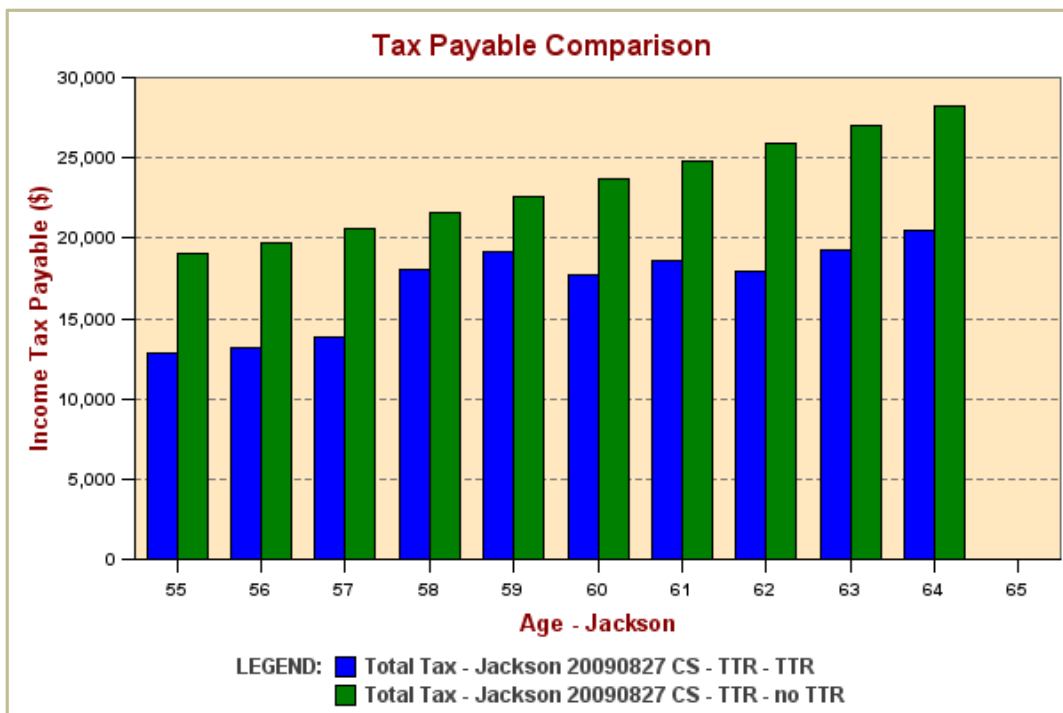
What hasn't changed?

Jackson's cash flow has been managed throughout the timeframe of this strategy to be substantially the same, as shown below where the **green bars** are No TTR Strategy and the **blue bars** are the TTR Strategy:



How is Jackson better off?

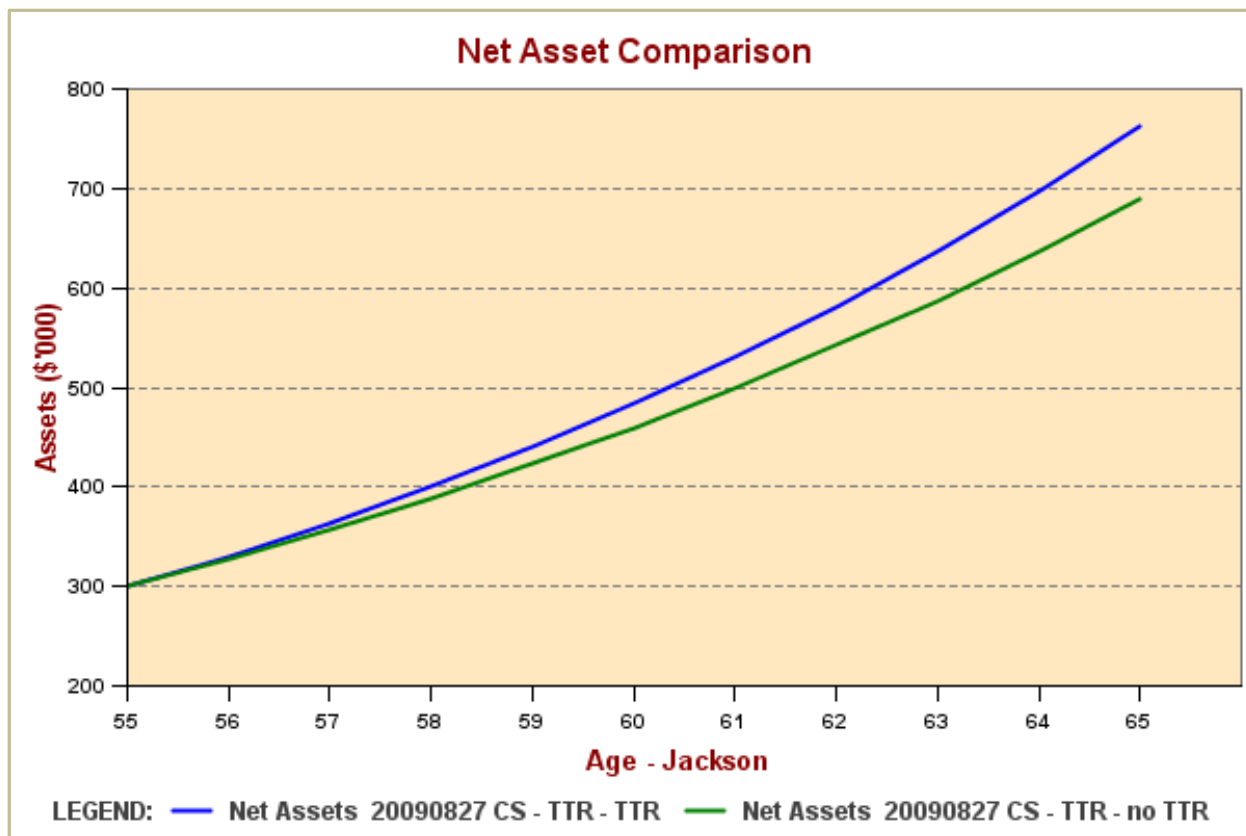
Jackson has **saved income tax** each and every year of the TTR Strategy, as shown below where the **green bars** are No TTR Strategy and the **blue bars** are the TTR Strategy:



CASE STUDY: TRANSITION TO RETIREMENT



The graph below shows the value of Jackson's **investment assets** (super and pension) over time to age 65 where the **green line** is the No TTR Strategy and the **blue line** is the TTR Strategy:



The table below summarises the benefits provided by the TTR Strategy:

	No TTR Strategy	TTR Strategy	Benefit of TTR Strategy
Income Tax Payable over 10 years	\$233,076	\$171,054	-\$62,022
Investment Assets – at age 60	\$459,678	\$484,639	+\$24,961
Investment Assets – at age 65	\$690,000	\$761,691	+\$71,691

Jackson decides to establish a TTR Strategy and looks forward to living off the same take home income, saving **\$62,022** in income tax (excluding super contributions tax) and being better off by **\$71,691** in the level of his assets at age 65. Jackson then looks forward to benefiting further from these additional assets as they provide tax free income potentially throughout the 20-30 years of his retirement!

CASE STUDY: TRANSITION TO 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:

- » Concessionally taxed pension income to age 60 – while Jackson's pension is taxable income until he reaches age 60, he receives a 15% tax offset that results in the less tax being paid on the pension income than is payable on his employment income
- » Tax free pension income from age 60
- » Lower tax on employment income – tax of 15% on salary sacrifice contributions relative to tax of 38.5% for Jackson if paid as salary
- » Lower tax on investment returns – tax on investment returns in pension phase super are tax free relative to those on accumulation super which are taxed at 15%
- » 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 TTR Strategy to benefit from the magic
- » Existing super balance – Jackson has sufficient existing super to make the strategy add value in his circumstances. A higher super balance would generally

What would alter the effectiveness of the strategy?

- » Existing super – a higher existing super balance will generally enhance the value of the strategy or at least provide greater flexibility
- » Salary Income – the tax savings are greater for those with higher salaries and therefore marginal tax rates however this is somewhat limited by the reduced amount of salary that can be sacrificed within the Concessional Contribution Cap
- » Concessional Contribution Cap – making use of the temporary \$50,000 CC Cap for those over 50 will enhance outcomes; as would any extension of the timeframe for this higher cap
- » Starting Point – as with many strategies, time is a key ingredient and therefore starting earlier will generally result in a greater amount of value being created
- » Self Managed Super Fund – operating a TTR strategy within a SMSF offers a greater degree of flexibility including the ability to readily rollback and recommence pensions if your income requirements change or other adjustments are required

Need more information?

If you wish to discuss how a salary sacrifice plan could provide you with a wider array of options in retirement, please feel welcome to contact Mammoth Financial on:

p 02 8920 9828

e alex@mammothfinancial.com.au

www.mammothfinancial.com.au

General Advice Warning: The advice may not be suitable to you because it contains general advice that has not been tailored to your personal circumstances. Please seek personal financial advice prior to acting on the information.

Opt Out Clause: Mammoth Financial respects your privacy. Should you wish not to receive further publications please contact our office.