Focus your mind on tax and collect rewards

Good advice about pensions and tax can mean better returns, writes **John Wasiliev**.

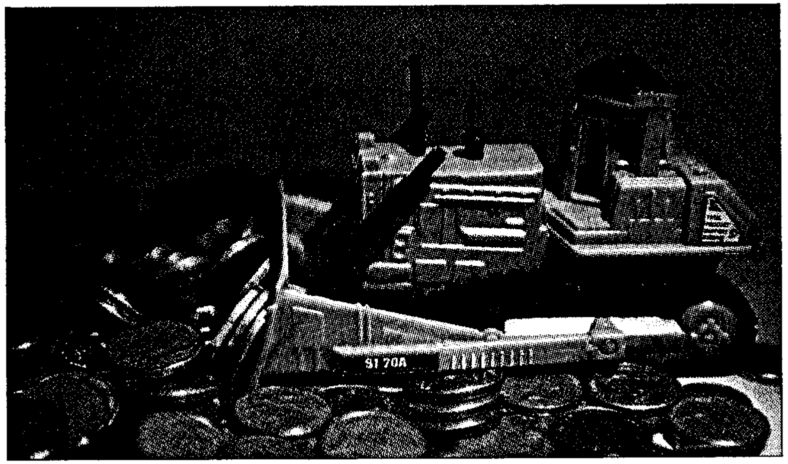

Photo: ROB HOMER

Many do-it-yourself super strategies deal with the effective use of pensions. While the obvious role of super pensions is to provide income in retirement, they can also be used tactically to increase retirement wealth.

When you start a pension with part or all of your super, says Peter Crump of ipac South Australia, there are various issues worth considering.

The first is moving investments to a zero tax status from the concessional tax that super funds pay during the savings or accumulation phase. During super accumulation the fund's investment earnings such as dividends, interest and rent – if it owns a direct property – are taxed at 15 per cent while any net realised capital gains are taxed at 10 per cent.

Under the superannuation tax rules, capital gains on investments owned for more than 12 months are entitled to a one third discount, which has the effect of reducing the 15 per cent tax to 10 per cent.

But once a fund enters the pension phase, so long as the investments that are used to pay the pension are clearly identified and segregated from investments in accounts that are still accepting super contributions, the super rules allow these investments to be exempt from any tax. This means there is no 15 per cent tax on investment income or 10 per cent tax on net capital gains. If a fund in the pension phase earns investment income and net capital gains of $40,000, it won't have to pay tax of at least $6000. In addition, if one third of the income comes from shares fully entitled to dividend imputation tax credits, instead of an after-tax 7.3 per cent income plus partial tax credit refund return, the zero tax plus full imputation credit refund return will result in a more than 9 per cent return.

Given it is possible to start a super pension from the age of 55 when a fund member born before July 1960 reaches the age when super can be available under the transition to retirement rules, starting a pension can create a valuable tax exemption with the potential to tactically enhance pre-retirement investment earnings.

This can be beneficial for those who can currently contribute $50,000 in tax concessional contributions until mid-2012 and then beyond if their super savings are less than $500,000.

While starting a pension from 55 will include an obligation to pay income tax on the taxable proportion of the pension income they withdraw until they turn 60, an entitlement to a 15 per cent tax offset can reduce this liability.

The origin of the offset goes back to the introduction of 15 per cent tax on super contributions and income in the late 1980s that saw various concessions allowed.

It is calculated as 15 per cent of the taxable proportion of a pension payment.

Taxable super is super that received concessionally taxed contributions and investment earnings. Super which comes from non-concessional sources. such as personal after tax contributions, is tax free from those who take a pension under the age of 60.

For instance if 75 per cent of a super pension is classified as taxable, then the offset will be 15 per cent of 75 per cent of the pension payment. If the annual pension taken is $40,000 then 75 per cent represents $30,000 with 15 per cent of this delivering a tax offset of $4500. This offset can be applied to reduce income tax on the pension.

The remaining 25 per cent of the pension is tax free if it comes from either after tax contributions to super, or from amounts entitled to tax free treatment like capital gains, or tax free proceeds from the sale of a small business which can be contributed to super under special contribution rules.

There is another attraction in starting a pension that is related to the proportions of super classified as taxable and tax free, says Meg Heffron, of do-it-yourself fund administrator Heffron.

Where a pension is sourced from an account that is divided 75/25 between taxable and tax-free proportions, that pension will be classified as having a tax free component equal to 25 per cent of the balance whatever the balance happens to be at any time in the future.

Investment earnings allocated to the pension will then be divided between the two components, in that 75/25 proportion. This contrasts with the tax treatment of super during the accumulation phase when investment earnings are added only to the fund's taxable component.

SPEB 006