Making most of super tax breaks

Consider borrowing big bucks to top up your super, reports **Tim Blue**

CALCULATORS are humming in financial planning land as baby boomers look for ways to enjoy the Government's latest tax breaks on super announced last week.

Up to $1 million can be pumped into super before next July, in a window of opportunity that's prompted a flurry of creative thinking.

The first plan is simply to borrow $1 million and invest it in a super fund. It's short, it looks sweet, but will it work? Only maybe, is the short answer, and only as a short term measure, according to financial planners contacted by *The Australian*.

Two big drawbacks apply here. First, an investor would need to be confident that the earnings of the super fund will outpace the cost of borrowing on the $1 million so that their net worth continues to grow.

And they would need to have deep pockets, to sustain repayments of $80,000 a year, on a borrowing rate of 8 per cent, since the super fund would not be paying out perhaps for several years.

Clearview technical manager Helena Gibson says: "You have to bear in mind that the cost of borrowing is paid by the investor in after-tax dollars and that the interest on the loan is not going to be tax-deductible".

Assuming our investor is paying 8 per cent interest and is on a 31.5 per cent marginal tax rate including the Medicare levy, the super fund would have to earn 11.68 per cent gross to be equivalent to cover our investor's pre-tax cost of borrowing.

Since the super fund itself pays tax of 15 per cent, it would have to earn 13.74 per cent to deliver 11.68 per cent to the investor.

Gibson says: "To be safe, the super fund would have to earn close to 15 per cent to make it worthwhile over the longer term."

It's a big call that investment markets will allow super funds to perform that well in the next year or two. Only the riskier all-shares options in super funds have done better than 20 per cent, while standard balanced options have earned around 14 per cent.

Remember that the three fat years on the share market were preceded by two lean years, where returns were among the worst on record at nil and even negative earnings.

And did we mention another interest rate hike at home to snuff out inflation, and signs of a spooked US economy that has put the skids under the commodities boom?

Some help may be at hand for those already aged 55. Borrowing $1 million and investing it in an allocated pension could generate a maximum annual tax-free income of $87,500, which would cover the $80,000 a year repayments but not leave a lot left over for living. It would also require our investor to have exited the workforce.

Various other options may be more appealing, says Prescott Securities principal Phil Middleton. "If you can afford to fund $80,000 a year in non-deductible interest, you must have a pretty high taxable income, which would mean your first strategy should be to make sure you first use up your full $105,000 in allowable deductible contributions to super.

"The $1 million window is only a big-ticket item for people over 60 or people with many millions not already in super.

"They could get $1 million of undeducted contributions into super over five years anyway, made up of $500,000 in after-tax contributions and $500,000 in deductible contributions, over that time to offset any capital gains tax liabilities."

An alternative strategy comes from Adelaide-based financial strategist Theo Marinis, who suggests the use of borrowing to invest in a term allocated pension (TAP) for those 55 and older.

In essence, a borrowing of, say, $500,000 invested into a TAP would generate cash flows to offset the loan repayments.

"When you retire, inaccessible funds now in super could be withdrawn tax-free and used to discharge the borrowing, yet leave the cash coming in from the TAP," Marinis says.

"The beauty of this strategy is that provided you act before September 20 next year, the asset of a TAP is only counted at 50 per cent of its value for Centrelink aged pension purposes, and enhances your ability to get a pension later."

Clearview's Gibson says a borrowing plan could have its appeal for those approaching retirement age who are reluctant to sell other assets and pass them into super.

"People may be reluctant to crystallise a gain or loss on the sale of shares or property now as they may not have any capital losses against which to offset their gains on their shares.

"Or they feel they are not doing their property value justice by selling now," she says. "Instead they may prefer to borrow, at least for a few years to allow them to make the large undeducted contribution (while they can) to superannuation and pay out the loan when they are ready to realise their assets.

"I would strongly suggest a backup plan that might allow a borrower to clear a debt promptly if needed."

Middleton believes that a simple loan idea only works if an investor can make the interest tax deductible, or if their capital gains tax liability on existing investments is too great to warrant moving them into super.

"The Government's latest moves still haven't overcome a big anomaly for people who have accumulated their wealth outside super — say through real estate.

"For example, if you have $2 million in shares, they can be transferred in specie into a self-managed fund — half for yourself and half for your spouse — with virtually no cost, other than handling the capital gains tax.

"If you have your money in real estate, the super fund can't acquire those properties from you unless they are business real property.

"It will have to be sold and the proceeds then contributed to your superannuation fund."

Middleton adds, however, that the extent of the super changes "mean that most people will never pay tax again in retirement if they get their planning right. In fact most will get hefty tax refunds for the rest of their lives."

Here's an illustration. Take a couple aged 60 with assets in a self-managed super fund of $3 million, up to their reasonable benefit limits for concessional tax treatment. These funds are invested in an allocated pension, delivering them $180,000 a year in income that enjoys a 15 per cent tax rebate.

In addition, they have assets worth several million dollars lying outside super, invested mainly in shares. It has stayed outside their self-managed super fund (SMSF) to avoid bumping up against the RBL concessional tax limits.

Earnings from these rental properties generate almost $120,000 a year, to lift their total income to $300,000 a year and deliver a tax bill of about $50,000 a year.

Happily for this couple, the Government has announced plans to drop all reasonable benefit limits, from July 1 next year. Our couple will be free to move the $2 million now in shares into their SMSF and enjoy a bigger income stream. Franking credits from the share dividends will be retained in the SMSF.

Our couple now has $5 million in the SMSF, of which about $2.5 million is in shares generating a dividend income of, say, 4 per cent a year, or about $112,000. About $48,000 of the franking credits remain in the super fund.

As a consequence, our couple no longer pays income tax as they no longer have any taxable income. All their income comes from the SMSF, which pays no tax because they are drawing an allocated pension and enjoys a $48,000 tax refund from the franking credits.

Our couple is now enjoying $280,000 a year totally tax free.

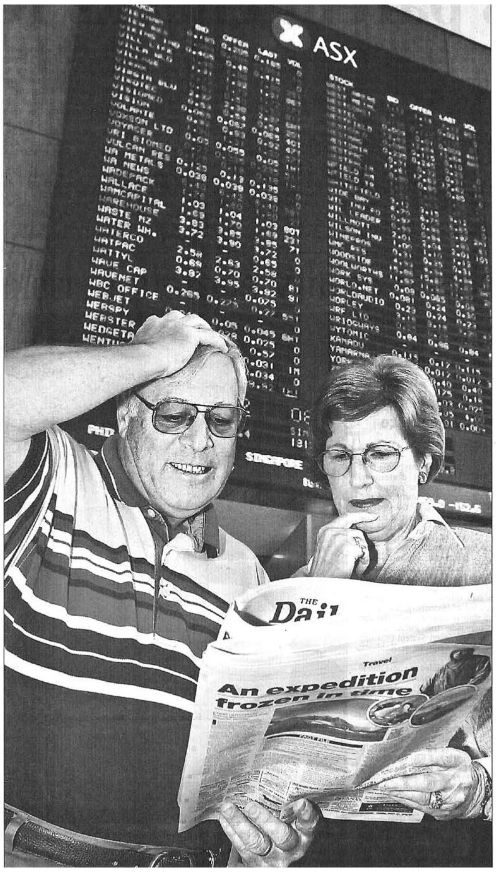
As Middleton says: "Their biggest difficulty will be spending the money!"

Other investors may be tempted to sell property assets and move the proceeds into the super fund and thus later generate an income.

Such a strategy will crystallise likely capital gains tax obligations but, given an increased income from the allocated pension, these are likely to be overcome within a few years.

KEY POINTS

- Up to $1 million tax-free can go into super before next July.
- Borrowing $1 million to pour into super risks capital loss via a downturn in investment markets.
- Borrowing strategy breaks even only when super fund earns 15 per cent a year, at 8 per cent borrowing costs.
- Strategy may work for those unwilling to sell other assets such as shares or property, and incur capital gains tax and fees.
- 55-year-olds could borrow $1 million to invest in an allocated pension to generate annual income of $87,500, to cover $80,000 a year loan repayments.
- 55-year-olds could borrow to invest in a term-allocated pension. On retirement, other super could discharge the borrowing debt. The TAP asset value is only half counted for later Centrelink pension purposes.



Decisions: People have to weigh up the pros and cons of selling shares to make a super contribution before July 2007