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Constitution allows super loophole

State government funds can bypass contribution limits

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AS Wayne Swan chews over the tax system and the thinking of Ken Henry's tax review and Jeremy Cooper's ideas on superannuation, let's hope he keeps one credo paramount: that is, to make superannuation simple, fair and free of inconsistencies.

One foible at the moment is especially irritating: the cap on how much can go into super each year at a concessional tax rate — a sum of $25,000 for anyone under 50 — introduced in last year's federal budget.

For baby boomers this constriction is a pain. It frustrates long-standing practices where everyone borrows to the hilt for a mortgage and to rear a family; then, as children leave home, the resulting spare cash is directed into super. This is much less likely to happen under the new cap.

It is becoming apparent that up to 15 per cent of all super savers can sidestep this constraint by joining or staying on as members of government super funds that are not covered by the cap rules that apply to mainstream commercial retail funds.

Senior public servants, judges, school principals and doctors working (even part time) within the state government systems of most states can load their super funds — within constraints — to pick up the tax concessions and later make use of transition to retirement arrangements.

"It means they can reduce the tax paid on a large portion of the earnings to no more than 16.5 per cent," Adelaide-based financial strategist Theo Marinis says. "Under the constitution, the federal government cannot tax state governments and therefore state government superannuation funds, so they are known as 'constitutionally protected funds'." The funds include several from Funds SA in South Australia and GESB in Western Australia, the former Government Employees Superannuation Board.

The loophole arises from Federation a century ago, when the states gave taxing and other powers to the federal government, and the regulation of banks that traded beyond state boundaries.

Those that didn't, such as the state-owned banks now largely taken over by the Big Four, were free to lend and borrow under more relaxed state law. Unhappily, several tripped up.

An ATO information paper published in December, Super Contributions — for Defined Benefit and Untaxed Funds, confirms that constitutionally protected funds are not affected by the budget changes that cap concessional super contributions to $25,000 a year for those under 50 and $50,000 a year for those over 50.

"Provided the CPF is willing to accept additional contributions [and various other legal requirements are satisfied], then the person making such contributions is free to do so," says Marinis. "An upper limit of $1.1 million [indexed], however, applies to benefits transferred out of the CPF environment, so careful planning is needed."

For those who can make use of them, the options are beaut. A senior school principal, for example, aged 49 and earning $110,000 a year who has a life partner who earns enough for both of them to live on, could salary sacrifice up to 100 per cent of salary into a constitutionally protected super fund rather than the $25,000 limit for ordinary super funds, to maximise the couple's retirement benefit.

Or take a 45-year-old orthopaedic surgeon, working 20 per cent of their time at two of Adelaide's teaching hospitals and receiving $161,000 a year from each for the work, who also has the maximum combined employer super guarantee of $28,922 from these two employers (the maximum threshold of the 9 per cent SG payable in 2009-10) paid into their superannuation fund. In addition, earnings from private practice total $700,000 a year.

At first sight, the usual SG contribution of 9 per cent ($28,922) would breach the eligible limits for someone under 50 and create a tax liability for the excess SG contributions.

"If, however, the super funds of both teaching hospitals are constitutionally protected, the doctor can legally salary sacrifice up to 100 per cent of his or her public hospital income to superannuation [potentially $322,000] with no tax liability being generated and cutting the tax paid on the majority of this income from 46.5 per cent to zero."

Ultimately the federal government will get its slice with a tax of 16.5 per cent on the withdrawal of the fund balance, but meanwhile the deferred tax means the funds can grow strongly in the accumulation phase.

For many others, of course, such anomalies are not fair.

"Not sufficient thought went into these cap arrangements," says Michael Dwyer, chief executive of First State super, the largely accumulation-based super scheme for NSW public servants.

"For example, a nurse who returns to the workforce after raising a family can only pull together $250,000 on a concessional basis over 10 years, when she would be thinking of retiring from what can be a back-breaking job."

One result can be that those seeking to boost retirement savings will turn to borrowing and negative gearing arrangements in shares and property.

"Is that what the government really wants, for someone over the age of 50 to become involved in such schemes?" Dwyer asks.

"These caps are punishing, are gender-biased and introduce more uncertainty in super."

Marinis says his experience with superannuation during the past 20 years leads him to think that inevitably the federal government will close this opportunity. "I would advise people who are members of, or who are able to become members of constitutionally protected super funds, to seek advice and act promptly."

Changes to superannuation law are usually "grandfathered", which means existing arrangements stand and savers are not caught out by a retrospective reach.

But given the track records of all government, there remains an element of doubt.

"Whatever the recommendations and whatever the system looks like this time next year, let's hope it's built on fairness and simplicity," Mercer retirement partner David Knox says.

"It is absolutely necessary to keep the system simple and fair.

"The government should make holistic changes, while maintaining the aspects of the system which have been instrumental in its success to date, as opposed to just tinkering around the edges and continuing to change the rules every budget night."

Government-employed professionals are freed from the contribution caps

PROTECTED SPECIES

- Caps apply to super contributions at a concessional tax rate: $25,000 for those under 50 and $50,000 for anyone older.
- Counted towards the cap are the usual 9 per cent salary contributions.
- Exceptions apply in so-called constitutionally protected funds, in several states.
- Those to benefit include senior public servants, judges, teachers and health workers.
- Missed years of contributions cannot be used retrospectively. Miss a window of contributions and the opportunity is lost.

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