The Super Gotcha for Constitutionally Protected Funds

It's not all a bed of roses when you work in the Australian public sector. Theo Marinis shares some strategies for public servants paying into Constitutionally Protected Super Funds.

By Theo Marinis
16 Jun 2022

Members of state-based Constitutionally Protected Super Funds (CPFs) with balances in excess of $1.65 million are liable for tax of up to 45 per cent when they start to draw down or are rolled out of their fund. This will come as an unpleasant shock to thousands of senior and long-term state government employees, many of whom are high-earning medical professionals working within our hospital system.

But there are ways to deal with the situation.

A major advantage of CPFs is they are not limited by the normal $27,500 pa Concessional Contribution thresholds. This means state public servants are able to salary-sacrifice up to 100 per cent of their salary to fast-track their super. But they need to be very careful.

Under the current rules, the first $1.65 million of the CPF untaxed balance is taxed at 15 per cent on rollover, or 17 per cent if taken as a lump sum after age 60 (and 32 per cent if paid to a dependant or under age 60). Tax is levied on withdrawal from the CPF (which will happen in the CPF eventually, even if it is after death). This is a “catch-up” tax, as due to their Constitutionally Protected status, the normal 15 per cent super fund tax cannot be levied by the ATO within a CPF.

Further, all balances which exceed the current Untaxed Plan Cap (UTP) threshold of $1.65 million are taxed at 45 per cent if rolled over, or 47 per cent if taken by the member as a lump sum.

This means that many professionals, senior executives and long-serving State public servants are saving nothing if their balance exceeds the UTP – and that includes the earnings of the fund.

It gets even worse when the rarely discussed annual Division 293 Tax is factored in. This additional contributions tax of 15 per cent applies to individuals whose combined income and contributions are greater than the Division 293 threshold of $250,000 pa, and it applies even before the CPF balance is rolled over.

If they are public sector high earners who are legally salary-sacrificing hundreds of thousands of dollars into their CPF every year (as do some of the most senior public service members and employees, including medical specialists) – each year when they lodge their personal tax returns, they will also pay up to 15 per cent Division 293 tax.

That amounts to 15 per cent Division 293 Super fund tax now, plus 45 per cent on their Untaxed Plan Cap excess amounts. At this point, many members of CPFs could be facing an unexpected 60 per cent tax whammy.

Very few realise there are ways to mitigate these punitive rules which impact on the retirement savings of thousands of senior and long-term state government employees; a situation which curiously, occurs predominantly (from personal experience) in my home state of South Australia.

Subject to timing and individual circumstances, there are strategies which can be applied to reduce potentially damaging taxation impacts, as demonstrated in the following real-life examples.

Case Study 1: A medical specialist with both private and public sector income sources, whose public sector employment arrangement terminated after attaining age 60.

As this action satisfied a “Condition of Release”, he was able to rollover his CPF balance, plus a portion of his private sector super (up to the current Transfer Balance Cap of $1.7 million) to pension phase. This action, in turn, crystallised his CPF balance while it was still under the UTP cap of $1.65 million, halting any further growth in his Super SA balance beyond the Untaxed Plan Cap.

As $1.7 million of his retirement savings are now in the tax-free pension environment, he will pay no tax on the future earnings of his new Account Based Pension.

This strategy has afforded him a potential tax saving of approximately $38,250 (on the basis of $1.7 million x 5 per cent pa assumed CPF earnings x 45 per cent on the UTP cap had he stayed in accumulation phase – versus nil tax by moving to pension phase).

Case Study 2: Senior State public service career couple 'Jack & Jill'.

With Jill's CPF balance fast approaching the UTP, by moving to 'Transition to Retirement' (T2R) pensions and ceasing Jill's salary sacrifice arrangement to the CPF, Jill was able to avoid triggering her UTP threshold and a 60 per cent tax liability on her salary sacrifice to super.

As in Case Study 1, transferring both their CPF balances effectively locked the Untaxed Plan Cap Balance, halting any further growth beyond the current $1.65 million threshold.

Both Jill and Jack will retain their current insurance cover through their CPF and continue to receive employer contributions via their Super SA Triple S accounts – with Jack continuing his salary sacrifice contributions. (Yes, Jill earns more.)

Jill's Super SA Funds are currently in a Transition to Retirement Account Based Pension (T2R ABP) as she has not yet ceased an employment arrangement after age 60. Therefore, she enjoys a 15 per cent ABP tax rate (versus the 45 per cent Super SA tax) and she receives tax exempt T2R pension income.

Using their situation as a couple to advantage, this helps to fund Jack's continuing salary sacrifice contributions to his Super SA Triple S account, in addition to paying down their (non-tax deductible) home loan debt.

By holding $1,339,570 (net of tax on the 'untaxed' amount rolled over) outside of her CPF, it is estimated that Jill's potential tax saved on income and earnings to be $10,046 per annum.

Had the current salary sacrifice arrangement continued (and taking into account assumed ongoing growth), by 1 July 2024 it is also estimated that Jill's CPF balance would have reached $2,252,925 or approximately $600,000 above the current Untaxed Plan Cap.

Jill also avoids the additional 15 per cent Division 293 Tax on her now ceased Salary Sacrifice contributions to her Super SA CPF.

For Jack, we estimate that for the time being, his large ongoing salary sacrifice arrangement will save him approximately $23,889 per annum in personal income tax.

By holding an additional $522,592 outside the CPF and now in full pension phase (as opposed to a Transition to Retirement Pension – Jack had already rolled over approximately 50 per cent of his CPF balance to a T2R ABP prior to consulting with me) the potential tax saved on income and earnings within his 100 per cent Tax Exempt ABP, is estimated at $9,532 per annum.

Their strategy helps meets Jill and Jack's objective to boost their retirement savings by reducing current and future tax and by reducing ongoing fees. This strategy also provides additional pension income that is now tax-free.

They will use their combined tax free T2R and ABP income, plus Jill's higher net salary (due to ceasing her salary sacrifice) to quickly eliminate their home mortgage.

In both the above examples, the CPF balances were rolled over while they were still under the UTP cap. This action mitigated the risk of the earnings and growth in the former Super SA balances from exceeding the Untaxed Plan Cap threshold and, therefore, the resulting 45 per cent tax impost.

Both the medical specialist from Case Study 1 and Jack in Case Study 2 were able to trigger their super balances after age 60 and now have tax free Account Based Pensions, rather than tax deferred Super SA accounts.

There's a saying: "you don't know what you don't know." This is most obvious in so many of the perverse and sometimes unfair pitfalls around complex superannuation matters and demonstrates the need to get professional advice to save paying excessive and unnecessary taxation and fees.

Theo Marinis is Managing Director of Marinis Financial Group.

Disclaimer: Performance data quoted represents past performance and does not guarantee future results. The information in this article is general information only.It is not intended as financial advice and should not be relied upon as such. The information is not, nor is intended to be comprehensive or a substitute for professional advice on specific circumstances. Before making any decision in respect to a financial product, you should seek advice from an appropriately qualified professional on whether the information is appropriate for your particularneeds, financial situation and investment objectives. The information provided is correct at the time of its creation and may not be up to date; please contact Marinis Financial Group for the most up to date information.

Proudly

INVESTSMART

Financial Strategies (SA) Pty Ltd trading as Marinis Financial Group
T 08 8130 5130 | F 08 8331 9161 | A 49 Beulah Road, NORWOOD SA 5067
E admin@marinisgroup.com.au | W marinisgroup.com.au
ABN 54 083 005 930 5067 | AFSL No: 326403

Reproduced with the permission of InvestSMART

Disclaimer:

Performance data quoted represents past performance and does not guarantee future results.

The information in this article is general information only. It is not intended as financial advice and should not be relied upon as such. The information is not, nor is intended to be comprehensive or a substitute for professional advice on specific circumstances. Before making any decision in respect to a financial product, you should seek advice from an appropriately qualified professional on whether the information is appropriate for your particular needs, financial situation and investment objectives.

The information provided is correct at the time of its creation and may not be up to date; please contact Marinis Financial Group for the most up to date information.