

Tax-free earnings a bonus



John Wasiliev

Starting a transition-to-retirement pension from the age of 55 has become a widely recommended strategy for those with do-it-yourself super. The major attraction is the tax-free earnings on the investments from which the pension is paid.

A \$1 million fund that doesn't have to pay tax on \$75,000 of investment income because it has moved into pension phase can make a saving of more than \$11,000.

Of course, if the fund has significant dividend imputation tax credits from share investments while in the savings phase it can also pay little tax. The attraction in starting a pension then becomes the opportunity to receive dividend imputation credits as cash refunds from the Australian Taxation Office.

The other attraction of starting a pension is concessional tax on the pension income payments. The best known concession is that there is no tax on pension income from the age of 60. But there are rules that apply to pension payments prior to this age.

If a pension is started by a fund member who is between 55 and 59, a major proportion of this will be taxed at their personal tax rate reduced by a 15 per cent tax offset.

You calculate the pension income offset as 15 per cent of the taxable proportion of your pension payment. For instance, if 80 per cent of a super pension is classified as taxable, the offset will be 15 per cent on 80 per cent of the pension payment.

If the annual pension taken is \$40,000, 80 per cent represents \$32,000, with 15 per cent of this delivering a tax offset of \$4800. This offset can be used to reduce income tax on the pension.

Eighty per cent of the account will be taxable because 80 per cent of the super was sourced from either tax-concessional contributions or investment income, both of which were taxed at 15 per cent at one stage.

In this example, the remaining 20 per cent of the pension is tax-free because it was sourced from either after-tax contributions to super or amounts entitled to tax-free treatment.

In response to a question from a 55-year-old reader who has recently started a transition to retirement pension after making a significant after-tax contribution to her super, Meg Heffron of DIY fund administrator Heffron says this strategy does have extra appeal.

The reader is puzzled after being told by her adviser that investment



Fund strategist Meg Heffron.
Photo Michele Mossop

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earnings during the pension phase can dilute the impact of personal after-tax contributions.

Her adviser told her, she says, that any income earned during the pension phase would be added to the taxable proportion of her account, whereas she was under the impression it would be divided between the taxable and tax-free proportions.

Heffron says the question picks up on a number of different tax and pension concepts. Firstly, it's worth explaining what happens when a pension starts. If it starts at a time when a member's account is

divided 80/20 between taxable and tax-free proportions, that pension will be classified as having a tax-free component equal to 20 per cent of whatever the balance happens to be at any time in the future.

This is unusual because when superannuation is accumulating – that is, before pensions start – investment earnings are added to the taxable component as the adviser said.

However, the treatment of investment income during the pension phase, says Heffron, effectively gives members with large tax-free components the opportunity to grow these components over time. Of course, any opportunities for growth will be limited by requirements to take at least the minimum pension.

Instead of making the significant non-concessional contribution and then starting a pension with the combined amount, an alternative strategy could be starting a transition-to-retirement pension with the existing super, following this up with a large non-concessional contribution and then starting a second pension with this amount. If this second pension consists entirely of non-concessional contributions, its tax-free component will be 100 per cent of the balance.