

Transitioning to retirement strategy for SMSFs

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Under the transition to retirement rules, if your clients have reached their preservation age they may be able to access part of their super as a tax effective regular 'income stream'.

SMSF beneficiaries in their 50's are likely to consider this transition to retirement strategy soon, so why not start planning now?

The transition to retirement strategy (TTR) allows eligible taxpayers access to part of their super at their preservation age as a tax effective income stream. A major benefit is that once the SMSF moves into the pension phase, ordinarily there is no tax on the earnings or capital gains.

The preservation age is based on a person's date of birth:

Date of birth	Preservation age
Before 1 July 1960	55
1 July 1960 – 30 June 1961	56
1 July 1961 – 30 June 1962	57
1 July 1962 – 30 June 1963	58
1 July 1963 – 30 June 1964	59
After 30 June 1964	60

Source ATO website

Introducing Nick

Nick recently turned 50 years of age and is one of two trustees of his self managed super fund. He is planning on starting a TTR strategy in five years time.

Nick wants to maximise capital growth within his fund over the next five years and take advantage of the zero capital gains environment once he is in the retirement phase. The majority of Nick's super is invested in residential property and he currently has just over \$50,000 in cash to invest now. He is prepared to look at borrowing to invest in the share market and is particularly interested in the Protected Loan, which is a limited recourse facility.

The strategy

Nick's adviser recommends that he take out a Protected Loan to build a portfolio of Australian shares worth \$250,000. As an SMSF investor Nick pays the initial one-off protection premium of \$42,575 and will be required to pay interest at the variable rate of 8.80% p.a. on the loan amount of \$250,000 (estimated to be \$22,000 p.a.). In this case the SMSF will be able to offset a large portion of this expense against the assessable income of the fund.

Nick chooses a maturity date just after the start of the TTR strategy to take advantage of the zero-tax environment.

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The terms of Nick's Protected Loan are:

Portfolio value	\$250,000
Loan amount	\$250,000
Loan to valuation ratio (LVR)	100%
Portfolio	BHP, CBA, TLS, WOW
Protection premium paid in advance	\$42,575
Tax rate of SMSF (accumulation phase)	15%
Tax rate of SMSF (pension phase)	0%
Term	5 years
Variable interest rate	8.80% p.a.
Estimated deductible rate*	8.80% p.a.

* The amount of interest deductibility is benchmarked to the Reserve Bank of Australia standard housing loan plus 100 bps. This rate is subject to change.

The result

In a rising market

In the example, we have assumed the investment is held to maturity and the portfolio of shares has returned 10% p.a. capital growth over the five-year term.

Nick's Protected Loan will mature after the start of the TTR strategy, following which the investment will be in pension phase and he will pay no capital gains tax – a saving of \$10,991.

The table below highlights the financial benefit of the Protected Loan maturing in pension phase compared with accumulation phase.

	Accumulation	Pension	Calculations
Return (p.a.)	10%	10%	
Maturity value	\$402,491	\$402,491	A
Portfolio value at start	\$250,000	\$250,000	B
Net capital gain	\$152,491	\$152,491	A – B = C
Less protection cost	\$42,575	\$42,575	D
Taxable gain	\$109,916	\$109,916	C - D
Tax payable on gain	-\$10,991	\$0	10% x D = E
After tax cost*	-\$39,996	-\$39,996	F
Net profit	\$101,504	\$112,495	C – E – F = G
Return as % of after tax cost	254%	281%	G / F

*The after tax cost of the investment takes into account dividends, franking, tax payable and interest deductions

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In a falling market

If the performance of the portfolio of shares had been flat or negative, Nick's losses would be limited to the \$39,996 after-tax cost of the loan. This cost reflects the net of borrowing costs after dividends and franking credits. The protection premium is added to the cost-base of the shares and would impact the capital gain/losses.

In the case where one of the companies goes into receivership, the limited recourse nature of the loan will still apply to these shares.

Conclusion

A major advantage of a SMSF is that trustees may be able to control when assets are sold. In the example, Nick has been able to take advantage of the zero-tax environment by timing his investment to mature in the pension phase, therefore boosting his net return.

The Protected Loan has also given Nick's SMSF the added benefits of:

- ➔ diversification without using a large amount of capital
- ➔ capital growth potential with protection where the investment is held to maturity
- ➔ no margin calls
- ➔ maximised potential tax efficiency

Getting the right advice

As with any financial strategy, using a Protected Loan to borrow and invest is not without its risks. One of the key risks of using a Protected Loan is that your return could be negative, after taking into account the performance of your shares and borrowing costs over the term. That's why it's important to read the Product Disclosure Statement to ensure you are fully informed.

Call us on 1300 786 039 for more information about how your clients can implement this TTR strategy.

Important information

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