# Thanks for the new super proposals - but should I still pay off my mortgage first?

By Garry Pammer, CA, BEc, LLB

I was out seeing one of my dental clients in my professional capacity recently, checking through tax and accounting issues and making future plans to develop and review a number of business strategies over the following months.

Apart from discussing specific circumstances, we also talked through a number of so-called old "truisms". Namely...

- Was it still worthwhile gearing a residential property portfolio or your surgery?
- Do company structures still provide the best asset protection, allow you to maximise superannuation contributions and help cap effective tax rates?
- Was superannuation still a race at the end; your last tax effective short term investment strategy before retirement?
- Did paying down your home mortgage still beat superannuation and other non-super investments?

**Super vs mortgage?**

The purpose of this article is to address a hybrid version of the last two "truisms" which has recently emerged as one of the most topical. Namely, should you now be redirecting some or all of your mortgage repayments into your superannuation? Certainly it has been prudent for many of our clients to consider this question, given the announced simplification and streamlining of superannuation, which is to come into effect from 1 July 2007.

**Proposals not legislation**

Notwithstanding that this next paragraph will read like a heavily qualified year-end tax scheme prospectus, I must emphasise from the outset that all advisors are still only dealing with budget announcements which are set to take effect on 1 July 2007. It is understood the bills will be introduced into parliament some time between early December and Christmas Eve (making wonderful festive reading for myself and countless other accounting, legal and financial colleagues). Parliamentary discussion and debate will follow in Autumn next year and if all goes smoothly, the legislation will be passed shortly thereafter. This means we actually only have some three months of legislative certainty between April and June 2007. Given this short time frame, it is highly recommended to sit down with your advisor, run the numbers on your own specific circumstances and then determine what you could potentially do with the proposals in developing a strategy in the lead up to 1 July 2007.

I will also emphasise that such a strategy very much focuses on the accumulation phase and lump sum withdrawal on retirement. Other commentators may disagree but I would consider it prudent to at least await the tabling of the draft legislation in December before seriously attempting to develop any "pension phase" strategies, whether transitioning into retirement during 55-60 years of age, or retiring post 60 years of age.

<u>The Budget proposals abolish the old reasonable benefit limits after 1 July 2007 and allow retirees to withdraw superannuation lump sums tax free after the age of 60.</u> Depending upon your...

- marginal tax rate (or effective tax rate arising from your business structure); and
- levels of non-deductible debt (e.g. mortgage on your principal residence),

...you may find yourself rethinking your current investment strategy of investing your surplus cash into paying down your mortgage and instead divert your surplus into superannuation.

**Is super better?**

The main driver behind any such change in strategy is assessing the differential between how much surplus cash is generated from:

- your personal after tax income/earnings; and
- your after-tax superannuation earnings.

The interest component of your non-deductible mortgage would continue to be paid out of your after-tax income. However, the capital repayment component could instead be invested into superannuation by salary sacrifice or making a deductible super contribution.

The higher your marginal tax rate (or effective tax rate), the larger the funds injected into superannuation. You have therefore diverted income away from personal income tax brackets of say, 31.5% or 46.5%, and into a 15% super fund tax environment. That low tax environment continues to apply after the contribution throughout the super fund's accumulation phase. This differential between tax environments could (assuming Budget proposals are made law) result in a tax free lump sum (after 60 years of age) which discharges your mortgage and still leaves you with a significant surplus cash benefit. Effectively, you have now paid off your mortgage with 85 cents for every dollar of gross income you earn as opposed to continuing to try and pay off your existing mortgage with say either 53.5 cents or 68.5 cents from every dollar of after-tax income.

**Limitations**

If you consider this strategy suits your particular situation, you should be aware that the Budget proposals contain lower deductible superannuation contribution caps that will limit how aggressively you can pursue the strategy. The old aged based limits on deductible superannuation contributions are to be abolished. <u>From 1 July 2007 the total of deductible self-employed contributions, salary sacrificed contributions as well as superannuation guarantee contributions will be limited to $50,000 per person per annum.</u> The exception is that people over 50 years of age will benefit from a transitional $100,000 annual cap from 1 Jul 2007 to 30 June 2012. Irrespective of your age, the practical upshot is that the $50,000 and $100,000 annual caps operate to set limits on the amount you can therefore invest into this low tax superannuation environment.

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**Risks**

Every opportunity also has its risks. Differentials between mortgage interest rates and super fund earnings over the investment period can impact significantly on the final net result. Be sure that the position your advisor takes in any financial modeling is conservative in this regard. There are also subjective emotional factors associated with high debt levels until retirement to consider. The current superannuation proposals introduce favourable conditions of release and taxation. Will they change again during the next 5-10 years? Personal risks such as loss of income due to sickness or injury, divorce, etc, can all impact adversely on the strategy. The redraw facility of most mortgages can be used to help cover unforeseen financial emergencies. The preservation rules on deductible superannuation contributions means the strategy does not have the same flexibility.

**Does it suit your circumstances?**

So where do you think you fit within the opportunity/limitation/risk matrix? Careful specific consultation with your advisor is warranted. However, you would do well to consider the strategy depending upon:

- The size, term and redraw facility of your existing mortgage. If you have already accumulated substantial equity in your home, then you could find this strategy suitable in terms of timing and amounts invested in superannuation;
- Your age. If you're closer to the age of 60, you have less legislative change risk as you are closer to your tax-free withdrawal release date. In addition, if you are aged over 50, you have the added flexibility of contributing up to $100,000 per annum until 30 June 2012.
- If you are self-employed. You would not have superannuation guarantee contributions using up any of your unused $50,000 (or $100,000 if over 50) concessional deductible contribution cap.
- Your personal risk profile. Life would be boring if we were all the same so don't rush into adopting even a widely accepted strategy if you would have trouble sleeping!

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**Disclaimer:** This article is designed to provide generic information only and should not be viewed as a recommendation to act. Individuals should seek advice from a qualified advisor to ensure their actions are commensurate with their financial needs and requirements.

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*Garry Pammer is director of Clark & Jacobs Accounting and Business Advisers who specialise in providing advice to dentists. Advice that includes planning for your financial wellbeing, superannuation, insurance, practice management, computer software and the buying and selling of dental practices. For a free assessment of your financial position and to see how you can achieve your goals, call Garry on (02) 9264-1111.*