

Redundancy

For many people, redundancy can be a time of anxiety and confusion, while for others, it can be a welcome opportunity to reassess lifestyle and career objectives.

Notice of redundancy or voluntary early retirement usually comes suddenly. It is a time when many important personal and financial decisions must be made - decisions that could save or cost thousands of dollars and affect the your future lifestyle.

This paper outlines viable investment strategies for people retrenched or retiring early, together with some useful ways to minimise income tax, lump sum tax and excess benefits tax and to maximise Social Security benefits.

Immediate steps

- Seek professional financial advice
- Consider clearing all debts, especially those where interest is not tax deductible, eg home mortgage.
- Ensure that medical benefit payments are up to date.
- Ensure that any insurance that was paid for through superannuation is reviewed and replaced if necessary.
- While unemployed, try to keep an adequate cash reserve to cover known and possible needs.

Options after redundancy

There are three main options available to those who have been made redundant from their job.

1. Seek employment and apply for Social Security benefits, if entitled;
2. Start a new job; or
3. Retire

The Social Security scenario

When applying for Social Security benefits after retrenchment, the following financial planning aspects should be considered to make the process of looking for a job as easy as possible:

- a) Money held in rollover or super funds is not counted under the income or assets tests until a person has reached Age Pension age. Therefore people applying for Newstart allowance should consider rolling over available ETP money to maximise Newstart allowance eligibility.
- b) If extra income is needed, consider making occasional withdrawals from rollover funds, or purchasing an annuity or allocated pension with part of the termination payment.
- c) Newstart benefits will not start immediately if the person has liquid assets greater than \$2,500 for a single person or \$5,000 for a member of a couple. Depending on the amount of the liquid assets, the waiting period can vary from one to thirteen weeks. The amount of paid leave entitlements can also affect the start date of Newstart allowance payments.

- d) Newstart may be reduced, or not available, for a period where a person is paid accrued annual and long service leave entitlements on termination

Subject to the income and assets threshold the current (until 20 September 2004) maximum rates of payment for Newstart allowance are \$389.20 per fortnight for a single person over 21 and \$351.10 per fortnight each, for a couple.

The new job scenario

If planning to return to the workforce for at least another five years, consider clearing any remaining debts and using the rest of the termination payment for long term planning once employment has been found. The elements of such a plan will include:

- a) A reasonable benefit limit (RBL) projection check prior to rolling over or committing to any future voluntary contributions to superannuation. This will ensure that any future benefits will not ultimately be taxed at the top marginal tax rate;
- b) Deciding how much, if any, of the ETP should be retained in superannuation given the debt and RBL situation;
- c) Ensuring that capital available for investment is spread across diversified investments either within or outside superannuation;
- d) Determining whether any further accumulation of assets is needed before retirement;
- e) Ensuring that long term ownership of investments is arranged tax effectively.

The retirement scenario

If retiring after retrenchment, the key elements of long term retirement financial planning need to be considered.

- a) Determine appropriate levels of spending, maintaining an acceptable standard of living without running out of money.
- b) Maximise investment efficiency in a way that is consistent with the need for security and other financial planning objectives.
- c) Ensure there is adequate annual cash flow to meet all living costs, with a buffer of 5% to 10%.
- d) Have an appropriate asset allocation to manage risk in accordance with achieving long-term return objectives.
- e) Minimise taxes, both when rolling over and on investment returns.
- f) Use immediate annuities and allocated pensions for tax effective income when appropriate.
- g) Maximise any Social Security entitlements.

Diversified asset allocation

Any prudent long-term portfolio should have a diversified asset allocation, reflecting recognised principles of risk reduction through a spread of investments. A diversified portfolio includes investments in each of the major sectors of fixed interest, shares and property.

In each asset category the main emphasis for retirees will be on income yield. For example, franked dividends from shares and tax effective income from high yielding listed property investments will usually provide higher after tax returns than most fixed interest or cash investments.

Withdrawal taxes on termination payments

Upon termination of employment, payments may be made from two sources - a superannuation fund of which the person was a member and/ or their employer. Some of these payments will be given concessional tax treatment, or may be rolled over particularly if they are ETPs. Details of termination payments and the tax rates applicable are shown below.

Component	Comment	Tax on withdrawal – under age 55 (Including Medicare levy)	Tax on withdrawal - 55 and over (Including Medicare levy)
Concessional	Received prior to 1/7/94 for some cases of invalidity or redundancy	5% taxed at person's marginal tax rates plus Medicare Levy	5% taxed at person's marginal tax rates plus Medicare Levy
Pre July 1983	Portion of ETP relating to service prior to 1/7/83	5% taxed at person's marginal tax rates plus Medicare Levy	5% taxed at person's marginal tax rates plus Medicare Levy
Post June 1983 – Taxed element	Portion relating to post June 83 service. Paid from a source that has paid contributions tax	21.5%	First \$123,808 at 0% Thereafter at 16.5%
Post June 1983 – Untaxed element	Portion relating to post June 83 service. Paid from a source that has not paid contributions tax	31.5%	First \$123,808 at 16.5% Thereafter at 31.5%
Post June 1994 – Invalidity	Amounts paid under invalidity after June 1994	Nil	Nil
Undeducted	Benefits from personal or spouse contributions since June 1983 for which no tax deductions have been claimed	Nil	Nil
Excessive	Amounts over your RBL	39.5% and/or 48.5%	39.5% and or 48.5%

Employer payments

- **Redundancy payments** made as a result of bona fide redundancy or from an early retirement scheme approved by the Taxation Office, are tax-free up to a limit calculated (for the year ended 30 June 2005) as \$6,194 plus \$3,097 for each completed year of service. These limits are indexed each year. Any amount in excess of these limits is taxed as an ex gratia employer payment (described below).
- **Ex gratia payment.** This is an ETP which may be split into a pre July 1983, and an untaxed post June 1983 component. You will get a pre July 1983 component where you commenced service with an employer prior to 1 July 1983. 5% of the pre July 1983 component is taxable as ordinary income. The post June 1983 component is taxed as if paid from an 'untaxed' fund. An ex gratia payment can be an employer 'golden handshake', a payment for unused sick leave or redundancy or a payment for early retirement, which is in excess of the tax-free limits.
- **Unused holiday and long service leave payments** paid as a lump sum on termination. The tax rates are determined by the period of service when the benefit accrued and whether or not the payments are made as a result of redundancy/ approved early retirement.

Reasonable Benefit Limits (RBLs) and excess benefits tax

The Government imposes a RBL on the overall amount of concessional taxed ETPs that can be received during a person's lifetime. If this limit is exceeded, excess benefits tax will have to be paid at the rate of 39.5% and/or 48.5% if the benefit is taken as a lump sum. This tax is not payable where the excess benefit is used to produce income through a superannuation pension or annuity, including an allocated pension.

Minimising taxes on ETPs

There are a number of ways to minimise exit taxes on an ETP:

- Consider rolling over the entire ETP initially to lock in the full pre-July 1983 period. This is particularly useful as earnings are allocated to pre and post components on a time related basis. Note that 15% contribution tax will be deducted from the post June 1983 'untaxed' component rolled over. In some circumstances part of the employer ETP may attract termination payment surcharge. Employer ETP's rolled over on or after 1 July 2004 are preserved and generally may not be cashed until at least age 55.
- Generally, stay in a rollover fund until at least age 55 when lump sum tax rates fall dramatically.
- Merging different ETP funds may be desirable so the longest eligible service period can apply.
- Consider using suitable immediate annuities or allocated pensions for a secure flow of income and/or the indefinite delay of lump sum tax.
- Consider rolling an excess component to an immediate annuity or allocated pension.
- There are some other strategies available to reduce the more highly taxed portion of the post 1983 component.

Immediate annuities and allocated pensions

Immediate annuities and allocated pensions can be attractive investments for generating income in retirement. Immediate annuities are provided by insurance companies using either ETP or non ETP money. In return a person can receive a guaranteed income for a set number of years or the rest of their life.

An allocated pension is a pension paid to a person from their individual 'account' in a super fund. Allocated pensions can only be purchased with ETP money and the payments you receive are not guaranteed. However, allocated pensions have the advantage of being far more flexible than immediate annuities both in terms of the regular payments you receive and in the choice of underlying investments available.

A person can choose the level of payments they want from an allocated pension, within broad minimum and maximum limits, which can be varied, as needs change. Allocated pensions also provide great flexibility in investment patterns. The money can be placed in a wide range of assets according to your needs. There is no earnings tax so those assets can continue to grow during retirement in a tax-free environment. However, choosing an allocated pension involves taking investment risk, so making the correct choice of investments is very important.

The taxation treatment of allocated pensions and immediate annuity income is quite generous. Part of the income payment may be tax free because it is regarded as a return of a person's own capital. Where portion of the income will attract a 15% tax offset.

In addition, by rolling over to an immediate annuity or allocated pension, ETP taxes are deferred or avoided completely.

Centrelink treats both immediate annuities and allocated pensions favourably under the income test. The purchase price of an immediate annuity or allocated pension is assessed under the assets test.

It is possible to generate quite high levels of income from these investments and have a large portion of it not counted under the income test, which helps maximise pension entitlements.

For self-funded retirees, a blend of allocated pension and immediate annuity income can provide both certainty and flexibility for your retirement needs.

Complying annuities and pensions

Both these types of investments work in much the same way in that you invest a lump sum of money and you receive a series of regular payments for a set period of time, or for a lifetime. The main distinction between complying pensions and annuities is that pensions can only be purchased using superannuation money and are paid by superannuation providers while annuities can be purchased using superannuation or non-superannuation money and are paid by life insurance companies.

They are called complying pensions or annuities because they comply with special requirements in the social security legislation and superannuation legislation and are less flexible than (for example) allocated pensions. However, they will have favourable social security means testing, they are, if commenced from 20 September 2004 50% exempt under the assets test and receive concessional treatment under the income test, and you may be able to access the higher Pension Reasonable Benefit Limit (RBL) to reduce excess benefits tax.

Complying pensions and annuities can be for your lifetime or for a fixed term based on your statistical life expectancy.

The importance of financial advice

During redundancy you are certain to be faced with important financial and investment decisions.

Your financial circumstances are unique. To improve the quality of your decisions you should consider professional financial planning advice. Our office can demonstrate how you may benefit from the strategies outlined in this paper.

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