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SUPERANNUATION - SUPERANNUATION BENEFITS UNDER THE NEW SUPER RULES – ESSENTIAL INFORMATION FOR VICTORIAN GOVERNMENT EMPLOYEES

by Daryl Dixon*

GENERAL INFORMATION

Why has the State Services Authority commissioned this briefing?

The SSA wants to provide superannuation information for Victorian government employees who are members of the Revised, New and ESS schemes (statutory defined benefits schemes) and Accumulation schemes such as VicSuper.

The plan is to update the website information from time to time and to draw attention to new opportunities which may benefit some employees.

Presumably the May 2006 Budget changes to superannuation will be covered. What else will be included?

The budget changes are very important in completely changing the tax treatment of superannuation pensions and lump sum benefits after 1 July 2007, especially for those aged 60 or more.

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But also important for individual public servants are the rules allowing eligible Revised Scheme, New Scheme and ESSS members to make their own personal contributions out of pre-tax dollars (salary sacrifice). This initiative allows eligible defined benefit fund members to contribute to their super fund on a tax-effective basis. The capacity to salary sacrifice employee contributions into defined benefits schemes is not available to all employees. The employers approved to date for salary sacrifice can be found on both the ESSS and GSO websites. Check your eligibility before taking any action.

What about the other 2006 super changes? Do any affect me?

The May 2006 budget changes will greatly simplify the super rules in the future. Instead of limiting the amount of superannuation benefits by the Reasonable Benefit Limit (RBL) system. RBLs will be abolished and replaced by annual limits on the amount of tax deductible employer super contributions. This limit will be set at \$50,000 p.a. for taxpayers aged under 50, indexed over time in \$5,000 lots for future changes in Average Weekly Ordinary Time Earnings (AWOTE). For those aged 50 or over the limit, there will be \$100,000 p.a. for a transitional 5 year period. Most Victorian public servants will not be affected by these changes.

Are there any limits on tax-deductible employer contributions this tax year?

Not for Victorian public servants. The new limits will start on 1 July 2007 and cover both employer contributions to the relevant employer fund and all salary sacrifice contributions to that or a second fund. The current tax year is the last opportunity for higher income public servants to salary sacrifice a large amount into super.

Can you explain why this is the case?

Certainly. The present super rules restrict the amount of employer contribution to super solely by denying the employer a tax deduction for contributions in excess of specified age based limits. The Victorian government is not a federal taxpayer and there is thus no limit on the amount that a public servant can salary sacrifice into super. This procedure changes from 1 July 2007 when the Taxation Office will apply the new \$50,000 and transitional \$100,000 annual limits on employer super contributions on an individual taxpayer basis. Instead of being subject to the 15% contributions tax, contributions in excess of these annual limits will be subject to the top 46.5% marginal tax rate.

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You also mentioned the benefits of taking out death and disability coverage in an accumulation super fund. Are these really worth while?

They are very significant benefits. Personal payments for death and disability cover are not tax deductible and have to be paid out of after-tax income. Only personal payments for income protection coverage are eligible for a tax deduction.

By arranging for your death and disability coverage to be provided in your super fund, the contributions can be funded pre-tax from employer or salary sacrifice super contributions. Australians, especially those with families and mortgage commitments, are notoriously under-insured. Obtaining coverage within your super fund provides an excellent opportunity to obtain essential cover. Again, this is an issue worth exploring with a financial adviser.

Please note that the Revised, New and ESS Schemes automatically have a death and disability (D&D) cover built into the benefit structure and there is no extra cost involved.

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SALARY SACRIFICE

Why is being able to contribute on a pre-tax basis to defined benefits super schemes a benefit to eligible Victorian public servants?

For two reasons. First, as for salary sacrifice super options offered to Victorian public servants, there is generally a substantial tax saving, if your income is more than \$25,000, from pre-tax contributions to super. Second, lowering the after-tax cost of contributing to the Revised, New and ESSS Schemes, frees up additional money which may allow you to afford a higher level of contribution to these schemes, if you are eligible, or other super funds.

What is the benefit of a higher level of contribution to these super funds?

Members of the Revised Scheme do not have any choice about the level of their member contribution to their fund. It depends solely on their age. New Scheme and ESSS members can be eligible to contribute between 0% and 8% of their salary to these funds. Generally New Scheme members can only pay 0%, 3% or 5%. It should be noted that New Scheme members can only pay 7% if certain limited circumstances apply, including where total benefits accrued are less than the 5% rate or prescribed members. An important fact not understood or appreciated by all New Scheme and ESSS members is that a higher rate of member contribution requires a larger employer contribution to the fund to support the significantly improved benefit.

Does this mean that by allowing public servants to contribute to their defined benefits superannuation on a pre-tax basis the government is also helping members to obtain additional superannuation benefits from the New Scheme and ESSS funds?

Precisely that. If you are in a position to use the tax savings as a result of salary sacrifice to increase the rate at which you contribute to the New and ESSS funds, you can significantly improve the rate your benefits accrue in those schemes. This change makes savings available which can increase your take home pay or be used to increase total superannuation benefits.

I see the point. This could be a big help but I'd like to see the actual figures.

This is why the SSA commissioned this briefing. It will cover all the super schemes and provide help to maximise the benefits obtained from whatever part of the family budget is allocated to superannuation savings.

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Before that detailed coverage, could you provide some basic facts about superannuation as a way of saving?

Of course. Super is a tax effective way of saving for retirement because generally employer contributions and fund earnings are only subject to 15% income tax compared with normal income tax rates of 31.5%, 41.5% and 46.5% of income received above \$25,000 annually. It is also a low cost way of obtaining death and permanent disability insurance coverage.

Personally, I have preferred to concentrate on paying off my home mortgage rather than putting more into super. This is because I can't touch my super till I retire.

The purpose of this briefing is to provide general information and not to provide specific personal financial advice. It is relevant, however, that the May 2006 super simplification changes will remove many of the previously negative features of superannuation. Specifically, super lump sums withdrawn after age 60 will be totally free of any further tax and mortgages can be paid off at that time. Pensions from taxed funds such as the GSO or allocated pensions from VicSuper will also be tax free. Building up super may be better than paying off a mortgage if there are substantial tax savings or your contributions attract additional employer funded benefits. ESSS members have an option to take their benefit as an untaxed benefit and in this instance from 1 July 2007, amounts up to \$1M will be taxed at 15% with any balance being taxed at marginal rates.

Salary sacrifice super. How does this operate and are there limits on how much of my wage income can be contributed to super?

Your employer has adopted a flexible approach to allow public servants to arrange to make additional contributions to super on a pre-tax basis. The term salary sacrifice means that pre-tax wage income is exchanged or sacrificed for additional employer super contributions which are taxed in the superannuation fund at 15%. Doing this allows public servants earning more than \$25,000 a year to significantly lower the costs of making additional super contributions because their marginal tax rate which would otherwise apply to these earnings is more than 15%. Personal super contributions are tax deductible only for the self employed and other people not receiving substantial wage income.

What about the limits on the amount that can be sacrificed?

Government policy does not limit the amount an employee salary sacrifices into superannuation. Therefore employees are strongly advised to obtain independent financial advice before entering into a salary sacrifice arrangement. Members who are employed by federal tax paying entities may need to check their individual contract (if applicable) or Enterprise Agreements for any limits.

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Are the tax savings from salary sacrifice super definitely worth the complication involved?

Definitely. Especially when there is an obligation or a definite benefit for the employee to contribute to their super fund. The tax savings depend on the taxable income of the taxpayer as shown below:

Taxable Income (p.a.)	Marginal Tax Rate	Gain from Salary Sacrifice*
\$10,000 to \$25,000	16.5%	1.5%
\$25,001 - \$75,000	31.5%	16.5%
\$75,001 to \$150,000	41.5%	26.5%
\$150,000 and above	46.5%	31.5%

* The gain from salary sacrifice is the marginal tax rate less the 15% super contributions tax rate.

Even a 16.5% tax saving provides a substantial benefit for lower and middle income taxpayers especially when the superannuation fund investment returns over time are factored in (this is not an issue for Defined Benefit Funds).

*Earlier you stated that **eligible** members of the Revised, New and ESSS funds can now salary sacrifice their member contributions to these funds. What's the benefit of this?*

This is a fantastic opportunity for **eligible** members of these funds to increase their take-home pay or put additional money into super on a tax favoured basis. Previously, all contributions had to be made out of after-tax dollars. With Revised Scheme member contributions as high as 9.5% and New Scheme and ESSS contributions potentially as high as 8%, your employer has, by allowing the salary sacrifice option, put more money into public servant's pockets or savings.

The following Table illustrates just how large the benefit is, depending on the level of member contribution to the relevant fund:

Salary for Superannuation Purposes*	After-tax saving for 2006-07 using salary sacrifice pre-tax contribution						
	3.6%	5.9%	8.3%	9.5%	10%	10.6%	11.2%
\$30,000	203	358	494	562	615	649	683
\$40,000	271	478	659	749	820	865	910
\$50,000	267	479	659	746	825	869	914
\$60,000	321	575	789	895	990	1,043	1,097
\$70,000	374	671	920	1,045	1,155	1,217	1,280
\$80,000	715	1,239	1,552	1,694	1,820	1,891	1,962
\$90,000	805	1,394	1,930	2,198	2,385	2,519	2,653

*Salary for superannuation purposes may differ from both your total remuneration and your total income.

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CO-CONTRIBUTION

There are many matters that have impacts in different situations. Members should refer to ESSB Salary Sacrifice Information Guides on the GSO and ESSS websites, for more information.

The advantages of co-contributions due to member post-tax contributions are often greater than the advantages of changing to pre-tax contributions. It is possible for members to benefit from both co-contributions and salary sacrifice.

Are there any pitfalls for contributing to super on a pre-tax basis?

There's only one potential issue to be aware of, and that's the government's co-contribution for lower income earners. Taxpayers receiving taxable incomes of less than \$58,000 p.a. are automatically eligible for a federal government co-contribution of up to \$1,500 p.a. if they contribute personal money post-tax to a super fund. Salary sacrifice can reduce your income below the level where a co-contribution is payable but people in these circumstances or simply on lower incomes need to remember to make an appropriate post tax personal contribution annually to be eligible for the co-contribution when they switch their member contributions to the Revised, New and ESSS funds to a pre-tax basis.

The following table sets out the value of the co-contribution at various levels of salary:

Taxable Income	After-tax Super Contribution	Maximum Co-Contribution
\$28,000 or less	\$1,000	\$1,500
\$33,000	\$833	\$1,250
\$38,000	\$667	\$1,000
\$43,000	\$500	\$750
\$48,000	\$333	\$500
\$53,000	\$167	\$250
\$58,000	\$0	\$0

The lower the public servant's income, the greater the value of the co-contribution. When there is insufficient income available to deposit the required additional post-tax contribution you would need to look carefully at the value of entering a salary sacrifice arrangement.

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Can you provide an example for a New Scheme member working part-time and earning \$35,000 a year contributing 5% post-tax to the New Scheme to maximise the employer subsidy?

Definitely. This is a very interesting example.

The 5% New Scheme contribution costs \$1,750 p.a. after-tax. If this contribution is made pre-tax (5.9%), it would cost \$2,065 p.a. pre-tax and reduce the public servant's taxable income to \$32,935 p.a. Contributing \$2,065 p.a. pre-tax is equivalent to contributing \$1,647 p.a. post-tax, saving \$418 p.a. in tax.

If this \$418 p.a. plus another \$418 p.a. (\$836 is the required contribution to gain the maximum co-contribution available) were then deposited in another super fund, this would provide access to a co-contribution of \$1,253 p.a.

But, if the additional post-tax super contribution was not made, the public servant would lose the \$1,150 of co-contribution that would be payable if the New Scheme contribution were made post-tax.

These are complex calculations. Is there any way to summarise the point you are making?

Yes. If you have a low taxable income, probably below \$45,000 a year, and can't afford to deposit additional personal money into a super fund each year, it may be profitable to continue to contribute on a post-tax basis to your Revised, New or ESSS fund in order to continue to receive the co-contribution. It is however, sensible, if possible, to contribute on a pre-tax basis to your defined benefit fund as well as to contribute another \$1000 post tax to a second fund. For ESSS members this could be ESSPlan.

What about VicSuper members?

This fund has no fixed rate of member contributions but accepts employer superannuation guarantee, salary sacrifice and personal contributions. For lower income members of this fund, it's highly advantageous to contribute after-tax each year to gain access to the co-contribution. The maximum \$1,500 federal grant annually is paid to those with incomes of less than \$28,000 a year. As income rises, the maximum co-contribution is reduced by 5% of income above \$28,000 a year phasing out totally at an income of \$58,000 a year.

Are there any other issues relating to accessing the co-contribution?

Yes. Two. First, reportable fringe benefits (such as are available in salary packaging in the hospital sector) are added to taxable wages in measuring annual income for purposes of calculating the co-contribution. Second, if your taxable income is

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reduced by salary sacrifice super contributions, this will increase the amount of co-contribution you may be eligible for. But to qualify for a co-contribution, your super contribution of up to \$1,000 must be made from post-tax dollars.

How do I obtain the co-contribution? Does it involve making a claim to the Tax Office?

No. The Tax Office pays the co-contribution directly to your super fund on your behalf. In assessing your annual tax return, your eligibility for the co-contribution is automatically assessed using information provided to the ATO by your super fund.

REMEMBER: Seek independent financial advice

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TRANSITION TO RETIREMENT ALLOCATED PENSION (TRAPS)

What other super issues are relevant to Victorian public servants

There are three.

1. Being able to start a Transition to Retirement Allocated Pension (TRAP) after age 55, even if you are still working;
2. Spouse Contribution Splitting; and
3. Being able to purchase additional insurance coverage at low cost

The TRAP option is available through VicSuper and other providers. It is not available to members of the Revised, New (if eligible to become exempt, take total lump sums to rollover funds and purchase allocated pensions) and ESSS defined benefit funds because the entitlements in these funds are not crystallised until the date of exit from the fund.

The Government is currently considering legislative amendments in respect of transition to retirement for Revised, New and ESSS Schemes. Such a change could allow members access to their benefits prior to ceasing employment (as opposed to exiting the fund).

Can you provide more details about TRAPS?

They were introduced two years ago to encourage people to continue working after they reach the minimum retirement age of 55. Under the previous rules, super fund members could gain access to their super after 55 only by retiring from the workforce to take a lump sum or start a pension. Now, the super rules permit people aged 55 or more to start a pension while they are still working.

What's the benefit of doing this?

The TRAP income can provide money to live on or service the mortgage while allowing public servants either to work part time or increase their salary sacrifice super contributions. There are substantial tax advantages from starting a pension, particularly when taxable income is less than \$75,000 a year.

These tax advantages include a 15% tax rebate on taxable pension income and the exemption of pension fund income from the 15% tax levied on super fund investment income. This is an issue that people aged 55 or more with super fund benefits that can pay allocated pensions might care to explore with a financial adviser.

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CONTRIBUTION SPLITTING

How can spouse super splitting help me?

In several ways. VicSuper (but not the defined benefit funds) allows fund members to split contributions with their spouse. The rules require that the super be deposited into the member's account first then after 1 July each year, up to 85% of new employer contributions and 100% of member contributions can be transferred to an eligible spouse account. The main restriction is that the spouse must be aged less than 65.

How will this help me?

It depends on your situation. If your spouse is older or about the same age, contributions splitting can give you access to your super benefits earlier than otherwise possible. Also, if your spouse has a lower income and is about the same age, building up the spouse account can help lower the tax liability on a TRAP started between ages 55 and 60. Again, this is an option that could be worth exploring with a financial adviser.

Overall, what is your assessment of spouse contribution splitting especially now that the RBL limits on super benefits are to be abolished from 1 July 2007?

These are early days yet, but I suspect that because of the age differences and differing incomes of married partners, being able to split super contributions into a spouse account will provide very tangible benefits to some VicSuper members especially.

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FINAL AVERAGE SALARY

What does the term Final Average Salary (FAS) mean and why is it important?

FAS is your average salary over your last two years of employment. Overtime and some allowances do not count in the calculation of FAS. FAS plays an important part in determining your final benefit, because it is the basis for calculating your final benefits under the defined benefits schemes. Over your last two years of service, annual salary increases and promotions will increase your final superannuation benefits.

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THE VICTORIAN GOVERNMENT SUPERANNUATION SCHEMES

What's the best source of information about my super fund?

You should start by looking at the GSO and ESSS websites.

www.gsoconnect.com.au

www.esss.com.au

If you are a member of VicSuper you can access information at

www.vicsuper.com.au

These websites provide detailed information about your superannuation scheme but aren't able to provide individual financial advice about the options available to you. The briefing which follows highlights information relevant to the development of your personal strategies. Each of the funds is discussed in order below.

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THE REVISED SCHEME

I am a member of the Revised Scheme; could you give me a brief summary of how this scheme operates?

Certainly. The Revised Scheme requires a compulsory member contribution of between 8.0 and 9.5 per cent of post tax salary. As previously highlighted, Revised Scheme members can now elect to make these contributions out of pre-tax salary ranging from 9.5 to 11.2 per cent of pre-tax salary. For this contribution, a member receives a final benefit available either as a CPI indexed pension or a part pension and a lump sum which has been significantly funded by the employer. If desired by the member, all the benefit can be commuted to a lump sum. The GSO can provide more detailed information about your options.

Fair enough. But how are the Revised Scheme retirement and resignation benefits calculated?

The final benefit depends on your final average salary over your last two years of employment, your age and your years of service at the time of your exit from the fund. Members resigning before age 55 are treated differently from those retiring after age 55 and members should obtain quotes from GSO to assist in comparing these options. Choosing whether or not to resign before age 55 (frequently referred to as the 54/11 months option) or retire after age 55 can be a difficult decision and employees should obtain independent advice when considering these options.

What about some precise figures about my pension entitlement?

My advice is always to obtain up to date quotes from the GSO but here is a short summary of the pension benefit calculated as the reduced taxed benefit as currently shown on the GSO benefit statement.

At 55, after 20 years' service, the pension is 34.65% of FAS whereas after 30 years of service it is 47.35% of FAS. At this age, the pension for 10 additional years of service is 12.7% of FAS.

Generally, the first 25 years of Revised Scheme membership generates a larger annual increase in pension entitlement to age 55, than further membership in the fund. The pension entitlement, as would be expected, increases with the age at retirement. At age 55, 25 years' service gives a pension of 47.02% of FAS. At age 60, the 25 years' membership pension is 48.52% of FAS, while at 65, the pension is 50.94% of FAS.

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It's not easy to interpret these figures. How do I assess whether it's worth my while to work on past 55?

You're right. It's quite difficult, but here goes. You need to consider these and many other factors:

1. How rapidly is your FAS increasing or likely to increase in the future?
2. How much does each additional year of membership increase your pension entitlement? and
3. What is the impact of retiring at a later age?

In assessing each of these you need to realise that once started your pension is CPI indexed every year. Consider this example. If your FAS is increasing annually by around 5% a year and the CPI by 2% a year each year your pension will increase by 3% a year in real terms.

Further at age 55 if you have less than 25 years' service your pension will increase by 2.1% of FAS each year.

At age 55 after 25 years' recognised service the pension increases by only 0.3% a year up to 30 years' service. Age is also important in increasing pension entitlement up to age 60.

After age 60 additional years are valuable only for people with less than 30 years of service.

Does all my service count for superannuation purposes?

Not necessarily. Service does not include apprenticeships, cadetships or teacher training etc, that happen prior to becoming a member of the Revised Scheme. Leave Without Pay can have a significant affect on the number of years of fund membership. The members' Annual Benefit Statement illustrates the service history and the membership dates used in the calculation of the pension.

Are you saying that I should look closely at my options once I reach 30 years' membership?

Absolutely. Indeed, every super fund member is well advised to monitor the annual growth in their benefits. With the Revised Scheme, particularly approaching age 60, eligible members may find it worth getting quotes from the GSO and consider if there might be an advantage in becoming an exempt officer (only available to certain employees) and joining another super fund.

You should consider the following in this context:

- Are you ready for retirement?
- Are there other employment opportunities for you?
- What other benefit options do you have, such as receiving a lump sum?

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Revised Scheme - Exempt Officer

I've never heard of that option ("becoming an exempt officer"). Tell me more.

Becoming an exempt officer is an option **NOT** available to all public sector employees. Check with your fund whether you can become an exempt officer before taking any action.

By electing to be an exempt officer, you crystallise your benefit in the Revised Scheme before you retire. This could be attractive, say at age 60 after 30 years' service, particularly for those wanting to take part of their benefit as a lump sum. Before taxed fund adjustments the crystallised Revised Scheme Pension at age 60 is two thirds of FAS (as an untaxed pension). This deferred pension is indexed by changes in CPI and increased by an actuarial factor, depending on your age at retirement. The benefit of doing this is that your employer will pay the compulsory SGC 9% employer contribution to a fund of your choice and you'll no longer be required to contribute to the Revised Scheme. If this additional amount is invested over time it would generate a useful lump sum on retirement. It is possible at age 65 for a member to become exempt, have their pension paid and continue employment.

Can you provide an example?

Yes. VicSuper has provided this example which is illustrative only but is representative of this type of scenario which is a common theme considered by VicSuper advisers:

Alice is a Revised Scheme member aged 60 and has thirty years' service. She wants to work until she is 65. Her Final Average Salary at age 60 is \$90,000. She was promoted last year and does not anticipate any further promotions. She thinks her current salary of \$100,000 will simply keep pace with inflation. She has asked for advice about her options.

Assuming a 3% annual increase in salary, her retirement benefit at age 65 will be a pension of \$70,711 based on a FAS of \$114,239. Her own contributions over the 5 years will be almost \$52,000.

Her exempt officer benefit at age 60 is a deferred pension of \$53,617 which will have increased to \$65,265 with CPI (3%) and actuarial adjustments at age 65. If she goes exempt at age 60 she will be entitled to Superannuation Guarantee at 9% which will amount to almost \$41,000 at age 65 and will have saved \$52,000 in contributions.

In this particular circumstance, the best option might be to go exempt at age 61 when the full impact of her promotion will be included in her Final Average Salary. This will provide a pension at age 65 of over \$70,000 plus \$33,000 Superannuation Guarantee with contribution savings of about \$42,000.

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Transitioning to retirement and FAS (Financial Average Salary)

Can you provide more information about Final Average Salary (FAS) and its importance?

Of course. FAS plays an important part in determining your final benefit. Because it is the average of your salary over your last two years of service, annual salary increases and promotions will increase your final superannuation benefits. If your salary is rising faster than the CPI, there can be a substantial benefit from delaying your retirement. Superable salary does not include overtime and some allowances.

I'd like to know how working part-time would affect me. Would it reduce my FAS?

The Revised Scheme legislation especially caters for part time work so that reduced hours do not impact on FAS. The FAS is based on equivalent full time earnings and all the adjustments are made on a pro rata basis for the time factor and contributions. This means that a person working say half-time pays 50% of the annual full time contribution and two years part time employment counts as one year of service. To ascertain accurately how part time service would affect your benefits, you should seek benefit estimates via the GSO website.

How can this be of benefit?

Well, here's an example. Jane is 56 and started work when she was 28. Her service in the Revised Scheme is 28 years. She plans to retire at age 60 and would like to work part time till then but is concerned that it might affect her retirement pension. Because Jane needs only two more years service at age 60 to secure the 2/3rds pension (taxed fund adjustments would apply) she could work at a time fraction of 0.5 and still accrue 30 years service by the time she retires. Her contributions would reduce by 50% but she would still receive the same pension at age 60. The only impact of going part time would be on her take home salary. Her superable salary would be based on equivalent full time earnings. This example would be especially profitable for Jane if her FAS were increasing significantly faster than the CPI over this period.

You haven't covered the option of resigning before 55. Everyone in the office is talking about it. Just how valuable is this option?

Frankly, it can be very valuable but in many cases less valuable than office gossip would lead Revised Scheme members to believe. Married women who entered the scheme during the 1975 and 1982 amnesties and are required to pay for prior service recognition, may not find 54/11 attractive. The resignation option (commonly called 54/11) allows members at age 54/11 to receive a refund of their member contributions and accrued interest plus a pension of 5/7ths of the full pension entitlement accrued up to the date of resignation. The benefit from a 54/11

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resignation comes from receiving a larger lump sum than could be obtained by commuting 2/7ths of the pension at age 55.

What's the case if I want to take all my benefit as an indexed pension?

The 54/11 option could still be attractive if you want to retire at 55 or not long after. In some cases of long periods of service prior to 55 and relatively low increases in FAS, the age 54/11 lump sum could purchase a larger private sector pension than the 2/7th of the Revised Scheme pension lost by taking the lump sum.

How do I evaluate my options?

You should always seek professional advice, particularly from an adviser able to assess the value to you of an indexed pension. The GSO will provide you with information about the lump sum available on resignation and the remaining age 55 pension entitlement. You can then compare this with the age 55 retirement pension and the lump sum that could be obtained by commuting your preferred percentage up to 50% or 100% of the pension at that time.

Here's an example provided by VicSuper which is illustrative only, but is representative of this type of scenario which is a common theme considered by VicSuper advisers:

Jim joined the Revised Scheme in 1975 at age 24.. In 2006 he is approaching age 55 and has 31 years' service. His Final Average Salary is now \$72,000. His contributions and interest have grown to \$253,360. If he waits till he is 55, he will be entitled to a full pension of \$34,083. His resignation benefit just prior to age 55 will be a deferred pension of 5/7ths or \$24,345 plus a lump sum of \$253,360.

Questions to ask your adviser:

Is the lump sum more valuable than the lost pension of \$9,798?

How much pension would you have to commute to a lump sum at age 55 to deliver an equivalent lump sum?

Jim does not want to retire yet and at age 55 after claiming his deferred pension he goes back to work for a further 5 years. He rolls over the lump sum (resignation benefit) which increases with interest to \$346,000. In addition, he contributes the equivalent of his pension back into superannuation which delivers an extra \$130,000 plus. His employer Superannuation Guarantee contributions provide a further \$35,000 and for comparison purposes he has continued to make an equivalent Revised Scheme contribution of 9.5% to net a further \$44,000.

He retires at age 60 by which time his pension has increased through CPI adjustments to \$28,222 and he has a lump sum of over \$555,000 tax free.

Had he remained in the Revised Scheme, assuming reasonable salary increases have lifted his Final Average Salary to \$84,000, he would be entitled to a pension of \$49,519.

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Questions to ask your adviser:

**Would his additional lump sum be worth the \$21,297 annual pension foregone?
How much pension would he have to commute to deliver an equivalent lump sum?**

What's your personal assessment of Jim's situation?

The 54/11 option is highly attractive for Jim provided he is able to obtain a comparable replacement job which permits him to work on for as long as he wants until age 60. There are no restrictions on returning to employment under the State Superannuation Act but individual employers may have their own policies in place. If proceeding with resignation before 55, it is important to claim the pension at age 55 in order to provide the cash flow needed for future salary sacrifice contributions.

One other observation is that the benefits available to Jim from 54/11 are larger than those available to Revised Scheme members with shorter periods of service. To gain some idea of the value of a CPI indexed pension, it would not be possible to purchase such a pension at age 55 for less than 20 times the pension. At the time of making the 54/11 decision, Jim received a lump sum of \$253,360 for giving up a pension of \$9,798 a year. The lump sum amounted to 25.86 times the annual pension foregone. At age 60 on the estimates of the additional lump sum available of \$555,000 would represent 26.06 times the annual \$21,297 pension foregone.

Clearly, before making a 54/11 resignation election, Revised Scheme members need to examine the magnitude of the benefits to be gained as well as their prospects to gain comparable employment after resignation.

REMEMBER: Seek independent financial advice

Assuming I decide to stay on past 55, what are the attractions of taking part of my Revised Scheme pay-out as a lump sum?

The rules allow you to commute up to 50% or 100% of your Revised Scheme pension to a lump sum. As for the analysis of the 54/11 option, you need to compare the value of the pension foregone with the lump sum obtained. The GSO can provide precise figures for individual situations but the 50% commutation offer either within three months of retirement or just before age 65 allows you to retain a surviving spouse pension option.

The GSO website provides an example of a 50% commutation at age 57, where the lump sum equates to 10.8 times the annual pension foregone maintaining the full surviving pension benefit and 12.8 times the pension foregone for forfeiting 50% of the surviving pension benefit. Before making any decisions on taking any part of your pension as a lump sum, obtain independent financial advice. Commutation can be an attractive if there are serious health issues that reduce the expected life span, As always, seeking personal financial advice is essential.

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THE NEW SCHEME

Can you tell me simply how the New Scheme works and what my best options are?

I'll try but you'll need to make your own decisions about the best options for your personal situation.

Unlike the Revised Scheme where member contributions are compulsory, New Scheme members can contribute 0%, 3%, 5% or 7% of salary to their fund annually. The 7% rate is available to allow people who have previously contributed on average less than 5% of salary to catch up and to prescribed officers. The New Scheme retirement and resignation benefits are provided solely as lump sums calculated as multiples of FAS based on the period of membership and the average contribution level.

So what benefit comes from contributing to the New Scheme and what level of contribution do you recommend?

- A 0% contribution rate accrues a retirement benefit of 8.5% of FAS for every year of service.
- A 5% of salary contribution increases the benefit accrual to 17.5% of FAS.
- This means that the 5% of salary personal contribution generates an additional benefit of 9% of FAS each year.

While FAS is the average of your last two years salary and lower than your current salary, there is still a substantial annual return in excess of 3% of your current salary from contributing 5% of salary annually to the fund.

Are you recommending a 5% contribution to the New Scheme?

That's for you to decide but it represents a pretty good investment, especially now that you can make your contribution on a pre-tax basis. Made on a pre-tax basis, a 5% personal contribution costs you 5.9% of pre-tax salary and if your marginal tax rate is 31.5%, 4.03% of post-tax salary. This outlay increases your New Scheme benefit accrual by 9% of FAS each year. No other safe investment offers such a high immediate return.

But I can't touch my super till 55 and I have a large mortgage. Surely I can make more by paying off my mortgage?

Sadly and unfortunately for you, no, you can not. The return from paying off your mortgage will be at most 7.5% p.a. compounded annually. Your FAS is likely, on past experience, to increase by between 4% and 6% a year but say 5% annually. Even if you are aged 35 and can't touch your super till age 60 under the preservation rules,

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investing 4.03% of salary after-tax in the New Scheme will increase in value to approximately 30% of FAS over the next 25 years.

How about some more examples?

Certainly. The following table considers a range of situations using a standard 7.5% p.a. mortgage interest rate and three assumptions about the average rate of growth of FAS over a career.

Value of Paying Off Mortgage Compared with Contributing 5% to New Scheme				
Period to Retirement ¹	Paying off Mortgage	Contributing to New Scheme		
Years	% of FAS	Growth in FAS		
		4%	5%	6%
25	25%	24%	30%	39%
20	17.1%	19.7%	23.9%	28.9%
15	11.9%	16.2%	18.7%	21.65%
10	8.3%	13.3%	14.7%	16.1%
5	5.8%	10.9%	11.5%	12.0% ¹

¹ 55 for people born before 1 July 1960 increasing in annual steps to age 60 for people born after that date.

What these figures show is that the closer you are to retirement age, the greater the advantage to you from maximising your contribution to the New Scheme. It's also a highly attractive proposition when your FAS is increasing at a rapid rate.

Surely there are other advantages from not tying up money in super?

If you opt not to contribute to the New Scheme, you'll need to save in some other way to be in a comparable situation in retirement. What you lose by not contributing to the New Scheme is the matching employer contribution. Certainly you can opt not to contribute while you are young and then increase your contributions at a later date as you get closer to retirement. This is why the New Scheme allows a 7% annual catch-up contribution rate, but it is all too easy to run out of time. If you made no contributions for 10 years it would take more than 15 years at the catch up rate to achieve a 5% average contribution over your period of membership.

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What are the precise figures involved?

A 3% annual contribution generates an additional 5.5% of FAS for each year of contribution at this level compared with a 9% of FAS increase for a 5% contribution level. The 7% contribution rate generates an additional benefit of 12.5% of FAS. The first 3% of salary contributed generates a slightly higher matching employer contribution

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than the 5% or 7% contribution, but the differences are marginal. The 7% that prescribed class officers pay will give an even greater return.

Are there any 54/11 issues involved with the New Scheme?

There are no special benefits from resigning before 55 from the New Scheme. However, members who transferred from the Revised Scheme to the New Scheme during 1988-90 and SERB to New Scheme transfers who have part of their benefit as a pension entitlement should at least investigate resigning prior to age 55 as compared to retiring at age 55. Eligible New Scheme members at age 55 or over should look at the exempt officer benefit available at that age. This option allows the New Scheme benefit to be rolled over to an accumulation fund which could grow at a faster rate than FAS which sets the limit on the rate of growth of the New Scheme benefit. The option of becoming an exempt officer (if eligible) is less attractive before age 55 because transfer of the New Scheme deferred benefit to an accumulation fund is discounted by 4% for each year you are under age 55.

How about an example?

VicSuper has provided an example of a New Scheme member considering his options at age 55. This member has averaged a 5% contribution over his period in the fund and has no option to increase his contribution rate.

Andrew just turned 55 and is a member of the New Scheme. He joined the Scheme in 1988 (18 years service) and has contributed 5% since commencing.

His lump sum multiple of his Final Average Salary at 30 June 2006 is:

0.175 (accumulation factor) x 18 years = 3.15 (a lump sum of \$315,000).

Based on his Final Average Salary of \$100,000 and his current salary is \$103,000.

He has heard of some colleagues becoming exempt officers and wants to understand the implications. He plans to retire at age 60 and anticipates a salary increase of 3% per annum till then.

If Andrew stays in the New Scheme to age 60, his multiple will have increased to 4.025 and his Final Average Salary will be \$117,666. His retirement lump sum at 60 will be \$473,606.

If he goes exempt at age 55 he would have a lump sum of \$315,000 to invest in superannuation. If we assume 5% rate of return the lump sum will have grown to \$402,029. When the equivalent of the New Scheme contribution and Superannuation Guarantee are factored in an additional \$77,000 would be payable making him over \$5,000 better off.

The effectiveness of this strategy is very dependent upon the interest rate achieved compared to salary movement. An additional 2% in interest makes the net gain over \$48,000.

This would not be a good option if you anticipated a promotion or a significant increase in superable salary in the critical years.

It is critical that you obtain independent financial advice before making any decisions on your superannuation options.

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EMERGENCY SERVICES SUPER

It would be good to have a brief summary of how the ESSS defined benefit fund works.

I recommend you examine the Product Disclosure Statement on the website www.esss.com.au because the scheme has complex provisions, especially for resignation within a relatively short period of time. The fund is open only to emergency service workers including police, fire brigade, ambulance employees (MAS and RAV), some Department of Sustainability & Environment employees, CFA employees and related services (member's spouses are also eligible to join). All members need to be operational to join the Defined Benefit Scheme. Benefits can be paid as taxed or untaxed. Because of the high pressure nature of these activities, the defined benefit fund offers members the possibility of obtaining a maximum benefit multiple of 7.5 times FAS after 30 years membership. Someone joining at 20 can thus achieve maximum benefit multiple at age 50, facilitating early retirement.

That sounds good. What's the catch?

Essentially, the only requirement is to maintain a member contribution of 7% of salary over the whole period. The ESSS defined benefit fund allows members to contribute at 0, 3, 5, 6, 7 or 8% and the employer contribution increases with the member contribution.

What are the benefits of the ESSS?

ESSS, to allow a rapid build up of benefits, provides generous matching arrangements up to an 8% member contribution rate, the 8% being a catch up rate. A 0% contribution rate generates an annual benefit of 8.5% of FAS while the 7% rate generates a total benefit of 25% of FAS. The 7% of salary member contribution generates an additional benefit of 16.5% of FAS providing a strong incentive to contribute at this level.

What happens if I just can't afford to contribute at the 7% rate?

You should contribute as much as you can afford. For example, a 3% contribution rate generates an annual retirement benefit of 14.5% of FAS. This is a big improvement on the 8.5% of FAS annual rate when you choose not to contribute to the fund at all. The 5% and 6% contribution rate similarly provide additional benefits of 18% and 21.5% of FAS respectively. You should obtain independent financial advice when making these decisions.

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You said earlier that ESSS members can contribute on a salary sacrifice basis. How significant a factor is this?

Very. Instead of having to contribute after paying personal marginal tax rates usually of 31.5%, 41.5% and for some 46.5%, pre-tax contributions only involve paying the 15% super contributions tax. A 7% post-tax member contribution equates to an 8.25% pre-tax contribution to the fund. In post-tax dollar terms, the cost amounts to 5.65% of salary for a 31.5% rate taxpayer and 4.41% of salary for the top 46.5% rate payer. Contributing to the ESSS is now much more affordable than it previously was.

How does contributing to the ESSS on a salary sacrifice basis compare with salary sacrificing to ESSPlan or other accumulation funds?

Additional salary sacrifice super contributions to separate schemes are best considered once the maximum salary sacrifice contribution is made to the ESSS defined benefit fund. By maximising the salary sacrifice to the defined benefit fund, you gain not only the tax saving from salary sacrifice super but also the higher employer contribution to the ESSS defined benefit fund.

Are there any 54/11 or similar benefits in the ESSS fund?

Not really. Once ESSS members have achieved their maximum benefit multiple of 7.5 times of FAS, there is an incentive to look elsewhere for employment unless their FAS is increasing significantly each year. Unlike members of accumulation funds, defined benefit fund members can't commence Transition to Retirement Pensions with their fund benefits. This can also be an incentive to contribute to an accumulation scheme such as ESSPlan or VicSuper once you reach this stage of your employment.

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VICSUPER & OTHER ACCUMULATION SCHEMES

Defined Benefit vs Accumulation Schemes

One of the major differences between Defined Benefit and accumulation schemes is investment risk. In a Defined Benefit Scheme, generally a member bears no investment risk, whereas in an accumulation scheme the member does bear this risk. This is a significant issue that Defined Benefit members need to consider before deciding whether to reduce Defined Benefit contributions in favour of contributing to an accumulation fund

What about VicSuper? How does this fund compare?

The fund is an accumulation scheme into which employers contribute the Superannuation Guarantee of 9% of salary. Members are able to contribute and are completely free to take advantage of all the benefits available to accumulation fund members including any combination of: post tax contribution, where they may gain a co-contribution; salary sacrifice contribution, where it is tax effective; spouse contribution splitting and commencing Transition to Retirement Pensions as soon as they reach preservation age.

Aren't you gilding the lily a bit?

Obviously, the larger the annual employer super contribution, the greater the benefit to the employee. But, particularly for younger people, the defined benefit funds require regular member contributions to the super fund to gain the maximum benefit. This requirement can put pressure on the family budget, especially when incomes are relatively low.

With an accumulation fund such as VicSuper, members have much greater flexibility in when and how they contribute to super. One attractive option is to minimise contributions while income is low and then fast track super contributions at a later age when income is higher and the tax savings from salary sacrifice super is larger.

I agree that defined benefit funds represent an excellent way to force or at least encourage people to make regular contributions to their super fund. Accumulation funds require more discipline on the part of the fund member.

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Do you have any specific points to help VicSuper fund members?

I certainly do.

- The first is to take the maximum advantage of the salary sacrifice super options when you have sufficient income or when you get closer to retirement age.
- Second, lower income earners should remember that the co-contribution benefit of up to \$1,500 a year provided by the Federal Government is available if the requisite personal contribution is made.
- Third, VicSuper offers the spouse contribution splitting option to its members. At the end of each financial year, you can transfer up to 85% of new employer and salary sacrifice super to a spouse account.
- Fourth, for those aged 55 or more, VicSuper offers the option of a Transition to Retirement Allocated Pension even if they are still working.
- Finally, members of VicSuper, like all other super fund members, should ensure they have an adequate level of income protection, death and disability insurance cover in the fund.

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SERB and Transport Schemes

What other schemes does the ESSS administer that might be of interest?

The ESSS Board also administers two small schemes being the State Employees Retirement Benefits Scheme (SERB) and the Transport Superannuation Scheme. Members of these schemes should contact the GSO for details of salary sacrifice and other benefit options

In general terms SERB members should consider the information provided in this document regarding the Revised Scheme as a guide as there is a smaller age 54/11 benefit available from this scheme.

Transport Scheme members should consider the information provided regarding the New Scheme with contribution options of 0%, 2.5%, 5% and 7.5% instead of the New Scheme rates.

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