



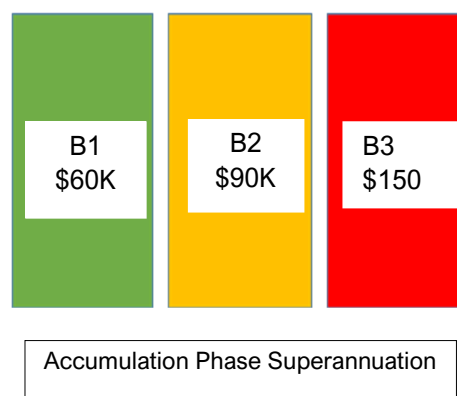
RE-ALLOCATION OF BUCKETS WHEN SPLITTING BETWEEN ALLOCATED PENSIONS AND ACCUMULATION FUNDS

As a result of the 1 July 2017 superannuation changes, many people will find that their superannuation balance is in excess of the allowed Transfer Balance Cap (TBC) so that not all of the balance can be in the pension phase. In these situations, the “next best” option is usually to maintain the excess amount in the accumulation fund.

The difference between a pension fund and accumulation fund is primarily taxation. Pension funds pay no tax on their earnings while accumulation funds are taxed at 15%. The higher the earnings, the greater the tax differential. This can be seen in the table below.

Bucket	Type of investment	Gross Return	Net return in pension fund	Net return in accumulation fund	Difference
1	Cash	0.2%	0.2%	0.17%	0.03%
2	Balanced	5%	5%	4.25%	0.75%
3	Shares	10%	10%	8.5%	1.5%

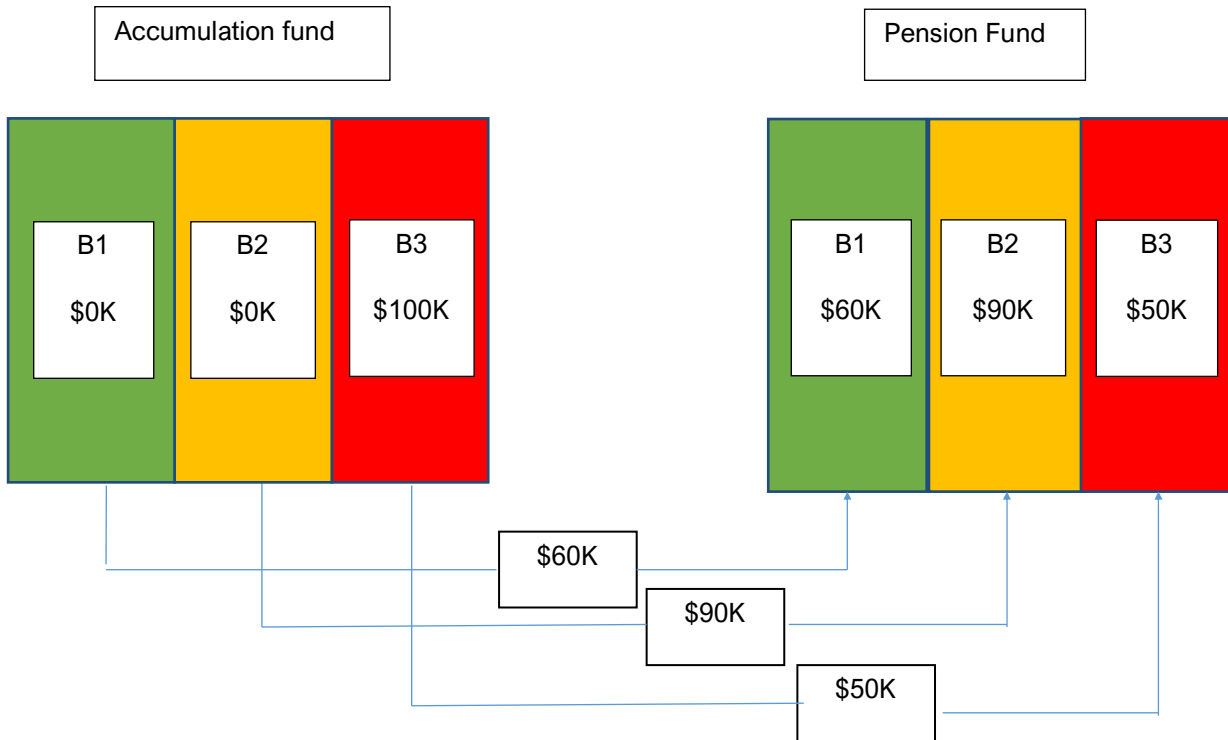
As can be seen in the table, in a typical B1 investment (cash) earning 0.2%, there is very little tax disadvantage of being in an accumulation fund (0.03% difference in net returns). However, if the shares in B3 earn 10%, there is a large (1.5%) differential in the net returns of the pension and accumulation funds. This suggests that if we have to split money between a pension and accumulation fund, it would be logical to keep the higher earning assets (B3) in the pension fund and the lower earning assets (B1) in the accumulation fund.



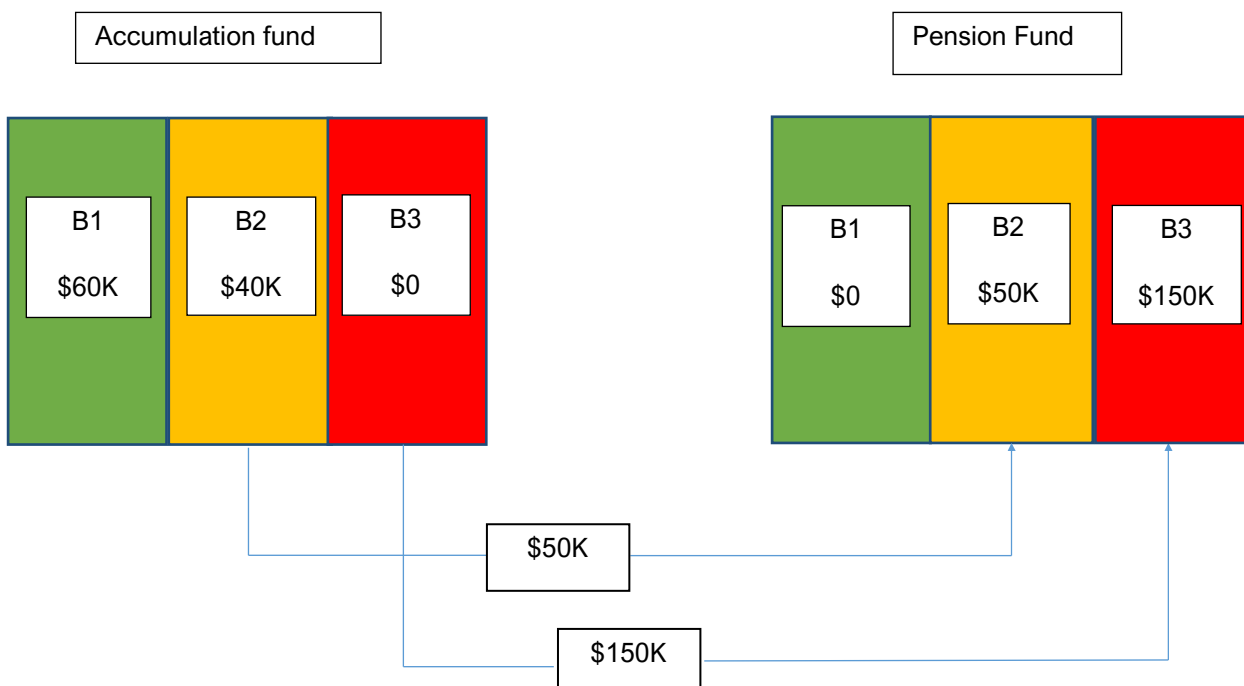
This can be seen in the following example. In this example an individual has a superannuation account of \$300,000 in the accumulation phase with a requirement for as much as possible to be moved into the pension phase. It is currently split into the three buckets of \$60K (B1), \$90K (B2) and \$150K (B3).

After an assessment of the individual's TBC, it is revealed that only \$200,000 can be moved into the pension phase. Consequently, \$100,000 must be left in the accumulation fund.

There are a number of ways that this could be done. The first would be to simply leave \$100K from the B3 investments in the accumulation fund. This would mean moving the current levels of B1 and B2 into the new pension fund, together with a lower level of B3 (\$50K). The accumulation fund would have no B1 or B2.



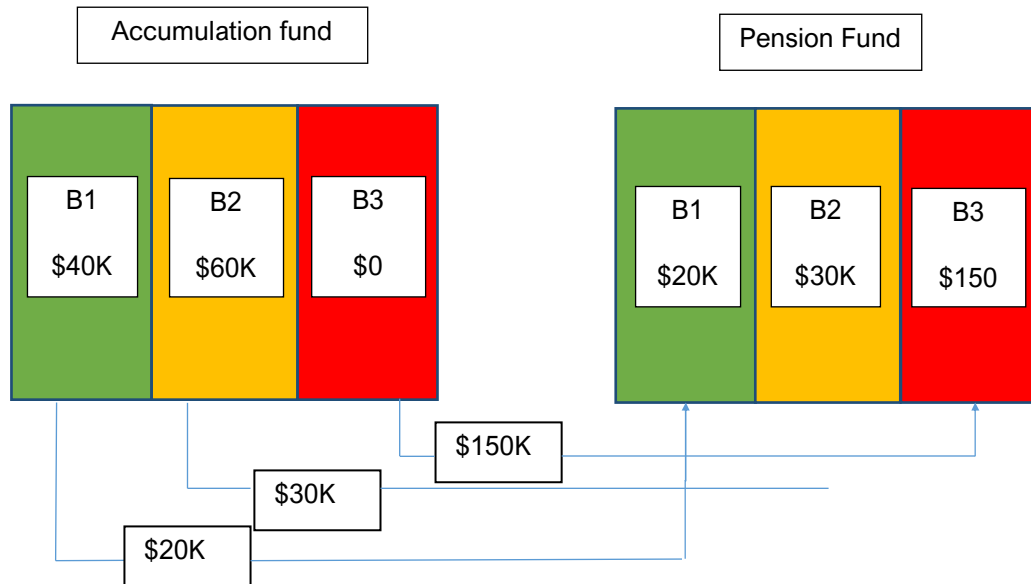
Although this seems a straightforward solution, it is the wrong strategy for maximising returns. By taking this action, the bulk of the high growth assets are now in the accumulation fund, where these higher earnings will be taxed at 15%. A more effective strategy would be to leave the lower returning investments (B1 and B2) in the accumulation fund. This can be seen from the example below.



This is certainly a superior arrangement from a tax perspective, as the highest earning investments (B3) have stayed within the pension fund, but this comes with administrative difficulties.

The difficulty with this model is that the pension fund has no B1 from which to pay the pension. In this model, we will assume that the annual pension payment is \$20K. This \$20K must come from the pension fund and without any B1 funds in the pension, the pension payment will have to come from B2. This somewhat defeats the point of having the buckets in the first instance.

The way around this lies somewhere in between the two options.



In this scenario, we have moved one year of pension payments into the pension fund (\$20K), but leave the remaining B1 (\$40K) in the accumulation fund. We have also moved \$30K from B2 and all of the B3 funds to the pension phase (to maximise the tax advantage).

A year down the track, the \$20K in B1 will be exhausted by the pension payments. Without action, the pension payments would then switch to be paid from B2.

However, before the B1 funds within the pension fund are exhausted, we perform a “switcheroo”. This is done by:

- In the pension fund, selling down \$20K of B2 investments and placing the proceeds in B1; and
- At the same time, in the accumulation fund, using \$20K of the B1 money to purchase B2 assets.

This is effectively a “contra” transaction. B1 in the accumulation fund has been reduced by \$20K but the B1 balance in the pension fund is increased by \$20K. This gives the pension fund the necessary cash to cover the pension payments for another year. The B2 balance in the pension fund has declined by \$20K, but the B2 balance in the accumulation fund has increased by \$20K. The combined levels of assets have not changed, but the pension fund now has the cash necessary to make the pension payments.

This process takes a little more work to get right, but ensures that the tax disadvantage of having funds in accumulation phase is minimised.

Companion document

Using the BL&A ‘Bucket Approach’ to investing Transfer Balance Cap

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