

# “The 10% test” – strategies, tips and traps!

## Overview

Making personal superannuation contributions continues to be a tax effective way for some individuals to save for their retirement. In order to benefit, clients must satisfy 2 key criteria.

Firstly, they must be eligible to contribute super<sup>^</sup> and secondly, they must receive **less than 10%** of their total assessable income plus reportable fringe benefits for the financial year from an employer source\* (e.g. salary, wages, commission, etc).

This article identifies a number of strategies involving the use of personal concessional contributions and the <10% test. It also outlines techniques that may allow otherwise ineligible clients to make personal concessional superannuation contributions.

## General Strategies

### Interaction with the Government co-contribution

The 2007/08 financial year is the first year in which self-employed individuals carrying on a business are eligible to benefit from the Government co-contribution.

Broadly, where a self-employed individual derives at least 10% of their income from carrying on a business, their *assessable income less allowable business deductions* is less than \$58,980, and they make a personal non-concessional (after tax) contribution, they will be eligible to receive the co-contribution.

However, while someone who is an employee may be able to increase their co-contribution entitlement by making salary sacrifice contributions to superannuation, unfortunately a self-employed individual is at a slight disadvantage. Even though they may be able to claim a tax deduction for their personal superannuation contributions, this tax deduction is not regarded as an allowable business deduction for self-employed individuals and will not improve their eligibility to receive the Government co-contribution.

Having said that, a self employed individual will be allowed to claim a dollar-for-dollar tax deduction for any concessional contributions they make while also receiving the government co-contribution on any additional non-concessional contributions.

### Example

Tony generates \$50,000 assessable income from a business that he conducts as a sole trader. He has \$10,000 of allowable business related tax deductions, income of \$5,000 from a term deposit and personal tax deductions (from charitable donations etc) of \$500.

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<sup>^</sup> i.e. be under age 65, or aged 65-74 and have be gainfully employed at least 40 hours in any consecutive 30 day period during the financial year in which the contribution is made

\* Also includes employment termination payments cashed and accrued leave payments received upon termination as per TR 2005/24

If Tony made a personal *non-concessional* contribution he would be eligible for the co-contribution as:-

1. His total assessable income minus allowable business related tax deductions is within the co-contribution income threshold (i.e.  $\$50,000 - \$10,000 + \$5,000 = \$45,000$ ), and
2. More than 10% of his total assessable income is received from an employer source and/or from carrying on a business.

Further, as Tony is self-employed and his total assessable income from an employer source is less than 10% of his total assessable income (i.e. 0% in this circumstance), he may **also** make a personal *concessional* contribution and claim a 100% tax deduction to reduce his income tax liability. However, this tax deduction would not improve his co-contribution entitlement.

## Concessional contributions for those aged 70 or over

Prior to 1 July 2007, deductible (concessional) contributions could generally only be made for individuals up to age 70. Since 1 July 2007, concessional contributions can now be made by, or on behalf of, an eligible individual up to age 75.

Further, since 1 July 2007, an individual's eligibility to claim a tax deduction for superannuation contributions has been simplified to one test only: the <10% test (discussed above).

This effectively means that for employees aged 70 or over, they will not be able to make personal concessional contributions simply because they are unsupported i.e. they no longer have SG support from their employer.

Thus, while personal concessional contributions can now be made up to age 75, generally the member must either be self-employed or, if they are an employee, be sacrificing part/all of their salary to meet the <10% test.

Note: Salary sacrifice contributions can be made up to age 75 for employees as an alternative.

## Special rule for those born in June

The superannuation (SIS) regulations allow a superannuation fund to accept contributions *on or before the day that is 28 days after the end of the month in which the member turns 75.*

This mirrors the tax law which states that a contribution may be deductible if it is made *on or before the day that is 28 days after the end of the month in which you turn 75.*

Therefore clients who turn 75 during the month of June, and satisfy the work test allowing them to make superannuation contributions, may choose to make a personal concessional contribution for the financial year in which they turn 75.

In addition, assuming they continue to meet the work test, they are also to make a personal concession contribution for the following financial year, provided the contribution is made by the 28<sup>th</sup> July.

This strategy may be especially beneficial for high-income earning clients who are still working in their senior years eg. farmers, doctors and barristers.

### Example

Trevor is self-employed and turns 75 on the 5<sup>th</sup> of June 2008. He earns \$150,000p.a. and intends to continue working full-time throughout the 2007/08 and 2008/09 financial years.

As he is self-employed, Trevor is able to make a concessional contribution of up to \$100,000 for the 2007/08 financial year. In addition, he is also able to make a \$100,000 concessional contribution for the 2008/09 financial year, so long as this contribution is made by 28<sup>th</sup> July 2008. Importantly, Trevor must pass the 40/30 work test **before** the contribution is able to be made in July.

### **‘Doctoring’ the 10% test**

In some cases, where an individual fails the <10% test, there may be some opportunities available to *doctor* this test and become eligible to make personal concessional contributions. In order to achieve this, there are effectively 2 levers available:

1. Reduce income received from employment sources and/or
2. Increase non-employment sourced assessable income.

The following strategies may be considered to reduce the percentage below 10%.

### **Salary sacrificing in order to meet the 10% test**

The ability to unlock 2 sets of concessional contribution caps via the *double deduction* strategy of previous years is no longer available under the better super changes. However, clients who earn a portion of their income from salary and a portion from self-employment, investment income, or assessable capital gains may benefit from a salary sacrificing strategy.

By salary sacrificing part or all of their employment sourced income, they may become eligible to obtain a tax deduction for any personal superannuation contributions they make, reducing the tax on their investment income.

### Example

Throughout the 2007/08 financial year, Mark (age 53) earns \$40,000 from employment and also realises a large assessable capital gain (after the 50% discount) of \$100,000 from the sale of an investment property.

Without salary sacrificing, Mark is ineligible to claim a tax deduction for personal superannuation contributions, as he fails the <10% test.

However, if at the beginning of that financial year, Mark had put in place an arrangement to salary sacrifice 100% of his employment income, this would reduce the amount of employer sourced income that he receives to nil, allowing him to make a \$60,000 personal concessional contribution, thereby reducing the CGT liability.

This effectively reduces Mark’s taxable income from \$140,000 to \$40,000 and, even after allowing for contributions tax, represents a tax saving of \$23,000. <sup>▲</sup>

<sup>▲</sup> Tax and Medicare on \$140,000 of income = \$45,200. Tax and Medicare on \$40,000 plus contributions tax on \$100,000 = \$7,200 + \$15,000 = \$22,200. Therefore, tax saving = \$45,200 - \$22,200 = \$23,000

In undertaking this strategy, it is crucial that the individual does not breach their concessional contribution cap, as any excess concessional contributions will effectively attract tax at the top marginal tax rate (i.e. 46.5%). Importantly, all concessional contributions made by, or on behalf of, the member are aggregated toward this cap.

So using our example above, if Mark had made a personal concessional contribution of more than \$60,000 and/or the employer had made SG contributions based on the original salary, the concessional contribution cap would have been breached.

## **Bring forward leave payment upon termination of employment**

As payments of accrued leave received following termination of employment are considered employer sourced income for the purpose of the <10% test, negotiating to bring forward such an entitlement into a different financial year may be an effective strategy.

### Example

Tracy (age 51) decides that she will retire around June or July in 2008. Following her retirement, she will receive a \$40,000 lump sum payment being for accrued annual and long service leave. Tracy also intends to sell an investment property during the 2008/09 financial year, and expects to realise an assessable capital gain of \$300,000 (after applying the 50% CGT discount)

If Tracy receives the leave payment upon termination in July 2008, she would not be able to claim a tax deduction for a superannuation contribution in 2008/09 as she would fail the <10% test (i.e.  $\$40,000 / \$340,000 = 11.8\%$ ).

On the other hand, if Tracy were to terminate employment and receive this lump sum payment in June 2008, the payment would be assessable during the 2007/08 financial year. As a result, Tracy will have no income from employment during the 2008/09 financial year. This results in her meeting the <10% test, thereby allowing her to make a \$100,000 personal concessional superannuation contribution to reduce the CGT liability on sale of the property.

## **Cash a lump sum superannuation benefit**

If an individual is aged between 55 and 60, the taxable component of a superannuation lump sum benefit will be included in their assessable income, despite the first \$140,000 being free of lump sum tax.

As a result, clients in this age bracket who have met a condition of release, or have access to unrestricted non-preserved benefits, may be able to meet the <10% test simply by making a withdrawal from their super.

### Example

Linda (age 58) is employed on a part-time basis by a hospital as a surgeon earning \$30,000p.a. This income must be treated as employer sourced income, as the hospital does not offer salary sacrifice to their employees. Linda also earns \$200,000 as a self-employed doctor in her private practice.

Unfortunately, Linda will not be eligible to claim a personal deduction for a superannuation contribution as more than 10% of her income is from an employer source. i.e.  $\$30,000 / (\$200,000 + \$30,000) = 13.04\%$ .

However, let's assume that Linda has a superannuation balance of \$500,000 (all taxable component) and has unrestricted non-preserved benefits of \$200,000.

If she were to withdraw a lump sum of \$140,000 from her superannuation fund, this amount would be added to her assessable income, but fortunately taxed at a rate of 0%. As this lump sum superannuation benefit is not regarded as employment sourced income, Linda would now meet the <10% test and be eligible to make a personal concessional contribution of up to \$100,000 i.e.  $\$30,000 / (200,000 + \$30,000 + \$140,000) = 8.1\%$ .

### **Borrow money to invest increasing assessable income**

As the <10% test is based on assessable income rather than taxable income, if all else remains equal, clients who implement a gearing strategy may improve their chances of meeting the <10% test.

This is due to the fact that the income from these geared investments will increase the total assessable income for the individual, without being reduced by the deductible interest expense.

As this assessable income is not employment sourced income, this will reduce the percentage of employer-sourced income for the purpose of satisfying the <10% test.

### **Trigger additional capital gains**

Another method that may help a client to qualify under the <10% test would be to realise a capital gain. Realising a capital gain will create additional assessable income that may allow the client to get over the line and be eligible to make personal concessional contributions.

However, the costs and benefits of this strategy would need to be carefully assessed before proceeding.

### **Redeem insurance bond within the 10 year tax period**

Where an individual has an insurance bond that is still within the 10-year period, redeeming such a policy will result in a portion of the growth being included in the individual's assessable income (but fortunately will also carry a 30% rebate).

This will help to increase assessable income in order to meet the <10% test while the available 30% rebate will help to offset any personal income tax liability.

Once again, the costs and benefits of this strategy would need to be carefully assessed before proceeding.