

3rd of February 2009

This week's email question:

John and Jenny are 60 years old and still working paying off a mortgage as quickly as they can. John earns \$120,000 per year and Jenny earns \$30,000 per year. They would like to know whether they are better off paying all surplus funds into the mortgage or whether super is a better alternative.

Answer:

Many people are conditioned to pay off their debt at all costs and as quickly as they possibly can. Since the recent changes to the tax and super systems the correct answer is not what it once was. The current tax regime demands people really consider their position carefully, as paying off debt at all costs is quite often **not** the best strategy for them.

Rodney has often stated on this program over the years that everyone should die with debt. Some people would not be comfortable with this concept; however there are some very sensible reasons why this does make perfect sense. Clearing debt at all costs is quite often not tax efficient and debt used sensibly can be a good wealth creation tool.

A person who earns over \$34,000 per year would in most instances be better off from a tax point of view to pay the money to a super fund by arranging a salary sacrifice with their employer. This is where any salary earned over the \$34,000 amount is paid to super instead of being received as cash.

We see many people who are not doing this and choose to instead pay off their mortgage. This is to their detriment.

Some important issues need to be considered here though. Especially the issues around accessibility. Therefore age becomes a critical factor when determining the best strategy for individuals.

If you can accept the money either not being accessible, if you are younger than 55, or only having limited accessibility, if you are over 55, contributing to super wins hands down. People who adopt this strategy and wish to clear their debt fully could elect to draw their funds from super, after meeting a condition of release, once they attain 60 years of age, and the proceeds would be **completely tax free**. They could then pay out the remaining debt at this stage.

So the answer to this question for John and Jenny is dependent on a number of factors.

The first relates to tax rates.

Deductible contributions to super funds are taxed at 15%.

If your income / marginal tax rate is 15% or less then you are better off to pay the money into your mortgage.

If your income / marginal tax rate is higher than this you are better off to pay the money into super as a salary sacrifice payment. This is where you forgo salary and have it paid to your super fund by your employer. Alternatively if you are self employed, you can make a tax deductible contribution to your super fund.

I believe someone earning less than \$34,000 today should elect to pay off their mortgage rather than contribute to super. Jenny in this case would be paying no more than 15% tax on income which is the same as what she would lose paying the money into super.

Jenny should also consider whether she can afford to contribute up to \$1,000 each year to super, as an after tax contribution, to make her eligible for a co-contribution. A person earning up to **\$60,342** is eligible to receive a co-contribution from the government. People who earn less than **\$30,342** will receive \$1,500 for a \$1,000 after tax contribution. This equates to a guaranteed 150% return on your investment not including any other returns you may achieve. There is a sliding scale after this point up to the **\$60,342** amount where it cuts out completely.

In John's case he is definitely better off arranging a salary sacrifice and getting the money into super. John's marginal tax rate is 40% plus Medicare Levy. This amounts to a 25% or \$10,000 tax saving on amounts contributed to super down to \$80,000 of assessable income and 15% or \$6,900 on amounts down to \$34,000.

John should enquire with his loan company as to whether he can make his loan payments interest only. The difference between his interest only repayments and the previous principle and interest payments will reduce the amount he has to pay into his loan and could also be contributed to super.

Many people would be concerned about the media reports of negative returns in super and possibly shy away from this strategy for fear of contributing money only to see the value eroded. The first thing I will say is the negative returns of the last 15 months has followed a very strong run in share investments for several years. Those that were invested over the last 15 months have seen large paper losses on their investments recently. This size fall is unlikely to occur again in the short term and looking back over history the scale of this fall is one of the biggest ever. We do know that it will recover eventually we just do not know exactly how long it will take. I say this because I believe now is a great time to be investing sensibly.

Even if you are not as confident as I am you can still pay your money into super and hold it in a guaranteed investment or a cash account where there is very little risk of the loss of capital.

This information is intended to be general advice only. Before acting on any of the information discussed you should consult your professional advisors.

Table 1: New personal tax rates and thresholds

Current		From 1 July 2008		From 1 July 2009		From 1 July 2010	
Taxable income (\$)	Rate (%)	Taxable income (\$)	Rate (%)	Taxable income (\$)	Rate (%)	Taxable income (\$)	Rate (%)
0 - 6,000	0	0 - 6,000	0	0 - 6,000	0	0 - 6,000	0
6,001 - 30,000	15	6,001 - 34,000	15	6,001 - 35,000	15	6,001 - 37,000	15
30,001 - 75,000	30	34,001 - 80,000	30	35,001 - 80,000	30	37,001 - 80,000	30
75,001 - 150,000	40	80,001 - 180,000	40	80,001 - 180,000	38	80,001 - 180,000	37
150,001 +	45	180,001 +	45	180,001 +	43	180,001 +	42

Table 2: Low income tax offset and effective tax free thresholds

	Current (\$)	From 1 July 2008 (\$)	From 1 July 2009 (\$)	From 1 July 2010 (\$)
LITO	750	1,200	1,350	1,500
Effective tax free threshold	11,000	14,000	15,000	16,000