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What to consider when withdrawing your Super early

As the COVID-19 virus took a sledgehammer to the economy, the federal government rapidly introduced a range of initiatives to help individuals who lost income as a result of the measures taken to control the virus.

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What to consider when withdrawing your Super early

One of those initiatives was to allow qualifying individuals access to a portion of their superannuation to help them meet their living costs. Withdrawals are tax free and don't need to be included in tax returns. Most people can withdraw up to $10,000 in the 2019/2020 financial year and up to a further $10,000 in the 2020/2021 financial year.

For many people this early access to super will prove to be a financial lifesaver, but for others the short-term gain may lead to a significant dip in wealth at retirement. And the younger you are, the greater that impact on retirement is likely to be.

Alexander provides an example that many people will be able to relate to. He's a 30-year-old hospitality worker, and due to the casual nature of his recent employment he is not eligible for the JobKeeper allowance. He is eligible to apply for early release of his super under the COVID-19 provisions, however before going down this route he wants an idea of what the withdrawal will mean to his long term situation.

TAKING THE MAX

Much depends, of course, on the future performance of his superannuation fund. However, if Alexander withdraws $20,000 over the two financial years, and if his super fund delivers a modest 3% per annum net return (after fees, tax and inflation), then by age pension age (currently 67), Alexander will have $39,700 less in retirement savings than if he doesn't make the withdrawal.

At a 4% net return, he will be $65,360 worse off if he makes the super withdrawal.

But that's not the only disadvantage for Alexander. A smaller lump sum at retirement means a lower annual income. If Alexander draws down his super over a 20 year period, at a 3% net return, he will be around $2,670 worse off each year as a result of making the withdrawal. Over 20 years that adds up to a total loss of $53,375. At a 4% return, his youthful withdrawal will cost him over $96,000 by the time he reaches 87.

REDUCING THE RISK

On the plus side, if Alexander is eligible for a part age pension when he retires, his smaller superannuation balance may see him receive a bigger age pension.

There are other things Alexander can do to reduce the financial consequences of accessing his super early. One is to only make the withdrawal if he absolutely has to. Or if he does make the withdrawal, to use the bare minimum and, when his employment situation improves, to contribute the remaining amount back to his super fund as a non-concessional contribution.

COVID-19 is adding further complexity to our financial lives, so before making decisions that may have a long-term impact, talk to your financial adviser.

Waiting in cash until share markets fall

As any long-term share market investor knows, markets can go up and they can go down. While most people view a falling market as a bad thing, some investors see it as a buying opportunity. After all, it's better to pay, say, $60 for a share after a market dip than $100 for the same share at the market peak.

Of course, to be able to exploit these buying opportunities, the cash needs to be available. That means hoarding some extra cash while markets are happy in anticipation of a rainy day. It also means having a strategy around when to invest, how much to invest, how long to hold and what to invest in. There isn't a single, off the shelf solution to this, but 58-year-old Barry provides an example of what the rainy-day investor needs to think about.

How much?

Barry is a seasoned investor with a sizable self-managed super fund. He has weathered several market slumps over the years, and when markets are trading normally, with low volatility, he is happy to build up a cash reserve of up to 20% of his fund's value to be used when the share market goes 'on sale'. The cash comes from dividends and distributions, contributions and realised capital gains.

When to invest?

With no hard and fast rules, Barry decides that if the market falls by 10% he will invest 25% of his reserved cash. For each further fall of 10% he will invest a further 25%, so after a market fall of 40%, all his cash stash will be invested. This could occur in a short time period or evolve over many months of ups and downs. In some market corrections he may not use all of this cash.

What to invest in?

Barry has some favourite shares and if they fall significantly in value he will top up his holdings. However, he knows this involves more risk than buying the market, so most of his purchases will be of index funds.

How long to hold?

In volatile markets price movements can be sudden, dramatic, and in either direction. Barry's strategy is to sell any shares that produce a gain of 20% or more during the recovery phase. He also uses stop-loss orders to provide some protection from further sharp falls. Barry also limits himself to buying quality assets, and is prepared to hold them long term if the recovery is a slow one.

Barry knows his strategy isn't perfect. If share prices don't fall, he is left holding larger amounts of low-yielding cash than would normally be the case. If they fall a long way, he'll miss out on buying at the bottom of the market. But Barry gains some peace of mind that if (or when) market corrections do occur, his strategy should provide some protection to his super portfolio and improve his long-term position.

Seek advice

This is just one example of a rainy-day cash strategy. Everyone's circumstances differ, and it is important to seek appropriate advice specific to your situation. Talk to your qualified financial planner about a solution that's right for you.

Hands up - who wants to save tax?

Most investors and business owners are aware that the interest paid on an investment loan is generally tax deductible. These deductions can be maximised by prepaying the interest on the loan.

To do this contact your financial institution and arrange to have all of the interest costs for the following financial year brought forward and paid during the current year. You may then be able to claim these costs as a tax deduction in the current financial year.

The advantages could be considerable as the following example shows:

Phillip earns an annual salary of $110,000 and owns a rental property that generates an additional income of $23,400 each year. Phillip currently owes $320,000 on the property, with an interest rate of 4.5% per year on the loan. Assuming no other tax deductions, the impact of prepaying interest on Phillip's assessable income is as follows:

Income	
Salary income	$110,000
Rental income	$23,400
Gross income	$133,400
Less deductions	
Prepaid interest ($320,000 at 4.5%pa)	$14,400
Assessable income	$119,000
Tax on gross income	$39,523
Tax on assessable income	$33,697
TAX SAVING DUE TO PREPAYING INTEREST	**$ 5,826**

Prepaying the interest on your investment can bring forward related tax deductions this financial year. It may also enable you to fix the rate on your loan for 12 months and in so doing, could attract a lower interest rate.

Other conditions apply to claiming a deduction on prepaid interest, so first seek professional advice to determine if your circumstances satisfy all requirements. **Don't leave it until next June - start planning now.**

Calculation assumptions: rent $450/week not including repair/maintenance costs, tax calculated on gross income not allowing for salary sacrificing or other deductions and includes Medicare levy.