Market Linked Pensions

6 October 2016

Market linked pensions are a type of complying income stream available for retirees in a Self-managed superannuation fund (SMSF).

The terms of a market linked pension are defined under section 1.06 (8) of the Superannuation Industry Supervision Regulations 1994 (SIS Regulations).

The name 'market linked' refers to the way in which the pension interest is linked to the market value of the assets at any date. Market linked pensions are therefore also a type of account-based pension. These pensions are also referred to as 'term allocated pensions' or 'TAPs' because the pensioner selects a fixed term at commencement over which the income stream payments are paid.

Background: simplified superannuation reforms

Market linked pensions first became available on 20 September 2004. From this date until 20 September 2007, any retiree could commence a market linked pension in an SMSF. However, changes introduced by the Simplified Superannuation reforms in 2007, meant that after 20 September 2007 any new pension interest commenced in an SMSF was required to be an account-based pension as defined under 1.06(9A) of the SIS Regulations. This means that a member can no longer commence a new market linked pension with their accumulation interest in an SMSF. A member may however commence a new market linked pension in an SMSF using the balance rolled over from the commutation of an existing complying pension (e.g. a defined benefit pension or another market linked pension).

Another significant change introduced by the simplified superannuation reforms was that market linked pensions commenced after 20 September 2007 must also satisfy the minimum pension standards for account-based pensions in addition to the market linked income payment rules.

Setting the term

Market linked pensions are payable for a fixed term which is specified at commencement and included in the details of the pension documentation. The member must select a term for the new market linked pension that is between their minimum and maximum allowable term, the length of which depends on when the pension commenced and the age of the member at that time.

For market linked pensions commenced on or after 1 January 2006:

Minimum term: The minimum term is based on the member's life expectancy rounded up to the next whole number.

For example the life expectancy of a 68 year old male is 16.24 years. Rounded up, the minimum term is 17 years.

Maximum term: The maximum term is equal to the period from the commencement day until the member reaches age 100, or life expectancy based on an age five years younger than the current age, whichever is greater.

For example:

The number of years to age 100 for a male aged 68 is 32 years.

The life expectancy based on an age five years younger for a male aged 68 years old would be based on the life expectancy of a 63 year old male which is 20.14 years. Rounded up this is 21 years.

The maximum term is therefore 32 years.

The life expectancies that must be used for these purposes are currently based on Australia Life Tables 2005-07[1] with no adjustments.

1 Australian Government Actuary, Australia life tables.

Essentially, the term will determine the level of pension payments the member must withdraw each year. The payment factors are designed so that the pension assets are drawn down over the term of the pension.

Selecting a lower term will lead to a greater amount of the balance being withdrawn each year and selecting a higher term means the payments are spread out over a longer timeframe leading to lower payments each year.

A market linked pension may be established with terms that allow for it to automatically continue (or revert) to a dependant of the member (beneficiary) after his or her death.

If a market linked pension is set up so to revert to a surviving spouse on death of the primary pensioner and the life expectancy of the spouse is greater than that of the primary pensioner, then the member can also select a term that is within the reversionary pensioner's minimum and maximum term.

Example: calculating the minimum and maximum term

At 1 July 2014 Mark is aged 65 and his wife Amanda is aged 60. Mark decides to set up a market linked pension with the balance of his commuted defined benefit pension that will automatically revert to Amanda on his death.

As the pension will automatically revert to Amanda, Mark can select a term within his minimum and maximum term, or within Amanda's minimum and maximum term.

Mark's minimum and maximum term:

- **Minimum term:** 19 years (life expectancy of a 65 year old male is 18.54)
- **Maximum term:** 35 years (it is 35 years until he reaches age 100)

Amanda's minimum and maximum term:

- **Minimum term:** 26 years (life expectancy of a 60 year old female is 26.0)
- **Maximum term:** 40 (it is 40 years until she reaches age 100)

If Mark wanted to draw the largest pension payments from his market linked pension then he could select his minimum term of 19 years, meaning he is only allowing for his pension assets to last 19 years. Alternatively, because the pension is reversionary if Mark wanted to draw the smallest pension payments he could select a term of 40 years in line with Amanda's maximum term.

If Mark's market linked pension was not set up to revert to Amanda then Mark could only select a term within his minimum term of 19 years and his maximum term of 35 years.

Income payment rules

Unlike account-based pensions, market Linked pensions have a minimum and maximum payment limit between which the actual pension payment withdrawn each year must fall. Where the pension commences on a day other than 1 July in a financial year a pro-rated payment must be made based on the commencement date with an exception being that if the commencement date is on or after 1 June no payment needs to be made. There is no flexibility to make payments outside the payment limit.

The payment amount is determined by dividing the account balance at commencement and subsequently on 1 July each year, by the relevant payment factor detailed in Schedule 6 of the SIS Regulations, rounded to the nearest ten dollars. The payment factor is based on the remaining pension term in whole years. As the income payments are made on a financial year basis, once the term has been calculated a rounding rule applies. The remaining term on each 1 July will be rounded up if the pension originally commenced between 1 January and 30 June, or rounded down if the pension commenced between 1 July and 31 December. When the remaining term of the pension is 1 year then the relevant payment factor is 1. This means that the member will draw down their market linked pension to $0 in the last year of the term. There is no residual capital value for market linked pensions.

The payment made must be within 10% of the calculated payment amount. In effect this means that the actual pension payment drawn for the year must be between 90% and 110% of the payment amount. The ability for the annual payment amount to be varied by 10% was introduced on 1 January 2006, prior to this date the pension paid had to equal the payment amount.

Example: calculating the minimum and maximum payment limits

Continuing on from the previous example, let's say Mark decides to commence a market linked pension on 1 July 2014 with $100,000 and chooses his maximum term of 35 years.

Mark's income stream payment would be calculated as follows:

Payment amount for first year = purchase price/payment factor = $100,000/20.00 = $5,000

Mark could select an annual income payment which is within 10% of either side of the calculated income stream payment amount. Therefore Mark's minimum and maximum limits are:

Minimum limit: 90% of $5,000 = $4,500

Maximum Limit: 110% of $5,000 = $5,500

As Mark commenced his pension after 20 September 2007 he will also need to satisfy the minimum pension standards for account-based pensions. The minimum pension requirement under the pension standards is determined using a percentage factor based on Mark's age at 1 July 2014.

Minimum Pension Standard Payment: 5% x $100,000 = $5,000

Mark must satisfy the greater of the minimum pension standards and the market linked pension's minimum limit. Therefore, as Mark's minimum limit is $4,500 and his minimum pension standard payment is $5,000, he will need to satisfy the higher one of the two which is $5,000.

Mark must make a pension payment between $5,000 and $5,500 before 30 June 2015.

Reversionary marked linked pensions

If a market linked pension is established as reversionary and the pensioner's life expectancies are used to determine the term of the pension then when the pensioner passes away, the market linked pension can be paid as a reversionary pension or taken as a lump sum.

However, if the reversionary pension is established using the life expectancy of the reversionary beneficiary then when the pensioner passes away the market linked pension will automatically revert to the beneficiary and cannot be taken as a lump sum. Only when the reversionary pensioner passes away can the benefit be taken as a lump sum.

Centrelink asset test

Market linked pensions that were commenced prior to 20 September 2007 are eligible to apply for a 50% asset test exemption. This means that only 50% of the market value of the assets supporting the market linked pension will count toward the asset test for an age pension. Market linked pensions that commenced after 20 September 2007 may also be 50% asset test exempt if they were commenced with proceeds from commuting a 50% asset test exempt income stream that commenced prior to 20 September 2007. However, if a 100% asset test exempt pension is commuted to purchase a market linked income stream (it may have failed the actuarial adequacy statement of opinion for example), it will no longer receive an asset test exemption. This means that all of the assets supporting the market linked pension will count towards the asset test for the age pension.

Market linked pensions in breach of the minimum pension standards

Under specific circumstances, a member can have a market linked pension where their minimum pension payment under the account-based pension standards is higher than their maximum limit under the terms of the market linked pension. This problem can occur for example where a market linked pension is set up to revert to a beneficiary who is much younger than the pensioner, and a high term is chosen based on the reversionary pensioner's life expectancies.

Example: market linked pension problem

Simon is aged 60 and commences a market linked pension with $100,000 on 1 July 2014 which is set up to revert to his wife Wendy aged 45 years. Simon can select a term within the following ranges:

Simon's terms

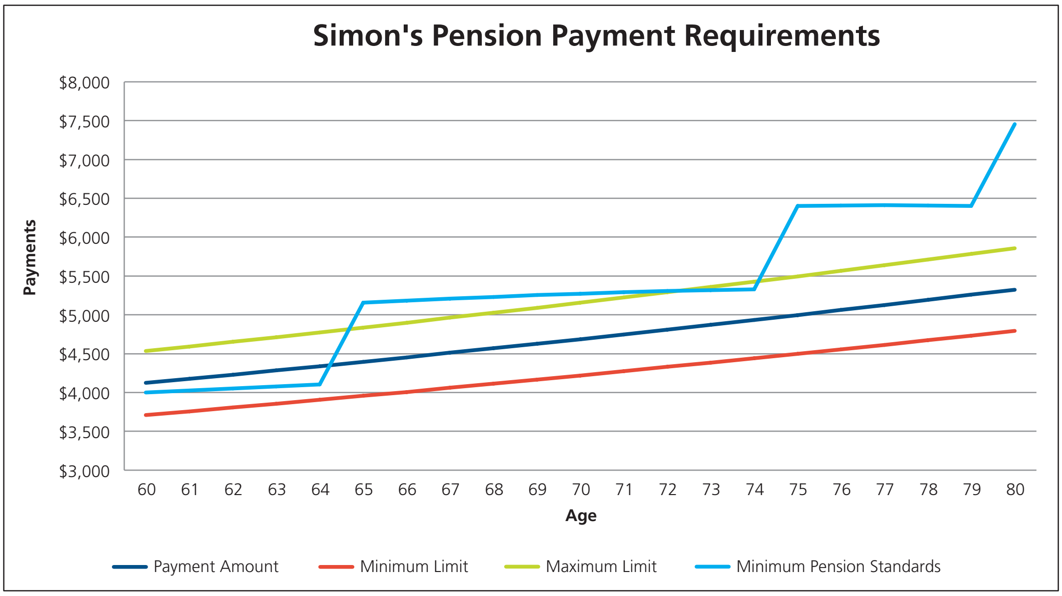
- **Minimum term:** 23 years (22.63 rounded up)
- **Maximum term:** 40 years (years to age 100)

Wendy's terms

- **Minimum term:** 40 years (39.90 rounded up)
- **Maximum term:** 55 years (years to age 100)

Simon decides to select his wife's maximum term of 55 years.

By selecting a term of 50, his pension will not be exhausted until he is 115 years old. The graph below shows the different drawdown requirements based on current minimum pension factors and an assumed investment return of 5% p.a. It shows that when Simon reaches age 65 he may have a situation where the minimum pension standards are higher than his maximum income limit. Therefore, even if Simon decides to make a payment equal to his maximum income limit then this will still be lower than the minimum pension standards. The result is that the pension will be in breach of the minimum pension standards and may not qualify as a superannuation income stream for tax purposes. Similarly, if Simon makes the pension payments needed to meet the minimum pension standards then his payment will exceed the maximum payment limit for market linked pensions and will be in breach of the SIS Regulations. If the pension has an asset test exemption this could lead to the exemption being removed by Centrelink.



One solution to this scenario is to cease the market linked pension and recommence another market linked pension with a lower term.

Consider Simon decides to cease his pension when he is 65 years old and recommence a pension with $100,000. His new terms would be:

Simon's terms

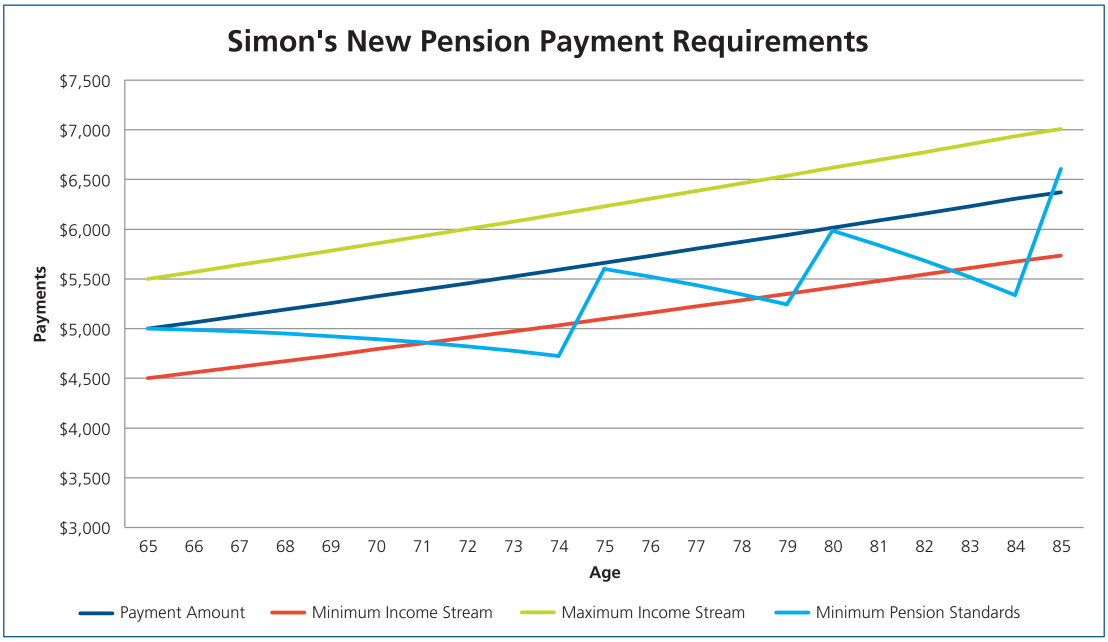
- **Minimum term:** 19 years (18.54 rounded up)
- **Maximum term:** 35 years (years to age 100)

Wendy's terms

- **Minimum term:** 36 years (35.17 rounded up)
- **Maximum term:** 50 years (years to age 100)

Simon decides to pick his maximum term of 35 years. The graph below again shows the different pension payment requirements based on assumed investment returns of 5% p.a. It shows that Simon is now less likely put himself in a situation where the minimum pension standards exceed his maximum payment limit.

The blue line representing the minimum pension standards is estimated to remain under the purple line representing the maximum payment limit under the rules of the market linked pension.



Market linked pension payment report

Paying the wrong amount of pension could lead to paying significantly more tax or even to the loss of Centrelink benefits. We offer a pension payment report that will calculate the maximum and maximum pension payments required for each financial year, including pensions that commenced part-way through the year. Our Pension Payment Report can assist in ensuring that members meet their pension's compliance requirements.

The excel report can be downloaded free of charge from the caculators section of our Technical Hub. The report applies to account-based, transition to retirement and market linked pensions.

Phone: 1800 203 123
act@accurium.com.au
www.accurium.com.au

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