Case study: Commuting a complying life-expectancy pension

August 2021

Karen is receiving a 15 year complying life-expectancy pension that will cease on 31 December 2017. Karen wishes to find out the options available to her and how each option will affect their retirement lifestyle.

Karen is receiving a 15 year complying life-expectancy (fixed term) pension from her self-managed superannuation fund (SMSF) which she commenced on 1 January 2002. The assets supporting Karen's complying pension (including reserves) are valued at $200,000. The pension is 100% Asset Test Exempt (ATE) meaning the value of the assets supporting it is not included in the means test for the Age Pension. Karen receives a $30,000p.a. pension payment from this complying pension that increases with CPI. Karen also has an account based pension (ABP) worth $180,000. Karen's husband, Steve, holds an ABP in the SMSF worth $300,000.

Karen and Steve are both 80 years old and live in their own home. They have $150,000 in financial assets outside SMSF and their personal assets are estimated to be $30,000. Their required annual spending level is $60,000.

Karen's complying life-expectancy pension ceases on 31 December 2017 and she wishes to explore the options available to her.

There are three options available to Karen:

- Option 1: Commute the complying life-expectancy pension to a retail complying annuity
- Option 2: Commute the complying life-expectancy pension to a market linked pension (a.k.a. Term Allocated Pension (TAP))
- Option 3: Allow the complying pension to cease and allocate funds from reserve

For illustration purposes we have utilised the complying annuity offered by Challenger Life Company Limited (Challenger Life).

The complying annuity offered by Challenger Life and market linked pensions are both fixed term pensions. Assuming Karen's new pension is non-reversionary, the minimum possible term is based on Karen's life expectancy (11 years) and the maximum term is number of years until Karen turns age 100 (20 years). We have chosen a period of 15 years and for a like-to-like comparison we have projected each option for the same period of time. The projections have not allowed for the probability of Karen or Steve passing away in this period.

We will look at how each one of these options would allow Karen and Steve to meet their desired spending in the next 15 years.

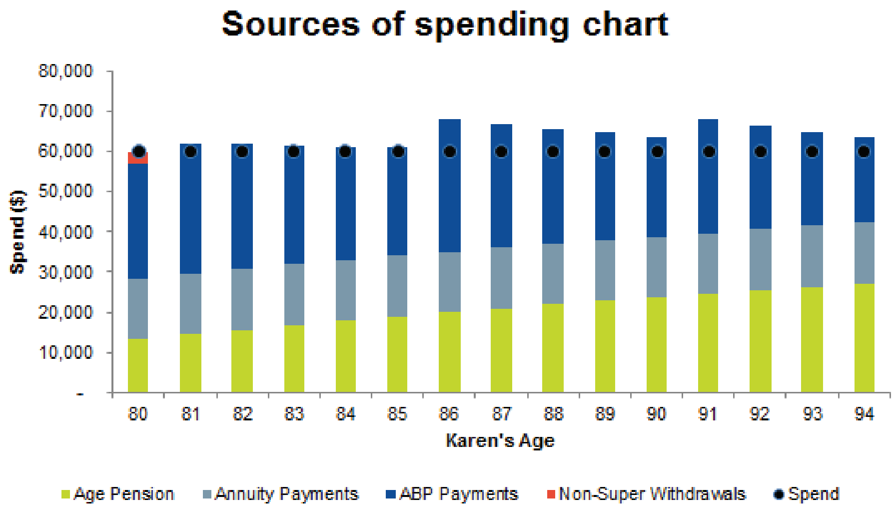
Important: When commuting an existing complying pension that is ATE, Centrelink requires all the assets supporting the complying pension (including reserves) to be commuted to a new complying income stream. Regulation 1.08 in the SIS Regulations restricts the amount of a complying life-expectancy pension that can be commuted to a lump sum. According to the SIS Regulations if the value of the assets supporting the complying life-expectancy pension (including reserves) exceeds the maximum amount calculated as per the Regulations then only the maximum amount calculated can be commuted to a new complying income stream. The assets in excess of this maximum amount would remain in an unallocated reserve in the SMSF. The trustees of the Fund could allocate the money from the reserve to the members but it is important to take note of the taxation treatment of those distributions, as specified in ITAR 291-25.01. Large allocations can result in significant tax liabilities.

Option 1: Commute the complying life-expectancy pension to a retail complying annuity

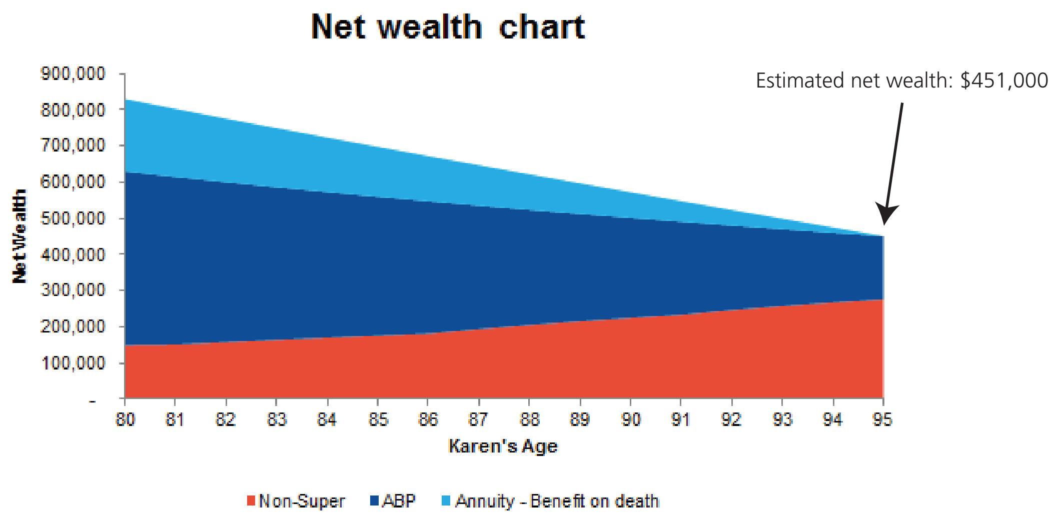
Karen can use the assets supporting the complying life-expectancy pension to commence a complying annuity with a retail life office. To do so, she would need to rollover the assets supporting her pension and use them to purchase the annuity.

As at 29 Sep 2017, purchasing a complying annuity with Challenger Life for a period of 15 years with her $200,000 balance would have provided an annual payment of $15,046, increasing each year with CPI.

The following chart illustrates how their retirement spending will be funded:



The following chart illustrates Karen and Steve's net wealth (excluding their home) at each age.



Advantages of this option:

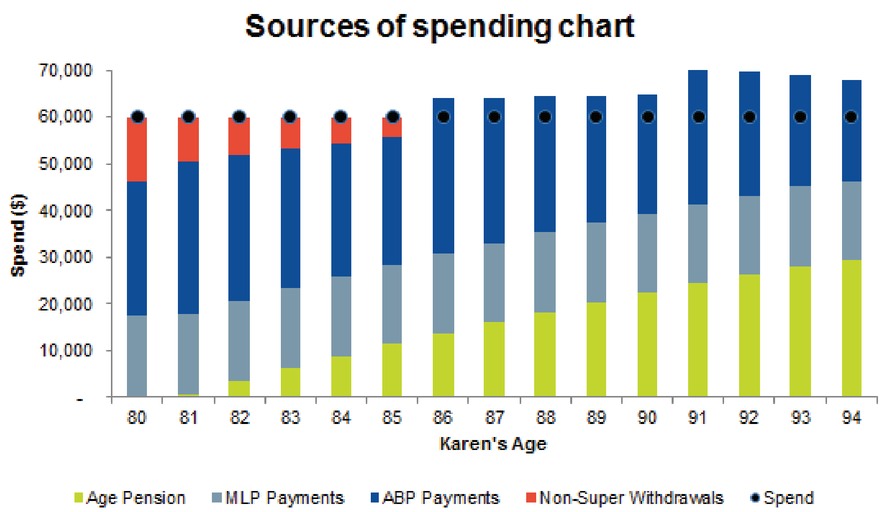
- The complying annuity will retain the ATE. Therefore Karen and Steve's current Age Pension entitlements of around $13,000 p.a. will remain largely unchanged.
- The estimated net wealth at the end of 15 years is significantly higher than the alternative options.
- The annual payments from the annuity are guaranteed and increase each year with inflation to help maintain Karen's standard of living.
- On Karen's death (if annuity is non-reversionary), a lump sum equivalent to the remaining annuity payments will be paid to her Estate.
- The earnings on a complying annuity would be entirely tax free.

Disadvantages of this option:

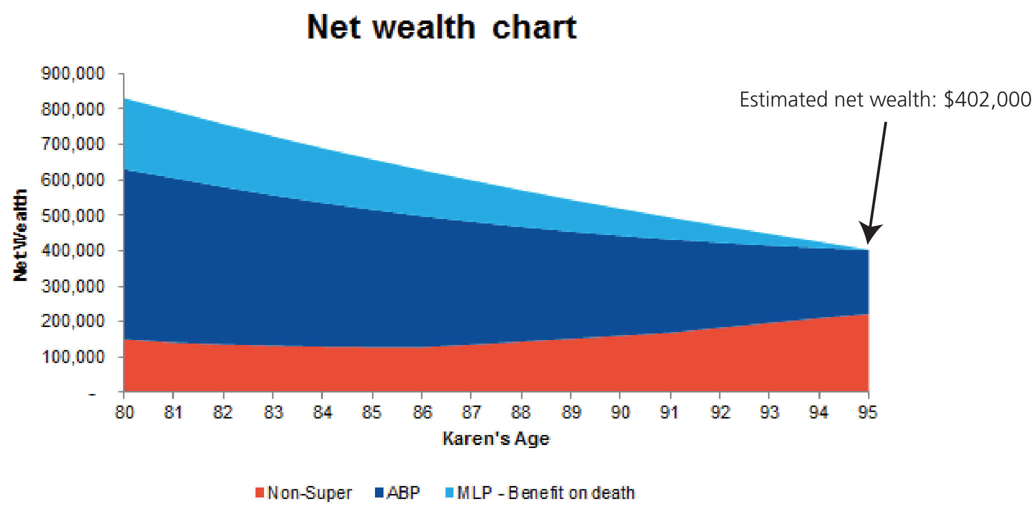
- The assets supporting the complying lifetime pension would have to be rolled over from the SMSF, potentially affecting its ongoing viability.
- The lump sum benefit payable from the annuity policy on death will depend on the interest rates at that point in time. Higher interest rates may mean a lower lump sum benefit.
- The new complying annuity will not be a capped defined benefit income stream. The value of the assets supporting the income stream ($200,000) will count towards the transfer balance cap. The special value of the complying life-expectancy pension is $30,000. Therefore commuting the complying pension would result in a $170,000 increase in Karen's transfer balance account.

Option 2: Commute the complying life-expectancy pension to a market linked pension

A market linked pension is the only type of complying income stream that could be commenced within Karen and Steve's SMSF. If Karen decides to commence a market linked pension with a 15 year term then the following chart illustrates how their annual spending will be funded.



This following chart illustrates Karen and Steve's net wealth at each age under this option.



Advantages of this option:

- Karen can retain the assets currently supporting her complying pension within the SMSF.
- On Karen's death (if pension is non-reversionary), the all the assets supporting the market linked pension can be paid out as a death benefit.
- All the income earned on assets within the SMSF would be tax free.

Disadvantages of this option:

- The market linked pension will not retain the ATE. Karen's Age Pension benefits will reduce immediately. As you can see from the sources of spending chart Karen and Steve will lose their $13,000 p.a. Age Pension benefit entirely for the first year.
- The estimated wealth at the end of 15 years is lower than the annuity option.
- The actual pension payments from the market-linked pension are dependent on the balance of the pension each year. Depending on the SMSF investment strategy, this is likely to be subject to market movements and the pension payments would not be guaranteed. The death benefit payable form his pension would also be subject to vagaries of investment markets.
- The market linked pension will not be a capped defined benefit income stream. The value of the assets supporting the income stream ($200,000) will count towards the transfer balance cap. The special value of the complying life-expectancy pension is $30,000. Therefore commuting the complying pension would result in a $170,000 increase in Karen's transfer balance account.

Option 3: Allow the complying pension to cease and allocate funds from reserve

Once the complying life-expectancy pension ceases all the assets supporting the pension would remain in an unallocated reserve controlled by the Trustees. The Trustees of the Fund could allocate the money from the reserve to the members but it is important to take note of the taxation treatment of those distributions, as specified in ITAR 291-25.01. Large allocations can result in significant tax liabilities. According to that regulation:

(1) Each fund member can receive allocations up to their concessional contribution cap each year. Age and work-test restrictions do not apply because the reserve is already in the superannuation system. The concessional limit applies because monies in the super system are concessionally taxed. It is our understanding that the lump-sum allocation must be grossed-up to determine the equivalent concessional contribution. For example, a lump-sum allocation of $8,500 to a member must be counted as a concessional contribution of $10,000. Excess contributions tax may be levied if the total of all concessional contributions to that member in a year exceeds their contribution limit.

OR

(2) Distributions to member accounts less than 5% (say 4.99%) are permitted without being counted against contributions limits (see ITAR 291-25.01). For example if a member has an account-based pension in the fund with a balance of $100,000 then less than $5,000 can be transferred to an account for that member without counting towards the concessional contribution cap, for that year. A particular requirement of this distribution method is that all member interests in the fund must be increased in a fair and equitable manner. For example, a distribution from the reserve of 4.99% of the value of all member interests must occur at the same time.

You cannot use both methods in one financial year.

Advantages of this option:

- Karen can retain the assets within the SMSF.
- There will be no further impact on the transfer balance cap if funds are allocated from the reserve using the 5% distribution rule.

Disadvantages of this option:

- The assets that were supporting the complying life-expectancy pension would lose the ATE.
- It might take few years to allocate funds from the reserve to the members.
- The income earned on the assets in the reserve would be taxable.

All these options have their own advantages and disadvantages as explained. The list advantages and disadvantages are not exhaustive and there might be other factors that might influence the decision.

Assumptions used in the modelling are outlined below.

The following economic assumptions were used in the modelling for this case study:

Investment return within SMSF (net of fees)	5.70% p.a.
Investment return non- super (net of fees)	5.65% p.a.
CPI inflation	2.50% p.a.
Annual administration fee of SMSF	$3,000

Other key assumptions include:

- The complying annuity illustrated is based on a 15 year Guaranteed Annuity (Complying) from Challenger Life on 29 September 2017
- Age pension rates and thresholds as at 29 September 2017

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