Case study: Commuting a complying lifetime pension

August 2021

John is receiving a complying lifetime pension and his pension has failed the high probability test this year. John wishes to find out the options available to him and how each option will affect their retirement lifestyle.

John is receiving a complying lifetime pension from his self-managed superannuation fund (SMSF) which he commenced on 1 July 2004. The assets supporting John's complying pension (including reserves) are valued at $360,000. 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. John receives a $20,000p.a. pension payment from this complying pension that increases with CPI. John also has an account based pension (ABP) worth $120,000. John's wife, Marg, holds an ABP in the SMSF worth $150,000.

John and Marg are both 70 years old and live in their own home. They have $200,000 in financial assets outside SMSF and their personal assets are estimated to be $50,000. Their required annual spending level is $65,000.

A requirement for maintaining the ATE on John's complying pension is that it is assessed each year by an actuary to ensure that there remains a high probability of there being sufficient assets in the SMSF to meet the pension payment obligations. This year John's complying pension has failed this high probability test and he wishes to explore the options available to him.

There are three options available to John:

- Option 1: Commute the complying lifetime pension to a retail complying annuity
- Option 2: Commute the complying lifetime pension to a market linked pension (a.k.a. Term Allocated Pension (TAP))
- Option 3: Continue with the complying lifetime pension in the SMSF

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 John's new pension is non-reversionary, the minimum possible term is based on John's life expectancy (16 years) and the maximum term is number of years until John turns age 100 (30 years). We have chosen a period of 20 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 John or Marg passing away in this period.

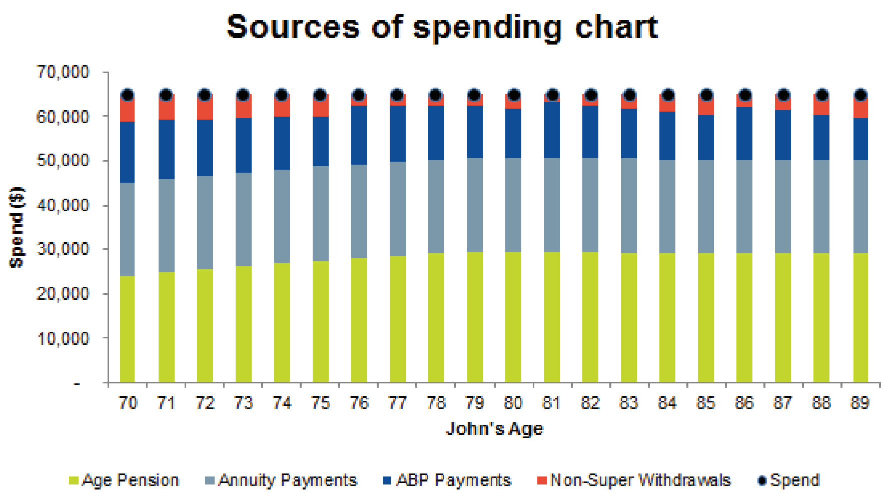
We will look at how each one of these options would allow John and Marg to meet their desired spending in the next 20 years.

Option 1: Commute the complying lifetime pension to a retail complying annuity

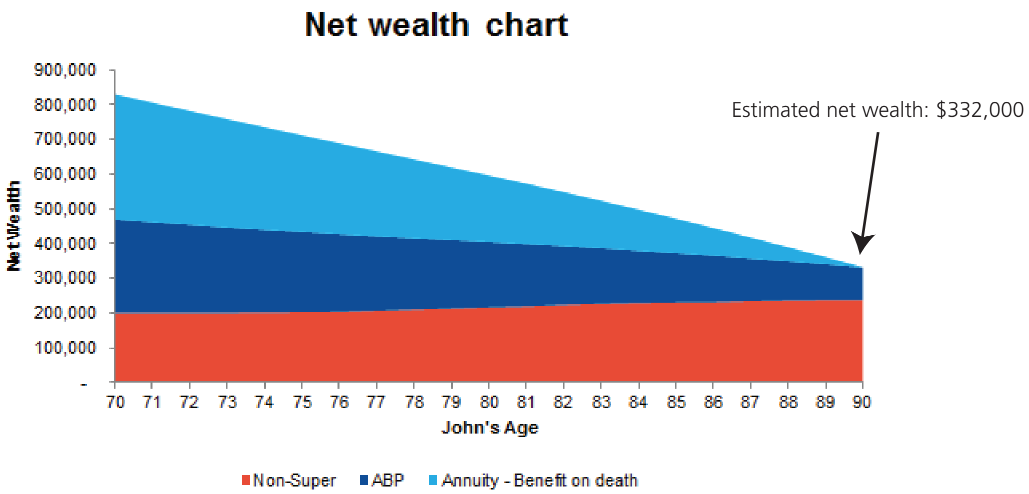
John can use the assets supporting the complying lifetime pension to commence a complying annuity with a retail life office. To do so, he would need to rollover the assets supporting his pension and use them to purchase the annuity.

As at 29 Sep 2017, purchasing a complying annuity with Challenger Life for a period of 20 years with his $360,000 balance would have provided an annual payment of $21,072, increasing each year with CPI.

The following chart illustrates how John's retirement spending will be funded:



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



Advantages of this option:

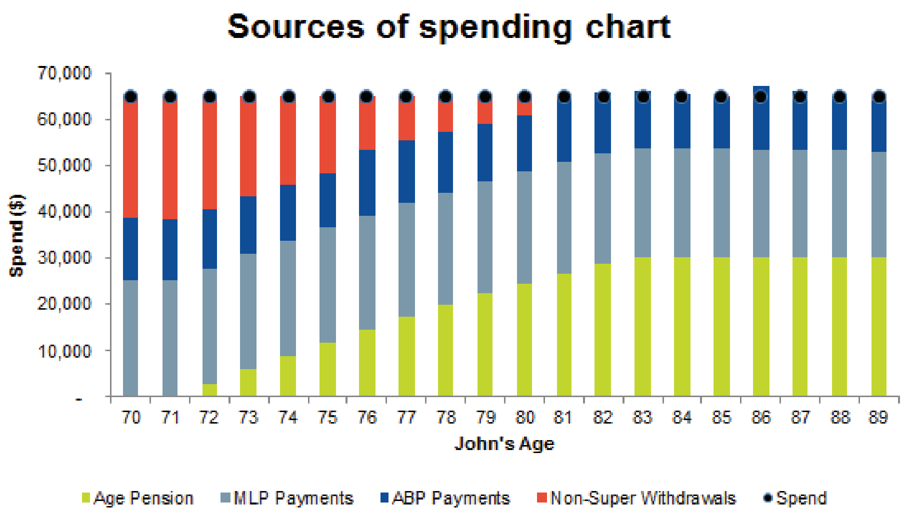
- The complying annuity will retain the ATE. Therefore John and Marg's current Age Pension entitlements of around $24,000 p.a. will remain largely unchanged.
- The estimated net wealth at the end of 20 years is significantly higher than the alternative options.
- The annual payments from the annuity are guaranteed and increase each year with inflation to help maintain John's standard of living.
- On John's death (if annuity is non-reversionary), a lump sum equivalent to the remaining annuity payments will be paid to his Estate.
- The earnings on a complying annuity would be entirely tax free.

Disadvantages of this option:

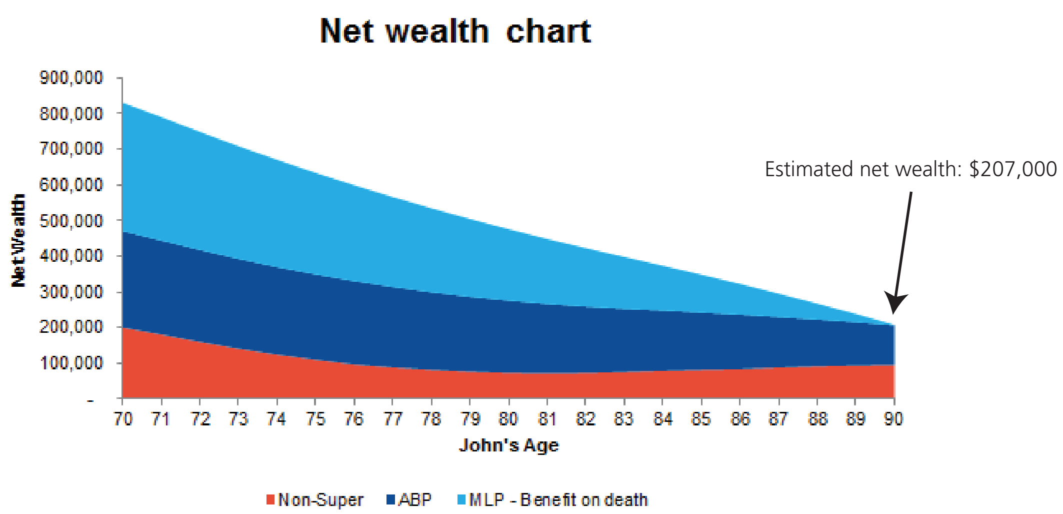
- The assets supporting the complying lifetime pension would have to be rolled over from the SMSF, potentially affecting its ongoing viability.
- The lump sum benefit payable from the annuity policy on death will depend on the interest rates at that point in time. Higher interest rates may mean a lower 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 ($360,000) will count towards the transfer balance cap. The special value of the complying lifetime pension is $320,000. Therefore commuting the complying pension would result in a $40,000 increase in John's transfer balance account.

Option 2: Commute the complying lifetime pension to a market linked pension

A market linked pension is the only type of complying income stream that could be commenced within John and Marg's SMSF. If John decides to commence a market linked pension with a 20 year term then the following chart illustrates how their annual spending will be funded.



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



Advantages of this option:

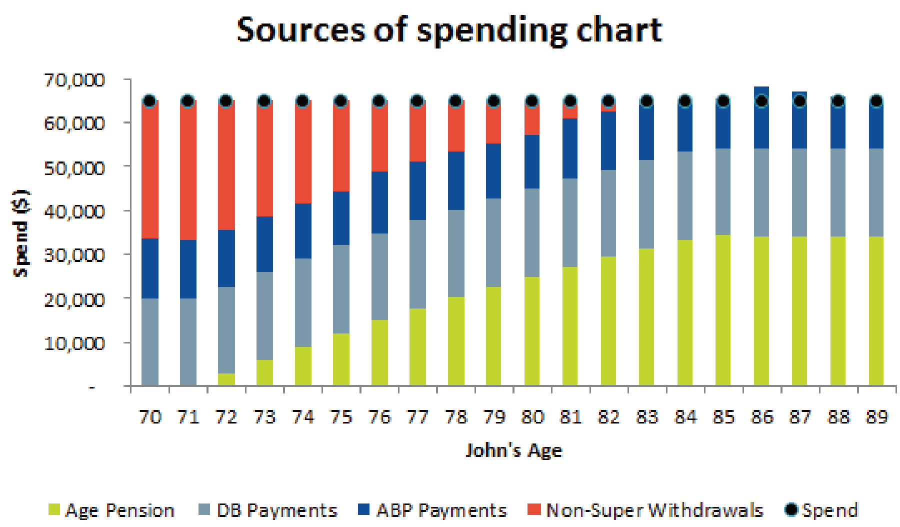
- John can retain the assets currently supporting his complying pension within the SMSF.
- On John's death (if pension is non-reversionary), the all the assets supporting the market linked pension can be paid out as a death benefit.
- All the income earned on assets within the SMSF would be tax free.

Disadvantages of this option:

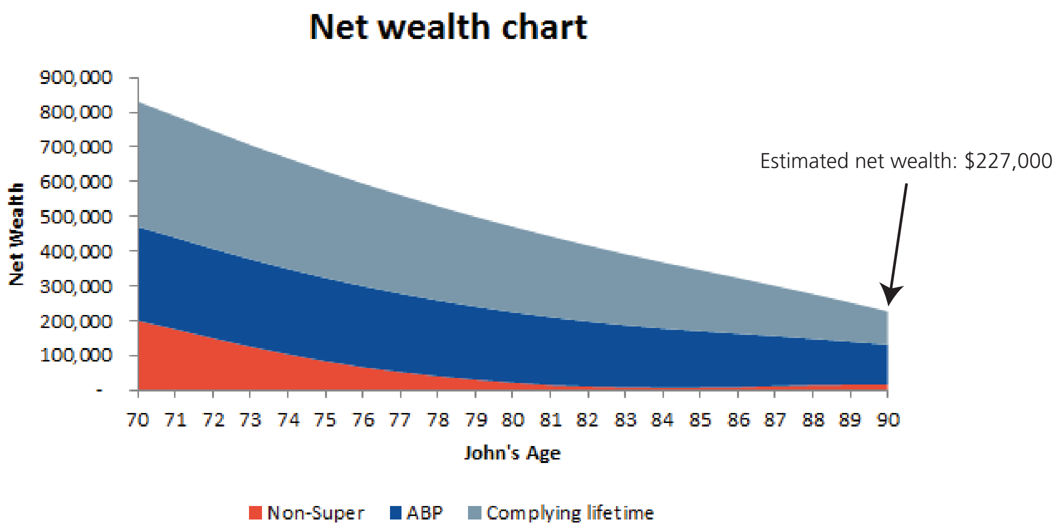
- The market linked pension will not retain the ATE. John's Age Pension benefits will reduce immediately. As you can see from the sources of spending chart John and Marg will lose their $24,000 p.a. Age Pension benefit entirely for the first two years.
- The estimated wealth at the end of 20 years is 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 ($360,000) will count towards the transfer balance cap. The special value of the complying lifetime pension is $320,000. Therefore commuting the complying pension would result in a $40,000 increase in John's transfer balance account.

Option 3: Continue with the complying lifetime pension

While John's complying lifetime pension has failed the high probability test meaning it loses its ATE, the actuary has still been able to certify it as solvent. John therefore has the option to continue with the existing complying lifetime pension. The complying pension would lose the ATE status. The following chart outlines the sources of spending under this option.



The projected net wealth under this option is illustrated below:



Advantages of this option:

- John can retain the assets within the SMSF.
- The pension payments from the complying lifetime pension would remain unchanged.
- There will be no further impact on the transfer balance cap.

Disadvantages of this option:

- The complying lifetime pension would lose the ATE. John's Age Pension benefits will reduce immediately. As you can see from the sources of spending chart John will lose Age Pension benefit entirely for the first two years.
- Losing the ATE can have further social security implications. The legislation allows Centrelink to assess the pension as if it has never had an ATE to claw back overpaid Age Pension entitlements from the previous 5 years. For John and Marg this could result in a debt from Centrelink of over $100,000. If John and Marg are seriously considering this option then they should discuss it with their Centrelink case officer to understand whether they will look to apply this measure.
- The estimated wealth at the end of 20 years is lower than the annuity option.
- The fund would require a defined benefit actuarial certificate every year and a proportion of income earned in the SMSF would continue to be taxable.
- On John's death (if pension is non-reversionary), the assets supporting the complying lifetime pension cannot be paid out as a death benefit. The assets will 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.

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 20 year Guaranteed Annuity (Complying) from Challenger Life on 29 September 2017
- Tax was levied on a proportion income earned on assets supporting the complying lifetime pension based on the estimated tax exempt percentage. All account based pension income is assumed to be tax free
- Age pension rates and thresholds as at 29 September 2017

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