

Allocated pensions and annuities:

what you need to know

A regular income stream from an allocated pension or annuity can be an effective way to fund your retirement. It's important to understand how each works to determine which may be right for you.

Will I have enough to retire?

With shorter working lives and improved life expectancy, Australians can look forward to a much longer retirement than past generations. A male retiring at age 60 will likely spend around 22 years in retirement and a female 26 years.¹

Enjoying a lengthy retirement, however, may cost more than you think. According to the Association of Superannuation Funds of Australia (ASFA), an individual seeking a comfortable lifestyle needs a yearly income of \$39,302 (after tax).² That requires savings of \$573,262 at retirement to provide this level of income for the next 20 years.³

Your financial adviser can help you by projecting your final savings at retirement and future income potential and talk to you about the options.

How do I access an income in retirement?

The most common ways to access a retirement income stream are:

- Allocated pensions – using only superannuation savings
- Annuities – using either super savings or ordinary (non-super) money.

Without adequate super or other investments, however, you may need to rely in part or whole on the government Age Pension for a retirement income. For more information on social security benefits, see the 'Social security' fact file.

Think twice before cashing out super

Just as it is more tax effective for most working Australians to invest 'inside super' than outside, the same can be true in the pension phase. That's because a pension drawn down from super is tax free whereas an ordinary investment income can be subject to tax. The case study on page 3 illustrates the point.

How does an allocated pension work?

An allocated (or account-based) pension lets you draw a regular income from a superannuation savings lump sum and any investment earnings. Your pension account balance is adjusted in line with market movements, investment returns, pension payments, lump sum withdrawals and fees.

Flexibility and choice

A pre-retirement pension that is part of a 'transition to retirement' (TTR) strategy is subject to a maximum annual drawdown of 10%. If you are fully retired, there is no maximum drawdown limit and payments will continue until your account balance is used up or you withdraw it in full.

You also have a wide choice of investments including low risk term deposit and cash products, and can generally switch options at any time should your needs and circumstances change.

Annuities

An annuity can be purchased with either super or ordinary (non-super) savings and converts a lump sum into guaranteed income payments for a set period of time. The two main types of annuities are:

- Fixed term annuities which pay a guaranteed income for a defined period of time eg 20 years.
- Lifetime annuities which pay a guaranteed income for the remainder of your life.

No investor risk but limited flexibility

By guaranteeing your future income payments regardless of the underlying performance, the annuity provider effectively carries all the investment risk. The trade off for an investor is limited flexibility.

While an annuity may offer an indexing option to protect your income against inflation, you generally have no choice of investments, can't change your income and can only access your capital in special circumstances.

What happens to your allocated pension or annuity when you die?

The status of the income stream benefits upon your death will depend on whether beneficiary arrangements are in place and the type of product (allocated pension or annuity). Your financial adviser can explain the differences and help you decide which is best for your circumstances.

Allocated pensions and superannuation annuities

When commencing an allocated pension or superannuation annuity, you can nominate a person(s) to whom benefits may be paid (as a lump sum or an income stream) when you die.

There are three types of arrangements: reversionary nomination, non-binding nomination and (lapsing or non-lapsing) binding nomination. In each case, the nominated person must be a 'dependant', which the Superannuation Industry (Supervision) Act 1993 defines as:

- your spouse⁴
- your child (regardless of age)
- a person who was financially dependent on you just before you died
- a person with whom you had an interdependency relationship just before you died.⁵

Annuities (non-super)

A lifetime annuity that has no beneficiary nomination arrangement in place will expire upon your death, meaning any residual benefit passes back to the annuity provider. With a nomination in place, income payments can continue to a beneficiary for their lifetime; alternatively a lump sum could be paid to your dependants or to your estate if you die within a chosen guaranteed period.⁶

If you take out a fixed term annuity and die mid-term, the future income payments may be made to a nominated beneficiary, or a lump sum based on the remaining payments may be paid to your dependants or to your estate.

How are allocated pensions and annuities taxed?

Tax concessions vary depending on your age and circumstances and the type of income stream.

Allocated pensions

- Aged between 55 and 60 – income received is assessable and taxed at your marginal tax rate. Part of each payment may be

tax free and you may qualify for a 15% tax offset on the taxable component which means you may end up paying little or no tax on your income. Lump sum withdrawals may also be taxed – part of the withdrawal may be tax free and the remainder taxed at a maximum rate of 15% plus Medicare levy.

- Aged 60 or above – any income and lump sum withdrawals received are tax free.⁷

Annuities

The income you receive will be assessable and taxed at your marginal tax rate. However, part of your payment – generally equal to the return of your original investment – will be tax free. If you purchase an annuity using your super savings, it is taxed in the same way as an allocated pension.

What might happen to my Age Pension entitlements?

Income you receive from your retirement income stream is counted under the social security income test. However, part of each payment, generally equal to the return of your original investment, is not counted.

In addition, 100% of the value of an income stream purchased from 20 September 2007 is counted as an asset under the social security assets test.⁸ For an allocated pension, the amount counted is the account balance of the pension. For an annuity, the amount counted is based on the initial investment used to purchase the income stream, less an allowance for annuity payments.

Which is better – allocated pension or annuity?

Your financial adviser can help you decide whether an allocated pension or annuity best meets your personal circumstances and income requirements. The table below provides a basic comparison.

	Allocated pensions	Annuities
Guaranteed income	No	Yes
Choice of investments	Yes	No
Ability to vary income	Yes – above a set minimum ⁹	No
Access to capital	Yes	Yes for fixed term annuities No for lifetime annuities
Guaranteed (fixed term)	No	Yes – either lifetime or a chosen fixed term
Purchase with non-superannuation savings	No	Yes
Death benefit payable	Yes – of the remaining account balance	Fixed term – yes, a lump sum based on the remaining payments Lifetime – no, unless death occurs within a chosen guaranteed period

Case study

John, age 60 with \$400,000 in super

John is 60 years old, has \$400,000 in super and decides he requires a net income stream of \$35,000 pa in retirement. John must weigh up whether to draw an income from his super through an allocated pension or cash out the funds and invest elsewhere.

	Cash out super	Convert to a pension
Superannuation amount	\$400,000	\$400,000
Initial investment (after tax)	\$400,000	\$400,000
Annual withdrawal needed to produce after-tax income of \$35,000	\$40,078 (Tax payable at marginal rate)	\$35,000 (No tax payable)
How long will John's retirement income last?	13 years	16 years

Being age 60, John can withdraw his superannuation tax free, meaning he has an initial investment of \$400,000. If John chooses to invest into a managed fund he will need to withdraw \$40,078 pa to provide a net income of \$35,000 pa. The difference of \$5,078 is payable as tax.

On the other hand, if John decides to roll his super over into an allocated pension, he can draw down an equivalent income of \$35,000 pa tax free. In this example, converting his super into an allocated pension would give John three extra years of income in retirement.

This table is for illustrative purposes only. Information contained in this case study is not personal advice, individual circumstances vary, thereby altering an outcome in each separate case. Tax rates also vary and are also used purely for illustrative purposes only.

Assumptions: Balance of \$400,000 (all taxable component, taxed element) at start of pension or non-super investment at age 60. All investment earnings (inside and outside super) are set at 7.7% before tax. Assume requirement of \$35,000 pa income in both categories. In the investment this requires drawing \$40,078 pa based on the standard individual tax rates and Medicare levy. Annual income is increased in line with anticipated inflation of 3%. 2010-11 tax rates used.

Speak to us for more information

If you would like to know more about which type of retirement income stream is right for you, contact us. We can give you more detailed information on the best approach for your situation.

- 1 Australian Bureau of Statistics, Life tables, Australia, 2005–2007.
- 2 Association of Superannuation Funds of Australia – ASFA Retirement Standard, How much do you need to spend to have a comfortable standard of living in retirement as at September 2010
- 3 Colonial First State 2011. Assumptions: Earning 6.5% pa with inflation at 3%, paid via an indexed pension and net of all fees and taxes.
- 4 Includes de facto relationships (whether of the same sex or different sex) or in a relationship that is registered under a law of a State or Territory.
- 5 Two people are classified as having an interdependency relationship if they have a close personal relationship, they live together, one of them provides the other with financial support, and one or each of them provides the other with domestic support and personal care.
- 6 Except pre-retirement pensions, which have a set maximum of 10% of the account balance.
- 7 Applies to income from a taxed fund only. Does not apply to untaxed funds.
- 8 Some income streams commenced prior to 20 September 2007 have a 50% or 100% assets test exemption. If you think this applies to you, check with your pension or annuity provider or your financial planner. Complying defined benefits pensions such as a Government Sector Super Scheme pension are 100% assets test exempt.
- 9 Except pre-retirement pensions, which have a set maximum of 10% of the account balance.

Important Information

This general advice has been prepared without taking into account your particular financial needs, circumstances or objectives. You should therefore consider the appropriateness of this advice bearing in mind your own personal situation and obtain, and read, a Product Disclosure Statement prior to making any decision to acquire a product. While every effort has been made to ensure the accuracy of the information, it is not guaranteed. You should obtain professional advice before acting on the information contained in this publication.

Taxation considerations are general and based on present taxation laws, rulings and their interpretation as at 1 April 2011. You should seek independent professional tax advice before making any decision based on this information.

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