Cameo 1 - $600,000 purchase price

Romeo is planning to retire on 1 July 2005 when he will be aged 65. He is married to Juliet who is 5 years younger than him. Romeo will have a benefit of $600,000. The following table illustrates the outcomes that Romeo would receive from the purchase of either an allocated pension, a market linked income stream or a lifetime pension paid from a small superannuation fund. The assumptions used for the illustrations are attached. The allocated pension is paid using the minimum drawdown factors. The market-linked pension is based on the life expectancy of a 55 year old female (5 years younger than Juliet), giving a term of 30 years. The lifetime pension is indexed at 3% per annum and is 100% reversionary.

Cameo 1 - $600,000 purchase price												
Age	Income Stream Payment ($)			Account Balance ($)			Age Pension ($)			Tax – if NO undeducted contributions($)		
	Allocated	Market Linked	Lifetime	Allocated	Market Linked	Lifetime	Allocated	Market Linked	Lifetime	Allocated	Market Linked	Lifetime
65	38,217	32,626	24,000	600,000	600,000	600,000	0	7,405	7,405	360	1,094	0
70	42,822	37,014	27,823	578,091	609,994	659,774	0	15,379	20,368	0	2,575	1,743
75	46,373	42,036	32,254	524,015	597,333	716,964	8,472	23,672	29,019	0	3,767	2,895
80	47,810	47,789	37,391	435,071	550,525	767,062	27,790	28,842	34,435	2,926	3,306	2,347
85	44,713	54,500	43,347	317,466	453,441	803,462	44,722	35,248	41,143	3,348	2,705	1,637
90	34,815	62,601	50,251	191,482	282,955	816,648	55,880	43,067	49,441	0	1,963	724
95	20,551	0	58,254	31,546	0	713,873	67,986	67,986	59,696	0	0	0

This table shows that the income taken from the lifetime pension can be considerably less than the minimum required to be taken under each of the allocated and market linked product. That is, $24,000 in the first year compared with $38,200 and $32,600 for the allocated pension and market linked product respectively. It is not until some 20 years later that the payment received from the lifetime pension is close to that required to be paid under the allocated pension. Because of the low pension payment, over time this results in a significant build-up in the fund, such that at age 85 the account balance remaining in the lifetime pension is $803,400 compared to $317,400 and $453,400 for the allocated and market linked products. In other words, the account balance has grown for the lifetime pension in nominal terms, compared with the reduction in the account balance in the other products.

In each case, the balance remaining in the fund at death is available for payment to dependants tax free or to the estate (how the estate distributes the death benefits will determine the tax outcomes). Clearly, the larger the amount remaining in the fund at older ages the greater the likelihood that a significant amount will remain on death. If beneficiaries are also members of the fund, there is the possibility that monies will be transferred to their accounts and remain in the accumulation phase attracting concessional tax treatment for a further 30 years or more. This shows the scope available for estate planning that can be obtained from the lifetime pension.

Further, the table shows that Government outlays in relation to the Age Pension are generally higher for the lifetime pension than for the other two products in this period. This is because there is no assets test exemption for the allocated pension while only 50 per cent of the assets supporting the other pensions are counted for determining access to the Age Pension. Lower tax payments are also made under the lifetime pension compared with the market linked pension, despite both qualifying for the same treatment for the assets test.

No tax is payable in any of the three cases if the $600,000 purchase price is made up wholly of undeducted contributions.

Cameo 2 - $5,000,000 purchase price

Carlos is planning to retire on 1 July 2005 when he will be aged 65. He is married to Camille who is 5 years younger than him. Carlos will have a benefit of $5,000,000. The following table illustrates the outcomes that Carlos would receive from the purchase of either an allocated pension, a market linked income stream or a lifetime pension paid from a small superannuation fund. The assumptions used for the illustrations are attached. The allocated pension is paid using the minimum drawdown factors. The market-linked pension is based on the life expectancy of a 55 year old female (5 years younger than Camille), giving a term of 30 years. The lifetime pension is indexed at 3% per annum and is 100% reversionary.

Cameo 2 - $5m purchase price, including $2.5m undeducted contributions												
Age	Income Stream Payment ($)			Account Balance ($)			Age Pension ($)			Tax – if $2.5m undeducted contributions($)		
	Allocated	Market Linked	Lifetime	Allocated	Market Linked	Lifetime	Allocated	Market Linked	Lifetime	Allocated	Market Linked	Lifetime
65	318,471	271,887	200,000	5,000,000	5,000,000	5,000,000	0	0	0	64,248	62,018	19,220
70	356,846	308,452	231,855	4,817,426	5,083,281	5,498,118	0	0	0	78,158	73,707	26,672
75	386,441	350,301	268,783	4,366,788	4,977,773	5,974,696	0	0	0	87,451	86,853	35,126
80	398,417	398,238	311,593	3,625,592	4,587,706	6,392,186	0	0	0	88,031	101,632	44,702
85	372,612	454,168	361,222	2,645,548	3,778,674	6,695,516	0	0	0	70,715	118,638	55,530
90	290,124	521,672	418,756	1,595,680	2,357,959	6,805,402	0	0	0	30,532	139,107	67,749
95	171,258	0	485,452	753,533	0	6,609,265	58,636	67,986	0	0	0	81,511

In assessing the cost of the lifetime pension for RBL purposes, it is assumed that there is no excessive component (that is the benefit has been compressed to below the pension RBL). This is achieved through $2,500,000 of the purchase price arising from undeducted contributions and RBL compression of the remaining component of the purchase price to reduce the amounted counted for RBL purposes to be less than the pension limit of around $1,200,000.

This table shows that the income taken from the lifetime pension can be considerably less than the minimum required to be taken under each of the allocated and market linked product. That is, $200,000 in the first year compared with $318,400 and $271,800 for the allocated pension and market linked product respectively. It is not until some 20 years later that the payment received from the lifetime pension is close to that required to be paid under the allocated pension. Because of the low pension payment, over time this results in a significant build-up in the fund, such that at age 85 the account balance remaining in the lifetime pension is $6,695,000 compared to $2,645,000 and $3,778,000 for the allocated and market linked products. In other words, the account balance has grown for the lifetime pension in nominal terms, compared with the reduction in the account balance in the other products.

In each case, the balance remaining in the fund at death is available for payment to dependants tax free or to the estate (how the estate distributes the death benefits will determine the tax outcomes). Clearly, the larger the amount remaining in the fund at older ages the greater the likelihood that a significant amount will remain on death. If beneficiaries are also members of the fund, there is the possibility that monies will be transferred to their accounts and remain in the accumulation phase attracting concessional tax treatment for a further 30 years or more. This shows the scope available for estate planning that can be obtained from the lifetime pension.

In this scenario age pension outlays do not arise with any pension product until age 92 (allocated pension) and age 95 (market linked pension).

Tax paid under the lifetime pension is only one-third to a half of that payable under a market linked pension, despite both qualifying for the same treatment for the assets test. Tax payments are also considerably less than under an allocated pension until after age 85. Approximately 35% more tax would be payable under the lifetime pension if the RBL test were aligned with the test for market linked pensions. However the market linked pension would still deliver about 70% more tax than the revamped lifetime pension. (This is because of the requirement to maintain reserves and the more favourable treatment of the undeducted purchase price for the lifetime pension.)

ASSUMPTIONS

For the purposes of providing illustrations, it is necessary to make assumptions about the future. Given the complexity of some of the issues involved, some simplifying assumptions have been made. Nevertheless, the resulting illustrations are considered, in aggregate, to provide a reasonably realistic exposition of the principles involved. It should, however, be noted that the assumptions used do not necessarily represent the Australian Government Actuary's (AGA's) or Treasury's best estimates of future outcomes on individual matters.

Assumptions set by Treasury

- *Common assumptions*
  - Financial
    - Investment return 7% pa
    - Wage growth 4% pa
    - CPI 3% pa
  - Data
    - Married couple with male primary pensioner aged 65 and female reversionary spouse aged 60.
  - Tax and age pension
    - Benefits from 100% Post 83 (taxed element) benefits
    - Homeowners
    - No other income or assets except for $100,000 in a term deposit paying 5%.
- *Product specific assumptions*
  - Allocated pension

Income using minimum drawdown factors

-Growth pension

Use maximum reversionary term (30 years).

-Lifetime pension

Pension is 100% reversionary

Guaranteed indexation at the rate of 3% pa

High probability of payment based on mortality to reflect self funded retirees.

Additional Assumptions set by AGA

- *Common assumptions*

- Expenses

Expenses are assumed to be 1% of fixed assets. That is, a net (after expenses) investment return of 6% pa has been used.

-Tax and age pension

All tax bands and age pensions are assumed to increase in line with wages (4% pa).
Outcomes are shown where both of the couple are alive for the whole projection period.
All income from the income stream is paid to the primary beneficiary.
The age pension income is split equally between the couple.
All other income (from other assets) is paid to the reversionary beneficiary.
The couple is assessed under age pension means tests and each spouse is eligible for the Senior Australians Tax Offset.
No transitional RBL involved.

-Pension details

The income streams are ‘purchased’ on 1 July 2005 and payments are made annually in arrears. That is, the first pension payment occurs on 30 June 2006. The male is assumed to be age 66 next birthday at the time of purchase.

-Undeducted member contributions

Additional illustrations which include undeducted member contributions have been provided.

Product Specific Assumptions

- Lifetime pension

It has been assumed that there is no guaranteed minimum term of payment.

Asset Test: It has been announced that lifetime pensions which commence on or after 20 September 2004 will be 50% subject to the assets test for age pension purposes. For the purposes of the illustrations only, we have assumed that the full asset value of the pension will be assessed as

$$\text{Purchase price} - \text{Term elapsed} \times \frac{\text{Purchase price}}{\text{Relevant number}}$$

The relevant number for the illustration is the life expectancy factor for a female aged 60 according to the Australian Life Tables 2000-02 (the longer of the primary and reversionary beneficiaries’ life expectancies).

It must be strongly emphasised that no decision has been made on the method for the calculation of the asset value and that the assumption made is for the purposes of the illustrations only.

Lifetime Pension – Initial Amount

For illustration purposes, figures have been prepared using an annuity value of 25. The first year’s pension is derived by dividing the purchase price by the annuity value. This annuity value is similar to what AGA would expect to see for a male aged 65 with a 60 year old spouse, based on recent cases that AGA has received for Centrelink assessment purposes. To be consistent with the Treasury request to assume a high probability of payment, the annuity value used is towards the more conservative end of the range of annuity values that AGA would expect to see for a male aged 65 with a 60 year old spouse.