Account-based pensions – more than just a pretty face

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Now that the super simplification rules have nearly settled down we can move forward with greater confidence with our client's planning despite the shocks in the market.

Those who went about their superannuation pension planning with a cool head are now reaping the benefits of making sure the fund had sufficient cash flow to draw down. Diversification of superannuation investments seemed to be the key to all of this.

For those who have commenced a pension over the past year or so may feel uneasy on the economic front but may find solace in the fact that they commenced an account-based pension.

Account-based pensions provide a great deal of flexibility, especially where someone has commenced as a transition to retirement pension, before reaching age 65 or for someone who continues to work full or part time beyond that age.

The flexibility of an account-based pension can be used to the greatest advantage because of the minimum amount that has to be paid and that you can turn the account-based pension on or off where circumstances permit.

For example, in these volatile times it may be worthwhile to reduce the amount being salary sacrificed to superannuation and increase the level of income being received and at the same time reduce or cease the receipt of an account-based pension.

Of course, before going ahead with any change like this, you need to do the maths to make sure the client is not significantly worse off both in terms of income being received and the costs associated with the change.

"Why are account-based pensions so appealing," you may ask? Many planners may see them as restricting their revenue base as the wide variety of pensions available up until 19 September last year and provided a complex web of intrigue from a tax and Centrelink perspective suddenly disappeared. The result appeared to be less planning opportunities as allocated pensions and complying pensions were sent to the history books.
In reality, most of the pensions that had commenced up to that time were allocated pensions and in the case of relatively high wealth individuals a small number of market linked and account-based pensions.

What the new world gave us was the new account-based pension and the possibility of using a market linked income stream where the need arose.

However, in effect what we were really left with was the account-based pension.

The only reason for retaining the market linked pension rules in the legislation has been mainly, if not absolutely, for purposes of rolling over market linked pensions from one provider to another.

**DRAFTING SPECIFIC RULES**

I have seen one case where a client insisted they commence a market linked pension with new money in a situation where their partner could not control their spending habits. This may be an effective method of controlling the amount being paid to the partner after the pensioner’s death.

It should be remembered that it is possible to place similar restrictions on an account-based pension with carefully worded conditions attaching to it.

Pension agreements are more common in smaller superannuation funds but there is nothing stopping the larger funds from placing payment conditions around particular account-based pensions when requested by fund members or their beneficiaries.

In some cases this can create a level of greater certainty relating to the payment.

The appealing features of a standard account-based pension include the timing of the payments, the ability to commute the pension at will and the ability to continue the pension with death benefit dependants.

In addition, an account-based pension could include special features including indexation, having a set amount of the pension paid or provide that the pension last for a particular time.

If the client decides to incorporate special features into the pension then it must be ensured that the minimum requirements are met.

**CASE STUDY: BASIL AND CYBIL**

As a case study, Basil who is 60 has about $1 million in his superannuation fund and wishes to commence an account-based pension with $800,000.

If he was to draw down the minimum pension and the fund was to earn 7 per cent net in the long term then it would last him well beyond age 100.

One issue with this is that the minimum draw down rate starts to increase significantly after the time a person reaches age 85 and beyond when the minimum percentage is 9 per cent and increases to 14 per cent when the person reaches age 95 and older.

For many people drawing down an increasingly greater proportion of the account balance the older a person gets the less the likelihood they will need a relatively larger amount to live on.

Therefore it may be better for Basil to commence with a larger amount, say, $50,000 p.a. and have that indexed annually to CPI, say, 3 per cent. This will allow Basil to live on a reasonable income in the earlier years and allow the pension to retain its value over time.

If Basil draws down a constant amount as an account-based pension from the fund which is indexed he has greater certainty in the amount he is to receive. However, on the downside it also may mean the money could run out before Basil dies.

As Basil gets older then he could adjust the dollar amount to something more suitable and still have it indexed year by year to provide him with a level of certainty.

Another option available to Basil could be to provide, Cybil, Basil’s spouse with a reversionary pension on his death. When determining the amount of the pension Basil and his adviser would need to take into account the longevity of any pension as well as the level of reversion to be provided to Cybil. This would take into account Basil and Cybil’s life expectancy at the time the pension commences.

**STOPPING AND STARTING ACCOUNT-BASED PENSIONS**

The ability to stop and start an account-based pension and the abolition of the compulsory payment rules, except death benefit payments, could be regarded as one of its strengths.

If a person has retired after age 55 and returns to work for a number of reasons or has commenced a transition to retirement pension they may wish to reduce the amount of pension they receive or stop the account-based pension altogether.

The flexibility provided by this strategy cannot be underestimated as it permits a person to supplement their income when required.

If a person has decided to stop receiving the account-based pension in future they are quite entitled to start another account-based pension when the need arises.

**TRANSITIONING INTO RETIREMENT**

Salary sacrifice to superannuation is considered to provide a range of advantages particularly when used in combination with salary sacrifice and transition to retirement.

There are many examples of how this combination can be used effectively.

The advantage is that salary and wages can be salary sacrificed to superannuation and the client is able to receive an account-based pension equal to or less than the amount sacrificed. A person could also receive a pension greater than the amount sacrificed.

Drawing an account-based pension in combination with salary sacrifice provides the pensioner with an income supplement and a tax offset equal to 15 per cent of the taxed portion of the pension.

On the other side of the coin the amount salary sacrificed to superannuation is taxed at 15 per cent in the superannuation fund.

While this strategy may not seem to provide any advantage it is the fact that the income and capital gains on the investments used to provide the pension are tax free in the fund. This can provide a considerable increase in the income credited to a member’s pension account of a couple of percent or more.
The effect is that over time the pension can last that little bit longer or the pensioner may decide to increase the amount they receive.

One concern that some clients may have is the longevity of an account-based pension. If a person draws down the minimum amount required and the fund is able to produce a reasonable rate of return, say 7 per cent p.a. net in the long term, they can expect to have an amount in their pension account in the fund at age 100 and beyond. Here is a short case study.

CASE STUDY: SANDRA

Sandra who is a 60 year old dance teacher wishes to commence an account-based pension as part of her transition to retirement strategy.

She currently has $600,000 in superannuation and aims to draw down the minimum pension.

At age 60 the minimum amount she can draw down is 4 per cent of her account balance for a full year. As Sandra wishes to take her account-based pension as a transition to retirement pension the maximum she can draw down can be no more than 10 per cent of the account balance each year.

Once Sandra finally retires or reaches age 65, whichever is earlier, the 10 per cent cap on the transition to retirement pension is lifted.

If Sandra draws down only the minimum permitted under the rules she will potentially have money in her pension account at age 100 and beyond.

Here is an indication at the balance in the fund and the amount of the pension she could expect to have at age 60, 80 and 100 if she drew the minimum account-based pension and the fund earned 7 per cent net in the long term:

Table 1.

<table>
<thead>
<tr>
<th>Age</th>
<th>Balance in Pension Account*</th>
<th>Minimum Pension</th>
</tr>
</thead>
<tbody>
<tr>
<td>60</td>
<td>$600,000</td>
<td>$24,000</td>
</tr>
<tr>
<td>80</td>
<td>$827,799</td>
<td>$58,231</td>
</tr>
<tr>
<td>100</td>
<td>$337,816</td>
<td>$51,395</td>
</tr>
</tbody>
</table>

*assuming a net return on the pension account of 7 per cent p.a.

If Sandra draws down the minimum pension then she could expect that the pension account balance will increase until she is in her early 80s. This is because the amount accumulating in the fund is less than the amount being taken as a pension.

From about age 82 or 83 the balance will decrease in view of the increased level of minimum pension she is required to receive. This is illustrated in Figure 1.

Figure 1. Superannuation pension account balance – account based pensions
IS A DRAW-DOWN AN INCOME PAYMENT OR A LUMP SUM?

Under the rules it is possible to nominate whether a particular drawdown from the account-based pension is to be treated as income or as a lump sum. It is necessary to nominate prior to receipt of a particular payment whether the draw down is a lump sum.

While the draw down of an income or lump sum amount does not have a great impact for taxation purposes for a person 60 or older it will have an impact for the Centrelink income test purposes.

Whether it is worthwhile to commute a current pension, such as an allocated pension, to an account-based pension depends on a number of factors. These would include the age of the pensioner, the timing of the commutation and the level of pre 1 July 1983 component in the pension.

Some clients have decided to continue with the allocated pension due the minimum and maximum amounts.

However, in most cases the account-based pension provides greater advantages than the allocated pension.

The main reason for converting to the account-based pension is to take advantage of a greater exempt component. This may have advantages to those under age 60 or for estate planning purposes where the benefit is ultimately paid to a non-dependant child over 18.

Account-based pensions are a much simpler way of thinking about income streams from superannuation and provide a minimalist approach to the rules surrounding payment of income streams.

However, there is great potential to give clients greater certainty by providing longevity and levels of protection within the terms of the account-based pension.

This can be done by incorporating special features such as indexation, set amounts or reversions into the pension.