Booklet 3

Account-based pensions: making your super go further in retirement

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Introduction

There are a number of ways to use your superannuation to fund your retirement income. One of the options available is an account-based pension which can provide you with a convenient, flexible and tax-effective income when you retire.

This booklet is the third in a series of four booklets that Macquarie Technical Services has developed to help you understand how superannuation works and to give you some tips on how you can get the most out of your super. In this booklet, we will cover how your superannuation can be used to provide income in retirement, focusing on account-based pensions.

The other booklets in this series are:

- **Booklet 1: Getting the best out of your superannuation savings** which focuses on saving through super and some things to keep in mind while your super is accumulating.
- **Booklet 2: Superannuation: dealing with life's changes** which focuses on some important superannuation-related issues to consider whenever you experience changes in your circumstances, whether planned or unexpected.
- **Booklet 4: Super and estate planning** which covers information about the treatment of superannuation death benefits and how you can use your super as an estate planning tool.

This series of booklets provides information about *taxed superannuation funds*. A *taxed superannuation fund* is a fund that pays tax on assessable contributions and investment income while benefits are accumulating. Most Australians belong to a *taxed superannuation fund*. We have not included information about *untaxed superannuation funds*, such as certain government or public sector funds. Different arrangements apply to these funds which are beyond the scope of these booklets.

We aim to answer some common questions people have about superannuation and how it works. But you'll probably have some questions relating to your own circumstances.

If so, we recommend that you talk to your financial adviser who will be able to give you advice that is tailored to your specific needs.

In this booklet, we will outline how account-based pensions work and point out some of their advantages. We also take a look at the payment rules, provide some tips for selecting your investment strategy and payment levels, and outline the tax arrangements that apply to account-based pensions. We look at what will happen to your remaining balance if you die with money still in your pension account, and how you might be able to have a say in how your death benefits are paid.

For many retirees, superannuation pension income is supplemented by a full or part-rate age pension, or we look at how your account-based pension will be treated under the social security rules.

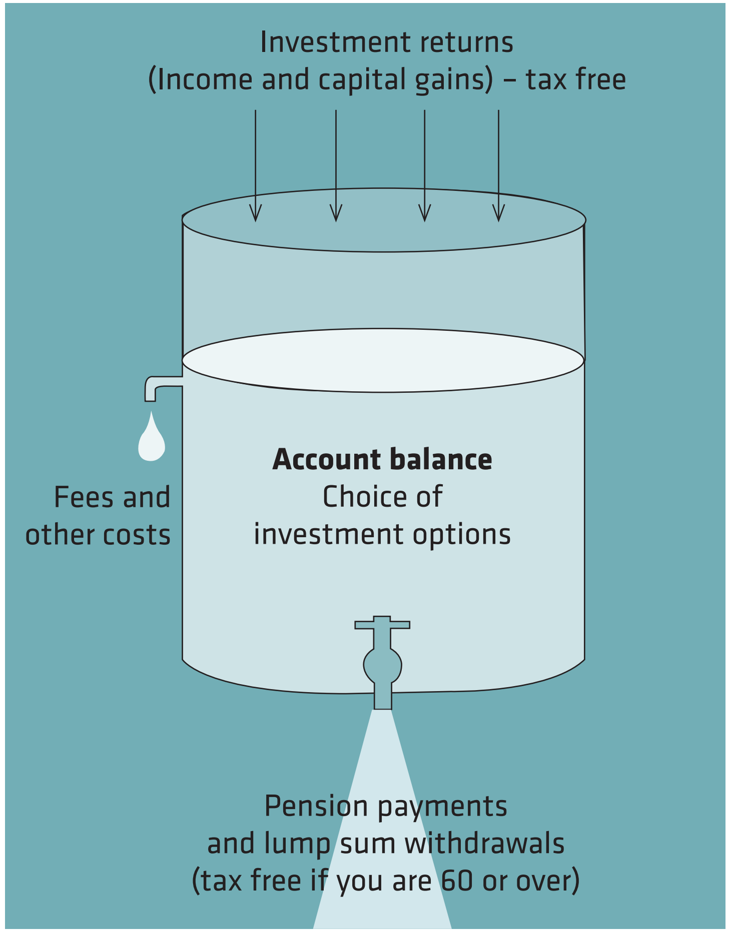
Finally, we take a brief look at some of the alternatives to account-based pensions including fixed payment income streams.

Technical terms that are used throughout this booklet are shown in *italics* and are explained in the glossary at the end of the booklet.

What are account-based pensions?

An account-based pension is like a personal retirement income account operating in a superannuation fund. You will receive regular income payments, while at the same time your account will earn investment income.

Here's how an account-based pension works:



You will continue to receive pension payments as long as there's money left in your account. How long that will be depends on the starting amount, how you choose to invest it (and investment performance), the level of income you draw and whether you take out any lump sum payments along the way.

There's no guarantee that it will last your lifetime, but tax advantages mean that you will get more mileage out of savings invested in an account-based pension than you would from many other types of investment arrangements.

Recent reforms to superannuation have made account-based pensions even more tax-effective and flexible, especially if you are 60 or more, as your superannuation benefits (whether taken as a pension or lump sum) are completely tax free.

Account-based pensions have the following advantages:

Convenient

An account-based pension allows you to consolidate your retirement savings in one place. This means that you won't have to keep track of lots of individual investments for tax purposes.

Flexible

An account-based pension generally allows you to:

- choose the frequency of payments (either monthly, quarterly or annually);
- choose the amount of your payments (subject to a minimum annual limit);
- withdraw lump sums whenever you need them;
- select from a range of investment options; and
- specify who will receive either the residual balance or continuing pension after your death (depending on your fund's rules).

You can adjust all of these to ensure your pension continues to suit your changing circumstances. However, there are some special restrictions if your pension is a *Transition To Retirement (TTR) pension*.

The planning possibilities are endless, and that's why many financial advisers recommend an account-based pension as the cornerstone of a retirement income plan.

Tax effective

The investment earnings added to your pension account are generally tax free.

Also, if you are aged 60 or more you won't pay any income tax on the payments you receive.

If you are aged between 55 and 59, pension payments may be taxable, but often they'll include a *tax free component*. You will also qualify for a 15% tax rebate on the *taxable component* of your payments.

The overall effect of these tax concessions is that you can receive quite a substantial income each year, even if you have not yet reached age 60, and still pay little or no tax.

Investing in an account-based pension

Investing in an account-based pension is easy.

1. Accumulate money in your super fund

You can only start an account-based pension with money you hold in superannuation. This can include money that you have accumulated in your current fund through contributions and investment earnings, and amounts rolled over from other superannuation funds.

It is not compulsory for funds to offer account-based pensions but many funds do. You can check with your fund or speak with your adviser who will be able to find out whether your fund offers account-based pensions.

When building up your superannuation, you need to be mindful of the contribution caps and, once you reach age 65, the restrictions and age limits that apply to most types of contributions. These rules are explained in *Booklet 1: Getting the best out of your superannuation*.

2. Meet a condition of release

Before you can start to receive a pension with your preserved super benefits, you must have met a *condition of release* such as retirement, reaching your *preservation age* or reaching age 65. If you have met a full *condition of release* (for example retirement or reaching age 65), you have unrestricted access to your superannuation benefits which means you can choose to receive a pension, lump sum or combination of both.

If you have reached your *preservation age* but have not yet retired, you may be able to use your accumulated superannuation benefits to commence a *TTR pension*. A *TTR pension* is an account-based pension with restrictions that prevent you from drawing payments above a maximum limit (10% of your account balance each year) and accessing your capital as a lump sum. *TTR pensions* are explained in more detail in *Booklet 2: Superannuation: dealing with life's changes*.

3. Rollover your super money into an account-based pension

Your accumulated super will be transferred into a pension account and you will begin to receive your payments. You will maintain the flexibility to invest in a range of investment options that are offered by your fund.

In some more sophisticated master trusts and *self managed superannuation funds*, your superannuation investments do not need to be sold down and converted to cash before being transferred to a pension account. They can be transferred from your accumulation account into a new pension account without triggering a Capital Gains Tax (CGT) liability. The advantage of this is that capital gains on your assets can be realised in the pension account where they will be tax free. For this reason, there can be advantages in choosing such a fund in the lead up to your retirement while you are still accumulating your super benefits. Your adviser will be able to let you know whether or not your fund offers this feature.

Pension payment rules

When you invest in an account-based pension, you are required to draw at least a minimum payment each financial year as set by the Government.

This minimum payment is calculated by multiplying a percentage factor (which depends on your age) to your account balance on the day you commence your pension, and then on each 1 July after that.

Your age on 1 July (or when you commence the pension in the first year)	Minimum payment factor
Under 65	4%
65 – 74	5%
75 – 79	6%
80 – 84	7%
85 – 89	9%
90 – 94	11%
95 or more	14%

If you commence a pension part way through the financial year, the minimum annual payment is calculated in proportion to the number of days remaining in the financial year (so you don't have to take a full year's pension payment if your pension is only being paid for part of a financial year). However, if you commence your pension on or after 1 June in a financial year, you are not required to take a minimum payment at all in that year.

There is no maximum limit, unless you are receiving a *TTR pension*. *TTR pensions* are subject to a maximum annual payment limit of 10% of the account balance each year. These extra restrictions that apply to *TTR pensions* are explained in more detail in *Booklet 2: Superannuation: dealing with life's changes*.

Your investment strategy and payment levels

Of course the higher the pension you choose to receive, the faster you're going to deplete your remaining balance, but that may be part of your plan. If, for example, you have another investment maturing in a few years, you may choose to take more out of your account-based pension now and then scale back the payments later. Alternatively, you may want to take smaller payments initially to take advantage of *compounding* returns and so your pension lasts for a longer period of time.

An account-based pension does not provide any guarantees to last your full lifetime. But because of the tax advantages, retirement savings will typically last as long or longer if they are invested in an account-based pension compared to investing outside super.

Choosing the right investment mix for your account-based pension is very important. The investment options you select will depend on how comfortable you are with risk.

As a general rule, the bigger the potential investment return, the higher the investment risk. While you're young, you can afford to take some risk with your investments, but as you get older you may wish to become more conservative in your approach. However, it is important not to be too conservative as even once you have retired, your retirement savings may need to last another 20 or 30 years or more.

It is important to select both your investment strategies and payment levels taking account of how long you want your pension to last. You may consider things like social security entitlements (explained later in this booklet), other investments you hold and your general health.

The following example illustrates the effect of different investment earnings rates on how long an account-based pension can last.

Example 1: An account-based pension at different earning rates

Iva commenced an account-based pension on 1 July 2008 at age 55 with an opening balance of $400,000. She would like to receive total pension payments of $21,000 in the first year (which is above the minimum required annual payment of $16,000). She also decides that she would like to increase her pension payments by 3% each year to account for increases in the cost of living over time.

Example 1 continued:

Based on the most recent Australian Life Tables published by the Australian Government Actuary[1], at the time she commences her pension, she can be expected to live until age 85.

The charts below show Iva's annual pension payments and account balance, assuming she earns investment returns of 6% and 8% (net of fees) per year. You can see how her pension payments change each year, and that in the early stages, the investment earnings largely offset the pension payments.

At an earnings rate of 6%, Iva's pension account lasts until age 83.

Chart 1:

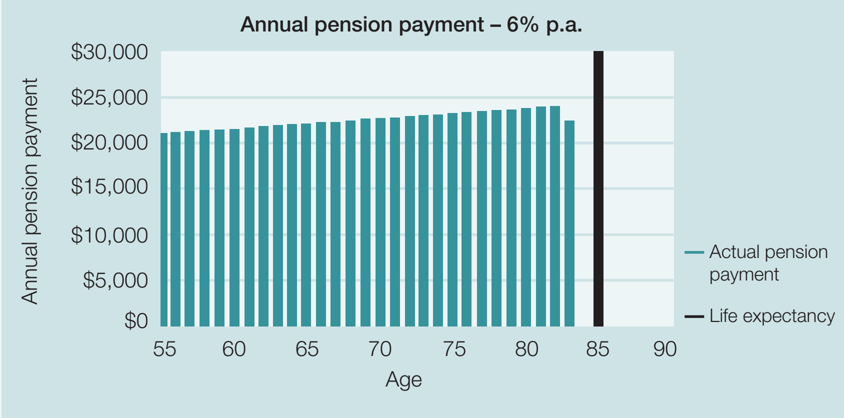
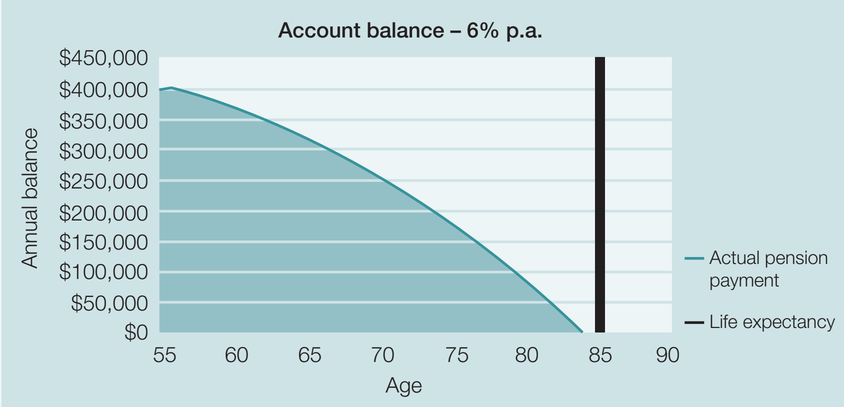


Chart 2:



[1] Australian Life Tables 2000-2002, Australian Government Actuary. The table of life expectancy factors can be found in the appendix to this booklet.

Example 1 continued:

At an earnings rate of 8%, Iva's account lasts until well over age 100.

Chart 3:

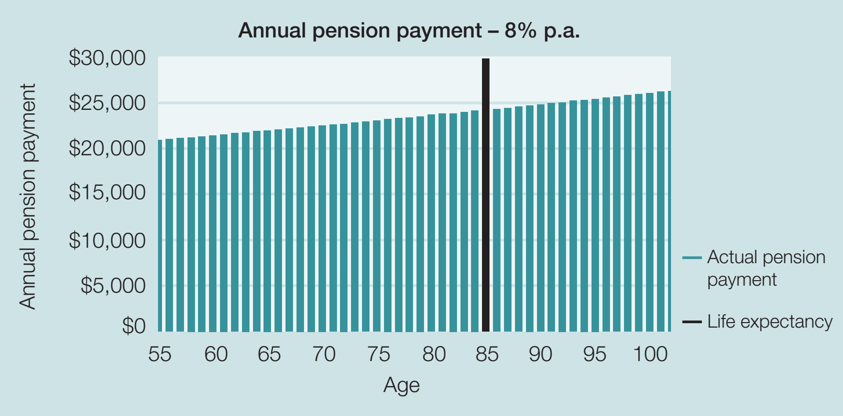
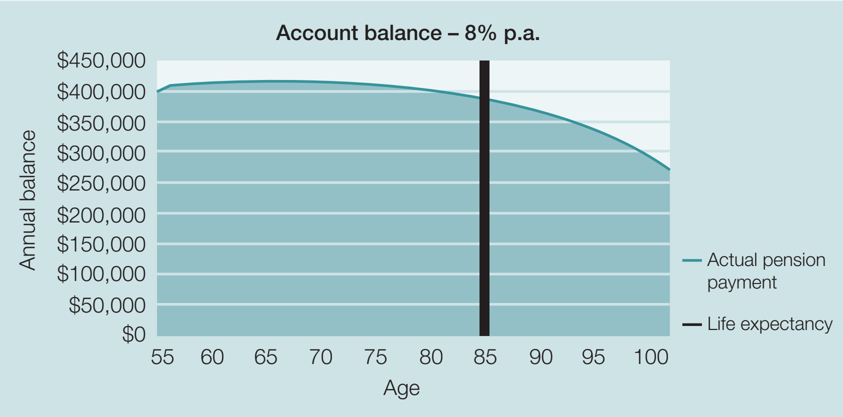


Chart 4:



Assumptions:

- all chart figures are in today's dollars (assuming the Consumer Price Index increases at the rate of 2.5% p.a.);
- pension payments are assumed to be made in the middle of each year; and
- earning rates are net of fees.

Example 1 continued:

You can see just how big an impact higher investment returns can have on your account balance and the length of your pension.

The results at an earnings rate of 6% were disappointing relative to Iva's life expectancy. This may be partly because Iva was drawing too much income from her pension. If she had chosen a lower annual payment level (keeping in mind that she is required to draw a minimum payment), or indexed her annual payments by less than 3%, her pension may have lasted longer.

Another important consideration when setting your annual payment level is whether you want your pension to provide for one or more of your dependants after your death (for example your spouse). The treatment of account-based pensions after death, and the options you may have available to pass on your benefits, are explained further on page 15 and also in *Booklet 4: Super and estate planning*.

You should review your needs with your adviser at least once each year to make sure you remain on track and that your account-based pension remains suited to your circumstances.

Tax arrangements

Tax treatment of investment income in your pension account

While you receive pension payments, investment earnings will be paid into your pension account. One of the great attractions of account-based pensions is that generally there's no tax on the investment earnings added to your account. This applies to both income and capital gains earned by the fund.

Pension payments

The tax treatment of payments to you out of your pension account can depend on your age and the percentage of *tax free component* in your account.

If you are aged 60 or more, the full amount of each pension payment is tax free. Technically, it's called *non-assessable non-exempt income*.

A key advantage of *non-assessable non-exempt income* is that it is treated as if it was never received for tax purposes. For example, *non-assessable non-exempt income* will not be taken into account in determining your eligibility for the Senior Australians Tax Offset or most other tax offsets. It will also not be taken into account in determining whether you are eligible for the Commonwealth Seniors Health Card. However, it will generally still be assessed for other social security purposes, for example, under the age pension means test.

If you have not yet reached age 60 but have reached your *preservation age* (ie. age 55 if you were born before 1 July 1960), the *tax free component* of your payments will not be taxed, and the remainder (the *taxable component*) will be taxed at your marginal rate. However, you will receive a 15% rebate on the *taxable component* of your payments.

Tax treatment of pension payments:

Age	Tax free component	Taxable component
Preservation age but less than 60	Tax free	Marginal tax rates (plus Medicare levy) less 15% rebate
Age 60 or more	Tax free	Tax free

The *tax free component* of your super entitlement generally represents *non-concessional contributions*. For example, if you made a personal contribution and did not claim a tax deduction, the contribution will form part of your *tax free component*.

When you start an account-based pension, the percentage of *tax free component* in your pension account is calculated and each payment made from the pension (whether a regular pension payment or a lump sum) will include this same percentage of *tax free component*.

The remainder of each payment is *taxable component*.

Example 2:

Continuing the example of Iva, let's assume that her starting account balance of $400,000 included an $100,000 *tax free component*. The percentage of *tax free component* of any payment made from the pension will be worked out as follows:

Tax free percentage = $100,000 ÷ $400,000
= 25%

Therefore, in the first year, the total assessable income from her pension (ie. the *taxable component*) will be:

Assessable pension income = $21,000 – ($21,000 x 25%)
= $15,750

If we assume that Iva receives no other income, the gross tax payable will be $1,462.50.

However, she will qualify for the following rebates:

- Superannuation pension rebate of 15% calculated as follows:

  Rebate = $15,750 x 15% = $2,362.50

- Low Income Tax Offset of $1,200 (maximum available as her assessable income is less than $30,000).

As a result of these rebates, even though Iva has not yet reached age 60, her tax liability is eliminated. And at this level of income, Iva will also not pay Medicare levy. This means she will get to keep every cent of her pension income.

Lump sums

The tax treatment of lump sums (either from your super accumulation or pension account) can also depend on your age and the percentage of *tax free component* in your account.

If you are aged 60 or more, the full amount of your lump sum is tax free.

If you have not yet reached 60, but have reached your *preservation age*, you may pay tax on your lump sum, depending on whether or not the *taxable component* of the payment exceeds the *low rate cap* (explained below).

Tax treatment of lump sums:

Age	Tax free component	Taxable component (taxed element)
Preservation age but less than 60	Tax free	0% up to the *low rate cap* ($140,000 in 2007-08) 15% plus Medicare levy on amounts above *low rate cap*
Age 60 or more	Tax free	Tax free

The *low rate cap* that applies to lump sum benefits paid between *preservation age* and age 60 is a lifetime limit. This means that the *taxable component* of any previous superannuation lump sum benefits (known as *eligible termination payments* before 1 July 2007) that you have received since reaching your *preservation age* will generally reduce your *low rate cap* for an income year. The *low rate cap* is indexed annually with Average Weekly Ordinary Time Earnings (AWOTE) in $5,000 increments.

What if you die before your account balance runs out?

Your account-based pension can play an important part in your estate planning, and you'll need to think about what would happen if you were to die while there's still money in your account.

You will need to consider things like:

- who you want to leave your benefits to.

  Generally, only your dependants as defined under superannuation law (known as *SIS dependants*) or your estate can receive your superannuation death benefits.

- will it be paid as a lump sum or a pension?

  Only certain dependent beneficiaries are eligible to receive your death benefits as a pension (explained on the following page).

- how will your death benefits be taxed?

  The tax arrangements for death benefits can depend on your age, whether benefits are paid as a lump sum or pension, your beneficiaries' ages and whether or not they are dependants for tax purposes (*tax dependants*) and the benefit's tax components.

The options available to you are subject to restrictions in the law and depend on your fund's rules.

Who can receive your benefits?

Under superannuation law, when you die, the trustee of your fund is generally required to pay your superannuation benefits as soon as practicable to either one or more of your *SIS dependants*, or to your *legal personal representative* (typically referred to as your estate). If paid to your estate, the proceeds from your superannuation death benefit will be distributed according to your will.

Many funds allow you to nominate one or more of your dependants, or your *legal personal representative* to receive your remaining account balance on death via a death benefit nomination. A death benefit nomination can be binding or non-binding, depending on the rules of your fund.

Alternatively, at the time you commence your pension, your fund may allow you to specify a *reversionary beneficiary* who may continue to receive the pension after your death. A *reversionary beneficiary* is usually a spouse but it could be another one of your dependants, provided they are eligible to receive a death benefit pension. When making a *reversionary beneficiary* nomination, it's important to consider whether the person you would like to nominate is eligible to receive your benefits as a pension (explained below).

How can your benefits be paid?

There are some important restrictions that can prevent certain types of beneficiaries from receiving your death benefits as a pension.

A death benefit pension can only be paid to a beneficiary who is:

- a *SIS dependant* other than a child;
- a child who is under 18;
- a child under 25 who is financially dependent on you; or
- a child who is permanently disabled[2].

A death benefit paid to a beneficiary who does not meet the above criteria can only be paid as a lump sum. For example, if your death benefits are being paid to your estate, or an adult child who is not disabled or financially dependent, they must be paid as a lump sum.

Tax treatment of death benefits

The tax treatment of your death benefits can depend on who receives your benefit, whether your benefits are paid as a lump sum or a pension and the benefit's tax components.

If your benefits are paid as a lump sum to a *tax dependant*, they will be tax free. A lump sum paid to a non-tax dependant will generally be subject to tax on the *taxable component*.

If a lump sum is paid to your estate, the estate may pay tax depending on the size of the *taxable component* and whether the beneficiaries of the super death benefit proceeds are *tax dependants* or not.

If your death benefits are paid to a dependant as a pension, the tax treatment depends on your age at death or the age of your beneficiary. If you die aged 60 or more, or if the beneficiary is aged 60 or more when they begin to receive a death benefit pension, it will be tax free. However, if you die aged less than 60 and your beneficiary is also less than 60, the *taxable component* of the pension may be taxed but a 15% rebate will apply.

These arrangements are explained in further detail in *Booklet 4: Super and estate planning*.

[2] Broadly, this is a disability that is permanent or likely to be permanent and results in the need for ongoing support and a substantially reduced capacity for communication, learning or mobility.

Social security treatment of superannuation and account-based pensions

The age pension and the means test

The age pension is designed to provide Australians with a minimum level of income support in retirement. Eligibility for the age pension can depend on a number of factors including whether you have reached *age pension age* and meet certain residency requirements.

Age pension age for a male is 65.

For females, *age pension age* is being gradually increased from age 60 to age 65 by 2014. *Age pension age* for females depends on their date of birth. If you are female and were born before 1 July 1944 you have already reached your *age pension age*.

Date of Birth	Age pension age – female
1 July 1944 to 31 December 1945	63.5
1 January 1946 to 30 June 1947	64
1 July 1947 to 31 December 1948	64.5
1 January 1949 and later	65

Eligibility for the age pension (as well as other social security benefits) also depends on whether you have income and assets below maximum levels. This is determined by applying two tests: an income test and an assets test (collectively referred to as the means test). Your age pension entitlement is calculated under both tests, with the lesser result determining the amount of age pension that you will receive.

Effective from 20 March 2008, the maximum basic rate of age pension for a single person is $14,367.60[3] per year. The maximum basic rate for a couple (combined) is $23,904.40[3] per year (both include pharmaceutical allowance).

The treatment of superannuation investments under the means test can depend on whether they are held in the *accumulation phase* or in a pension and also on your age. If you hold superannuation investments in the *accumulation phase* and are under *age pension age* your investments are exempt from assessment under the means test. However, once you reach *age pension age*, your *accumulation phase* assets will be assessed under the assets test and deemed investment income on your assets will count under the income test.

[3] These are the rates of pension (for a single and couple) effective 20 March 2008. Pension payments are indexed to the Consumer Price Index on 20 September and 20 March each year. The single rate cannot fall below 25% of Male Total Average Weekly Earnings at the March and September indexation points.

Means test treatment of pensions

If you invest your super in an income stream, it will generally be assessed under both the income and assets test. The assets supporting an account-based pension are assessed under the assets test and income payments are assessed under the income test.

Assets test

Your pension account balance is included as an asset for the purpose of the assets test. The balance is revalued every six months, unless you only receive your pension annually (in which case your account balance is also revalued annually), or if you make a lump sum withdrawal during the year (in which case it will be revalued following the withdrawal).

Under the assets test, your age pension is reduced by $1.50 per fortnight ($39 per year) for every $1,000 of assets above the assets test free area (single and couple combined). The assets test free area depends on your family situation and whether or not you are a homeowner. It is indexed annually in line with increases in the Consumer Price Index. The assets test free areas and maximum asset levels that will allow you to qualify for a part-rate age pension applicable from 20 March 2008 are as follows:

Assets test for homeowners:

Family situation	Assets test free area[4]	Maximum assets for part-pension[5]
Single	$166,750	$535,250
Partnered (combined)	$236,500	$849,500

Assets test for non-homeowners:

Family situation	Assets test free area[4]	Maximum assets for part-pension[5]
Single	$287,750	$656,250
Partnered (combined)	$357,500	$970,500

[4] These are the assets test free areas that apply from 1 July 2007. The free areas are indexed to the Consumer Price Index on 1 July each year.

[5] The maximum asset limits are subject to change due to indexation of both the asset test free areas and maximum basic rates of age pension.

Income test

Your annual pension, less a 'social security deduction amount', is counted as income. The deduction amount is designed to allow for the return of your capital over the period of payment.

For an account-based pension, it's calculated by dividing the full purchase price by a life expectancy factor.

The life expectancy factor is generally your life expectancy (in years) when you started the pension (unless you've nominated a reversionary beneficiary, in which case it's the longer of yours and the *reversionary beneficiary's* life expectancies). Life expectancy factors are published by the Australian Government Actuary. A table of the most recent life expectancy factors is contained in the appendix at the back of this booklet.

If you make a lump sum withdrawal from your pension account, it will generally not be assessed under the income test. However, your deduction amount will be recalculated, taking account of the amount of the withdrawal.

The income test reduces the basic rate of age pension (for a single person) by 40 cents per fortnight for each $1 of assessed income above the free area. For a couple, the couple's rate of age pension is reduced by 20 cents each per $1 of income above the free area. The income test free area depends on your family situation. The income test free areas and maximum income levels that will allow you to qualify for a part rate age pension applicable from 20 March 2008 are as follows:

Income test:

Family situation	Income test free area (per year)[6]	Maximum income for part-pension (per year)[7]
Single	$3,432	$39,351
Couple (combined)	$6,032	$65,793

[6] These are the income test free areas that apply from 1 July 2007. The free areas are indexed to the Consumer Price Index on 1 July each year.

[7] The maximum income limits are subject to change due to indexation of both the income test free areas and maximum basic rates of age pension.

Example 3: Social security treatment of an account-based pension

Joseph (aged 65) rolled over $300,000 into an account-based pension on 1 April 2008 and chooses to draw a payment of $20,000 in the first year. Joseph has not nominated a *reversionary beneficiary*.

Joseph's life expectancy factor (according to Australian life tables) is 17.7. The social security treatment of his account-based pension is as follows:

Assets test:

Assessed asset (first 6 months) = $300,000

Income test:

Assessed income (first year) = annual pension – (purchase price ÷ life expectancy factor)
= $20,000 – ($300,000 ÷ 17.70)
= $3,051

Calculating Joseph's age pension

Joseph is single and, apart from his pension, has other assessed assets of $50,000, and other assessed income of $4,000 for the year. Therefore, Joseph's total assessed assets are $350,000 and his total assessed income is $7,051.

Joseph also owns his own home (which is exempt from assessment under the assets test).

1. Pension payable under the assets test:
   The age pension payable under assets test is calculated as follows:
   Age pension = full rate age pension – (assessed assets – free area) x ($39 ÷ $1,000)
   Age pension = $14,367.60 – ($350,000 – $166,750) x ($39 ÷ $1,000)
   = $7,220.85

2. Pension payable under the income test:
   The age pension payable under the income test is calculated as follows:
   Age pension = full rate age pension – (assessed income – free area) x $0.40
   Age pension = $14,367.60 – ($7,051 – $3,432) x $0.40
   = $12,920.00

As Joseph's pension as calculated under the assets test is lower than under the income test, his rate will be determined under the assets test. The amount of age pension he will receive will be $7,220.85 per year (including pharmaceutical allowance).

Account-based pensions: summing up and a brief look at the alternatives

Advantages of account-based pensions

Convenient

An account-based pension allows you to consolidate your investments in one place.

Flexible

With an account-based pension, you can:

- choose how often you want to receive payments;
- choose the amount of your payments (subject to a minimum payment requirement);
- select how you would like to invest your pension capital;
- nominate one or more of your dependants to receive your benefit after your death (depending on the rules of your provider); and
- make lump sum withdrawals from your pension whenever you need to.

Tax effective

- The investment earnings added to your pension account are tax free.
- If you are aged 60 or more you do not pay any income tax on the payments you receive.
- Even if you haven't reached age 60, tax concessions mean that you can receive quite a substantial income each year and still pay little or no tax.

Because of the income test treatment, account-based pensions can also be effective for social security purposes.

Disadvantages of account-based pensions

The main disadvantage with an account-based pension is that there is no guarantee that your pension payments will continue throughout your lifetime. Your pension will last only as long as there is money in your account.

What are the alternatives?

In addition to, or instead of, an account-based pension you may choose to use your accumulated super benefits to purchase other types of income streams to fund your retirement income. These income streams generally do not have an account balance so payment levels are determined up front when you purchase the income stream.

Fixed payment pensions or annuities

Fixed payment pensions and annuities can be payable for either a fixed term, or for your lifetime. They generally benefit from the same tax concessions that apply to account-based pensions but they will not provide the same degree of flexibility. Fixed payment income streams are usually provided by life insurance companies.

Life pensions and annuities

A life pension or annuity can provide a regular stream of income payments which are generally determined by a contract with a life company at the time you purchase the income stream. Your payments may be indexed annually to keep pace with increases in the cost of living and you may also be able to specify a *reversionary beneficiary* who can continue to receive the income stream after you die.

While life pensions and annuities are guaranteed and can therefore provide you with greater certainty, one of the difficulties with them is that you are usually locked into a level of income that's determined at the time of commencement. You generally do not have ready access to your capital to make lump sum withdrawals. This is because the life insurance company locks in pension and annuity rates based on investment conditions, particularly interest rates, as well as mortality rate assessments at the time of purchase.

Despite these limitations, life pensions and annuities may be useful for people who want the security and certainty of knowing they will not outlive their pension.

Fixed term pensions and annuities

A fixed term pension or annuity can also provide greater certainty. You may choose from either a long or short-term pension or annuity and, subject to some restrictions, you may choose to either index your payments annually or lock in a *residual capital value* (which will be paid to you as a lump sum at the end of your term). Like account-based pensions, there is a minimum annual payment requirement, but this is calculated based on the purchase price as there is no account balance.

With a fixed term pension or annuity, like life pensions and annuities, you are generally locked into a level of income at rates which depend upon conditions at the time of purchase.

Fixed term pensions and annuities also have their limitations. They lack the flexibility of account-based pensions, while at the same time there is still the risk that you may outlive the term of your income stream. However, fixed term pensions or annuities can be suitable for people who want a regular and reliable income for a fixed period of time.

Fixed payment income streams and investment risk

In buying a fixed payment income stream, the investment risk is passed from you to the life insurance company.

In so doing, subject to the capital strength of the life company, you may gain additional security. Importantly however, that security generally comes at a cost. For instance:

- some flexibility is lost (you may not be able to commute the income stream or penalties may apply);
- the life company will ordinarily ensure that it retains a margin from the actual asset returns over and above the income it pays to you; and
- the life company, not you, benefits from any upside achieved by the underlying assets.

If you are concerned about taking on investment risk, an account-based pension can be invested in more conservative assets. You can have all the flexibility that an account-based pension offers (including access to capital and ability to vary your income payments) without taking on a high level of investment risk.

Hybrid products

Some income stream products are becoming available which offer a blend of market-linked investment returns (like account-based pensions) with some coverage of mortality risk (that is the risk of you outliving your income stream). The pros and cons of these products need to be weighed up carefully with the assistance of an adviser, taking account of expected performance, fees and the nature of the guarantees offered.

Other types of income streams

Complying pensions and annuities

Some types of pensions and annuities that started before 20 September 2007 were eligible for extra social security concessions. These income streams are known as *complying income streams*. For *complying income streams* purchased between 20 September 2004 and 19 September 2007, only 50% of the value of a *complying income stream* is counted under the assets test. *Complying income streams* purchased before 20 September 2004 are not counted at all under the assets test.

Before 1 July 2007, these income streams may have also assisted an individual to qualify for a higher *pension reasonable benefit limit (RBL)*. Individuals with income streams that qualified for the *pension RBL* may have paid less tax than they would have if they were assessed against the *lump sum RBL*.

There were broadly three types of *complying income streams*:

- life pensions and annuities;
- life expectancy pensions and annuities (fixed term); and
- term allocated pensions or TAPs (also fixed term) which were not available until 20 September 2004.

The general characteristics of *complying income streams* are:

- they must be *non-commutable* (ie you can't withdraw lump sums) except in limited circumstances;
- they must either run for life or have a term based on your life expectancy, (or if you had a spouse who was nominated as a *reversionary beneficiary*, your spouse's life expectancy); and
- there must be no residual capital left when the income payments finish.

From 1 July 2007, *RBLs* no longer apply and the tax concessions for superannuation benefits have been widened. From 20 September 2007, it is generally no longer possible for a new *complying income stream* to qualify for the extra social security concessions. However, if you purchased a *complying income stream* before 20 September 2007, your income stream will continue to receive these concessions. Because generally there are no longer any tax or social security benefits of purchasing a new *complying income stream*, these income streams are no longer readily available.

Pensions paid from defined benefit funds

Some public sector and corporate superannuation funds are *defined benefit funds*. In these funds, your final superannuation benefit is determined using a formula that is often based on final salary, years of service and a benefit accrual rate. Members of a *defined benefit fund* generally do not have an account balance and their entitlements do not depend on investment performance.

Because defined benefit pensions are paid from amounts that did not accumulate in the fund and earn investment income, generally no tax has been paid on contributions or earnings. For this reason, these pensions receive different tax treatment compared to pensions paid from *taxed superannuation funds*. They may also be assessed differently for social security purposes. Your adviser will be able to help if you need more information about pensions paid from *defined benefit funds*.

Glossary

Accumulation phase is a term used to describe the period when your superannuation benefits are accumulating in the fund. This is the period of time when you are likely to be working and contributing to your super.

Age pension age is the age when a person may qualify for the age pension. Age pension age for a male is 65. For females, age pension age is being gradually increased from age 60 to age 65 by 2014. Age pension age for females depends on their date of birth. If you are female and were born before 1 July 1944 you have already reached your age pension age.

Date of Birth	Age pension age – female
1 July 1944 to 31 December 1945 (inclusive)	63.5
1 January 1946 to 30 June 1947 (inclusive)	64
1 July 1947 to 31 December 1948 (inclusive)	64.5
1 January 1949 and later	65

Complying income stream is a type of income stream that was available before 20 September 2007. Complying income streams receive concessional treatment under the social security means test. Before 1 July 2007, complying income streams may have also assisted you to qualify for certain tax concessions. They are generally *non-commutable*, payable for life or a term based on your life expectancy, or spouse's life expectancy, and cannot have a *residual capital value*.

Compounding is when you earn interest on your interest. It occurs when your earnings are reinvested. Compounding is one of the many benefits of saving through superannuation.

Condition of release is a condition you must meet before you can access your preserved and *restricted non-preserved benefits*. The conditions of release are set down in superannuation legislation. Examples are retirement, reaching your *preservation age*, reaching age 65 and permanent incapacity. Some conditions of release have restrictions on the amount of, or form in which you can take your benefits, while others (such as retirement) allow unrestricted access.

Defined benefit fund is a type of fund where your final superannuation benefit is calculated using a formula that is often based on final salary, years of service and a benefit accrual rate. Unlike members of an accumulation fund, members of a defined benefit fund generally do not have an account balance and their entitlements do not depend on investment performance.

Interdependency relationship exists between two people if they have a close personal relationship, they live together, one or each of them provides the other with financial support, and one or each of them provides the other with domestic support and personal care. If a person is in an interdependency relationship with another, then that person is considered to be a dependant for the purposes of paying and taxing superannuation death benefits.

Legal personal representative means:

- an executor or administrator of an estate of a person who has died;
- a trustee of an estate of a person who is under a legal disability; or
- a person who holds a general power of attorney that was granted by another person.

Low rate cap is a limit on the amount of the *taxable component* of a superannuation lump sum that attracts a lower rate of tax (usually 0%). The low rate cap applies to lump sum benefits paid between *preservation age* and age 60 and is a lifetime limit. This means that the *taxable component* of any previous superannuation lump sum benefits (known as eligible termination payments before 1 July 2007) that you have received since reaching your *preservation age* will generally reduce your low rate cap for an income year. The low rate cap is $140,000 in 2007-08 and indexed annually to wages in $5,000 increments.

Lump sum Reasonable Benefit Limit (RBL) was a lifetime limit on the amount of superannuation benefits you could receive at concessional tax rates. An individual's benefits were assessed against the lump sum RBL unless they invested more than half of their benefits in a *complying income stream* (in which case may have qualified for assessment against the higher pension RBL). From 1 July 2007, RBLs no longer apply.

Non-assessable non-exempt income is income that is excluded from your assessable income. It is a class of income that is ignored for the purposes of working out your taxable income or loss. A key advantage of non-assessable non-exempt income is that it is treated as if it was never received for tax purposes. For example, non-assessable non-exempt income will not be taken into account for determining your eligibility for the Senior Australians Tax Offset or most other tax offsets.

Non-commutable in relation to an income stream, means that the income stream cannot be converted to a lump sum (except in limited circumstances).

Non-concessional contributions are generally contributions that are not tax deductible. They are typically personal contributions for which you do not claim a tax deduction or contributions that are made for a spouse. These contributions are not taxed when they are made. Non-concessional contributions are also subject to an annual contribution limit which is known as the non-concessional contributions cap.

Pension Reasonable Benefit Limit (RBL) was a lifetime limit on the amount of superannuation benefits you could receive at concessional tax rates. An individual's benefits were assessed against the higher pension RBL if more than half of their benefits were invested in a *complying income stream*. From 1 July 2007, RBLs no longer apply.

Preservation age is generally the age when you can access your superannuation benefits after you retire. However, there are some limited circumstances when you may access your benefits before reaching preservation age or retiring (such as under permanent incapacity).

Your preservation age depends on when you were born.

If you were born:	Your preservation age is:
before 1 July 1960	55 years
1 July 1960 to 30 June 1961	56 years
1 July 1961 to 30 June 1962	57 years
1 July 1962 to 30 June 1963	58 years
1 July 1963 to 30 June 1964	59 years
after 30 June 1964	60 years

Reasonable benefit limits see *lump sum reasonable benefit limit* and *pension reasonable benefit limit*.

Residual capital value is an amount that may be paid as a lump sum at the end of the term of an income stream or on death. For fixed term income streams, a residual capital value may be 'locked in' at the time the income stream is commenced.

Restricted non-preserved benefits are benefits that, although not preserved, cannot be accessed until you have met a *condition of release*. However, unlike preserved benefits, you may access your restricted non-preserved benefits (in pension or lump sum form) on termination of employment with an employer who contributed to your fund.

Reversionary beneficiary is someone who will continue to receive your pension payments after you die. The pension does not stop, payments simply 'revert' to another person. A reversionary beneficiary is usually nominated when you first commence a pension. Only certain beneficiaries (such as a spouse) are eligible to receive a death benefit in the form of a pension so it's important to keep these in mind when you are making a reversionary beneficiary nomination.

Self managed superannuation fund is a fund that, in general terms, meets the following requirements:

- it has less than five members;
- each member of the fund is a trustee and each trustee is a fund member;
- if the trustee of the fund is a body corporate each director of the body corporate is a member of the fund;
- no member of the fund is an employee of another member of the fund, unless they are related; and
- no trustee of the fund receives any remuneration for their services as trustee.

SIS dependant in relation to superannuation death benefits is:

- your spouse (including a de facto);
- your child (of any age);
- someone with whom you have an *interdependency relationship*; or
- someone who is a dependant of yours within the ordinary meaning of that term, such as a person who depends on you financially.

Under superannuation law, the trustee is required to cash a member's superannuation benefits as soon as practicable after their death to one or more of the member's SIS dependants or to their *legal personal representative*.

Tax dependant in relation to superannuation death benefits is:

- your spouse (including a de facto);
- your former spouse (if any);
- child under the age of 18;
- someone with whom you have an *interdependency relationship*; or
- someone who is a dependant of yours within the ordinary meaning of that term, such as a person who depends on you financially.

If the deceased died in the line of duty as either a member of the defense force or a police officer, beneficiaries of the death benefit who are not tax dependants will be treated as tax dependants. Death benefits paid to tax dependants receive greater tax concessions compared to benefits paid to tax non-dependants. For example, a death benefit lump sum paid to a tax dependant is tax free.

Tax free component is the component of a superannuation entitlement (or benefit) that represents contributions that were not taxed when received by the fund (generally *non-concessional contributions*).

Tax non-dependant in relation to superannuation death benefits refers to a beneficiary who is not a *tax dependant*.

Taxable component is the value of your superannuation entitlement (or benefit) less the *tax free component* of your entitlement (or benefit).

Taxed element is the part of the *taxable component* of a superannuation benefit representing amounts that have previously been taxed in the fund.

Taxed superannuation fund is a fund that pays tax on assessable contributions and investment income while your benefits are accumulating.

Transition To Retirement (TTR) pension is an account-based pension that is generally *non-commutable* until you meet a full *condition of release* or unless you transfer benefits back to the *accumulation phase*. TTR pensions are also subject to an annual payment limit of 10% of the account balance on 1 July each year (or on the commencement day in the first year). You can access your benefits as a TTR pension once you have reached your *preservation age* before you have retired (depending on the rules of your fund).

Untaxed element is the part of the *taxable component* of a superannuation benefit representing amounts that have not previously been taxed in the fund. For instance, if you die and have life insurance proceeds paid into your account, your death benefit may include an untaxed element which broadly reflects the fact that no contributions or earnings tax has been applied to life insurance premiums.

Untaxed superannuation fund is one that does not pay tax on contributions or investment income. This can occur because the fund is 'unfunded', where no employer contributions have been made for a member until the member is ready to retire.

Appendix: Life expectancy factors

Age	Male	Female
0	77.64	82.87
1	77.08	82.25
2	76.12	81.29
3	75.14	80.30
4	74.16	79.32
5	73.17	78.33
6	72.18	77.34
7	71.20	76.35
8	70.21	75.35
9	69.21	74.36
10	68.22	73.37
11	67.23	72.37
12	66.24	71.38
13	65.25	70.39
14	64.26	69.39
15	63.28	68.41
16	62.30	67.42
17	61.33	66.44
18	60.37	65.45
19	59.43	64.48
20	58.48	63.50
21	57.54	62.52
22	56.59	61.54
23	55.65	60.57
24	54.71	59.59
25	53.77	58.61
26	52.83	57.63
27	51.89	56.65
28	50.95	55.68
29	50.01	54.70
30	49.07	53.72
31	48.13	52.75
32	47.19	51.77
33	46.24	50.80
34	45.30	49.82
35	44.35	48.85
36	43.41	47.88
37	42.47	46.91
38	41.53	45.94
39	40.58	44.98
40	39.65	44.01
41	38.71	43.05
42	37.77	42.09
43	36.84	41.14
44	35.91	40.18
45	34.98	39.23
46	34.06	38.28
47	33.13	37.33
48	32.22	36.39
49	31.30	35.45
50	30.39	34.51
51	29.49	33.58
52	28.59	32.66
53	27.69	31.73
54	26.80	30.82
55	25.92	29.91
56	25.05	29.00
57	24.19	28.10
58	23.34	27.21
59	22.49	26.32
60	21.66	25.44
61	20.84	24.57
62	20.04	23.71
63	19.24	22.85
64	18.46	22.00
65	17.70	21.15
66	16.95	20.32
67	16.21	19.49
68	15.48	18.67
69	14.78	17.87
70	14.08	17.08
71	13.41	16.29
72	12.75	15.53
73	12.11	14.78
74	11.50	14.05
75	10.90	13.33
76	10.32	12.63
77	9.77	11.94
78	9.24	11.27
79	8.73	10.61
80	8.24	9.98
81	7.77	9.38
82	7.32	8.81
83	6.89	8.27
84	6.48	7.76
85	6.11	7.28
86	5.77	6.83
87	5.47	6.41
88	5.20	6.02
89	4.95	5.66
90	4.74	5.33
91	4.54	5.03
92	4.36	4.75
93	4.19	4.50
94	4.03	4.28
95	3.87	4.07
96	3.73	3.88
97	3.60	3.71
98	3.47	3.55
99	3.35	3.40
100	3.24	3.26

Australian Life Tables 2000-2002, Australian Government Actuary

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If you have any questions or require more information, we recommend you speak to your financial adviser or contact Macquarie:

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