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Legislated means test changes and advice opportunities

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As advised in the February 2019 issue of Challenger TechNews, legislation for the new social security means test assessment of lifetime income streams (contained within the Social Services and Other Legislation Amendment (Supporting Retirement Incomes) Bill 2018) passed parliament on 14 February 2019. This legislation subsequently received Royal Assent on 1 March 2019.

These new rules present significant opportunities for retirement income advice, both before and after 1 July 2019.

The new income and assets test assessments for lifetime income streams will commence from 1 July 2019. Grandfathering provisions will apply to lifetime income streams that commence prior to this date.

These new rules present significant opportunities for retirement income advice, both before and after 1 July 2019.

The new rules will not apply to fixed term annuities and income streams, account-based pensions, defined benefit income streams or asset-test exempt income streams (for example term allocated pensions).

Income test

The new rules will assess 60% of payments from lifetime income streams under the income test. For example, where a lifetime income stream pays income of $5,000 p.a., $3,000 p.a. will be assessed under the income test.

For deferred lifetime income streams purchased using superannuation, the assessment will apply once income payments commence, i.e. no income assessed during the deferral period.

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Assets test

For new lifetime income streams that meet the Capital Access Schedule (CAS) in the Superannuation Industry (Supervision) (SIS) Regulations 1994 (introduced as part of the "Innovative Superannuation Income Streams" Regulations 2017) and where the individual has reached their 'assessment day', 60% of its purchase amount will be assessed as an asset until the life expectancy of a 65 year old male, currently age 84, or for a minimum of five years. After this, the assessment reduces to 30% of the purchase amount for the rest of the person's life.

The 'assessment day' is a new concept that is designed to determine when the new rules will apply to lifetime income streams. The definition is quite complex however for many retirees, this will generally be the day the income stream is purchased.

If the new lifetime income stream provides a surrender value and/or death benefit above the CAS, the assets test assessment will be based on the greater of:

- The amount assessed as above (60% until age 84 with a minimum of 5 years, 30% thereafter);
- Any current or future surrender value above the limits in the CAS; and
- Any current or future death benefit above the limits in the CAS.

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Comparing the current means test rules with the new rules

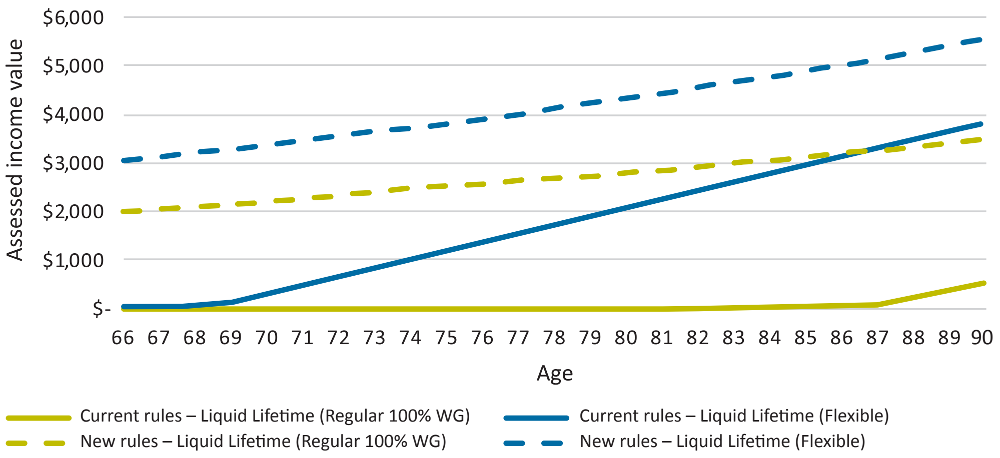
Table 1 and Charts 1 and 2 below summarise the comparison between the current and new social security assessment of lifetime annuities including Challenger lifetime annuities.

Table 1: Comparison of current and new means test rules for lifetime annuities

	Current rules	New rules	Challenger Liquid Lifetime annuity
Income Test	Regular payment less deduction amount	60% of regular payments	Regular, Flexible, and Enhanced options
Assets Test – declining capital access schedule	Purchase price less (deduction amount x term elapsed)	60% of purchase price until age 84 (minimum of 5 years), 30% thereafter	Flexible and Enhanced options
Assets Test – does not meet declining capital access schedule	Purchase price less (deduction amount x term elapsed)	Greater of: • Above assessment; • Current or future surrender value; • Current or future death benefit	Regular option

Note: Deduction amount equals purchase price (net of any commutations) divided by life expectancy

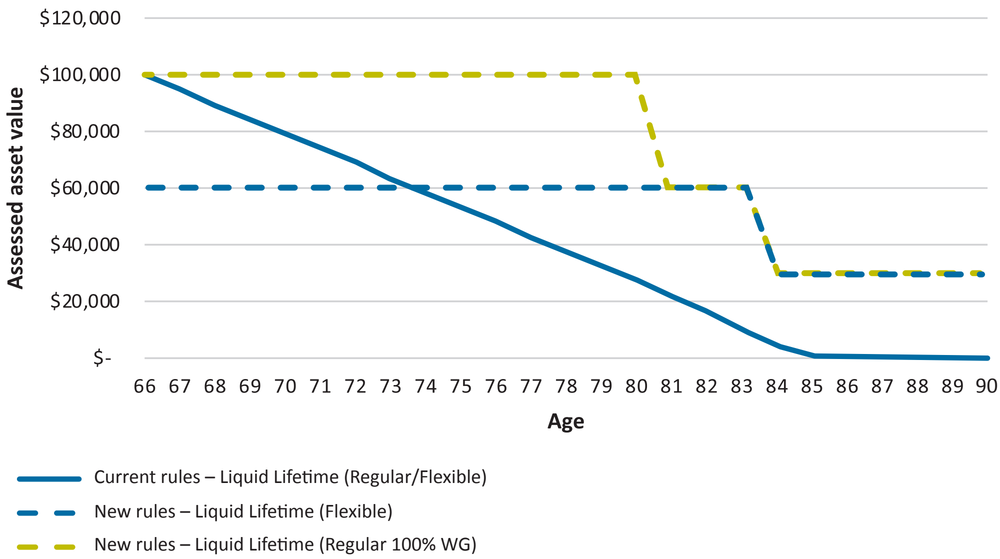
Chart 1: Comparison of the income test assessment over time for Challenger lifetime annuities under the current and new rules



Assumptions: Based on a Challenger Liquid Lifetime annuity quoted on 18/3/2019 for a 66-year old male with an investment amount of $100,000, monthly payments in the first year totalling $5,096 for Liquid Lifetime Flexible (maximum withdrawal period of 17 years) and $3,242 for Liquid Lifetime Regular (100% withdrawal guarantee), CPI indexation (assumed to be 2.5% p.a.) and nil adviser fees.

Chart 2 below compares the current assets test assessment over time with the new rules applying from 1 July 2019.

Chart 2: Comparison of the assets test assessment over time for Challenger lifetime annuities under the current and new rules



Assumptions: Based on a Challenger Liquid Lifetime annuity Flexible Income option (complies with CAS) and Regular Income option (with a withdrawal guarantee of 100% at year 15 and does not comply with CAS) for a 66-year old male with an investment amount of $100,000 quoted on 18/3/2019.

Observations: Comparing the current and new rules

While the new rules only assess 60% of payments, the new rules generally produce higher assessable income compared to the current rules which utilise a deduction amount.

The new assets assessment provides an initial concession under the assets test and maintains this concession for a period of time before providing a further concession in the future. However, unlike the current rules, the assets assessment will never reach nil.

These differences mean assets tested part pensioners who incorporate a lifetime income stream into their retirement portfolio from 1 July 2019 will likely experience higher Age Pension entitlements in the early years when compared to incorporating a lifetime income stream today.

In the later years however, many retirees have their Age Pension assessed under the income test due to lower levels of assessable assets. At that stage Age Pension entitlements will likely be lower from the less favourable income test assessment.

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A practical application

Consider Linda and Leon (both age 66) who retired with $300,000 each in superannuation. They are balanced investors with a 50/50 growth/defensive asset allocation. In addition, they have $50,000 in the bank for liquidity and personal assets of $20,000. They desire $60,000 p.a. income to fund their retirement but as a minimum require $42,000 to meet needs and essentials.

They have allocated $75,000 (25% of their portfolio) each to a lifetime annuity to help fund their needs and essentials for their lifetimes. This also ensures they're never solely reliant on a single source of income, i.e. the Age Pension.

Chart 3 projects their retirement income under the current rules and Chart 4 under the new rules.

Chart 3: Linda and Leon's projected retirement income under the current rules

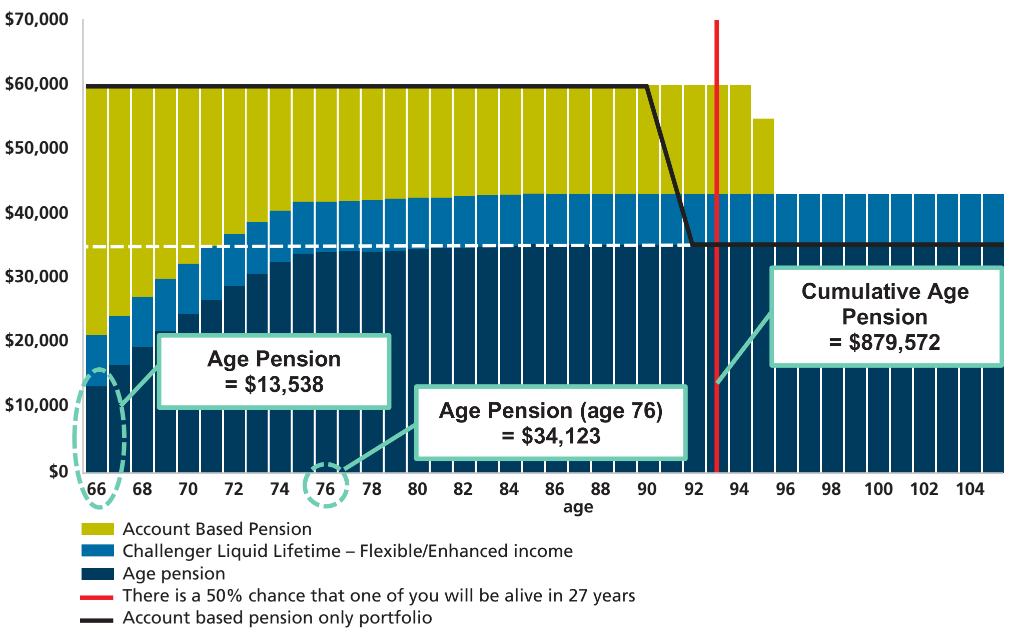
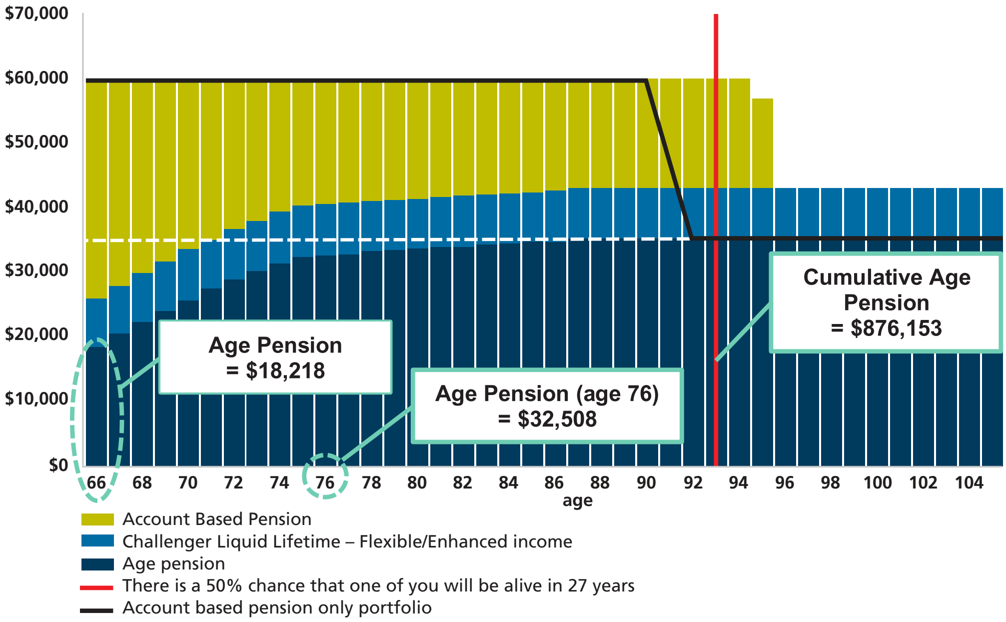


Chart 4: Linda and Leon's projected retirement income under the new rules



Assumptions and source: Challenger Retirement Illustrator (beta version) July 2018. Values are in today's dollars. Please refer to the appendix for assumptions used.

Under the new rules, Linda and Leon experience a higher Age Pension entitlement in the early years ($4,680 higher in the first year) due to the immediate assets test concession. However, this is offset by a lower Age Pension entitlement in the later years due to a higher income test assessment, for example $1,615 lower at age 76.

Regardless, in each scenario their retirement outcomes are broadly similar, with an additional layer of lifetime income in addition to the Age Pension to meet their 'needs' and their account-based pensions depleting by age 95.

Strategic opportunities prior to 1 July 2019

The commencement date of 1 July 2019 for the new rules as well as grandfathering provisions for existing lifetime income streams creates some immediate strategic opportunities.

Income tested clients

The first opportunity is available to income tested pensioners or asset tested pensioners who will become income tested over the short term.

For these clients, and where appropriate, commencing a lifetime income stream prior to 1 July 2019 can provide better Age Pension outcomes as the income test assessment under the current rules (based on a deduction amount) are generally more favourable than the new assessment.

Clients who prioritise capital preservation over income

The second opportunity is available to clients who prioritise access to capital, instead of higher income throughout retirement, and looking to use a lifetime income stream that features liquidity greater than the amount allowed by the CAS.

For these clients, accessing lifetime income streams that offer a withdrawal value higher than the CAS before 1 July 2019 (and grandfathered under the current rules) can

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provide higher Age Pension outcomes. Where such an income stream was used on or after 1 July 2019 any higher withdrawal/death benefit value will be assessed under the Assets Test instead of any current declining assessment or the 60%/30% assessment under the new rules.

Example: Using the Challenger Liquid Lifetime (Regular income option) before 1 July 2019 for clients who prioritise capital preservation

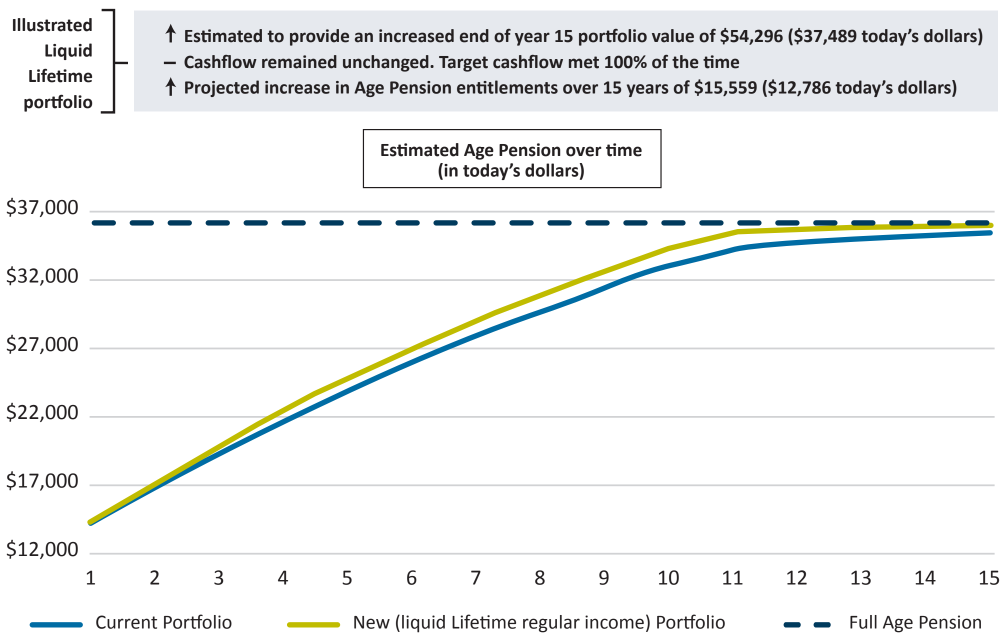
Assume that Linda and Leon in the previous case study prioritise being able to access and preserve their capital over higher income from an annuity for their lifetime. Under this scenario, they could instead allocate 25% ($75,000 each) of their superannuation to the regular income option of the Challenger Liquid Lifetime annuity.

The regular income option provides Linda and Leon with total payments of $7,500 p.a. and the option to withdraw their annuity during the first 15 years and if withdrawn at the end of year 15, received 75% of their initial investment ($112,500 in total).

Compared to an account-based pension only retirement portfolio (as summarised in Chart 5), the investment in the Lifetime annuity:

- provides them with the same $60,000 p.a. cash flow,
- can help increase their Age Pension entitlements by $15,559 ($12,786 in today's dollars) via the deduction amount, and
- increase their portfolio value by $54,296 at the end of year 15 ($37,489 in today's dollars and includes the withdrawal value of the annuity).

Chart 5: Linda and Leon's projected Age Pension entitlements over 15 years



Source: Challenger Age Pension calculator as at 18/03/2019. Please refer to the appendix for assumptions used.

Appendix – Assumptions used in Charts and Tables

Charts 3 and 4:

- Centrelink rates and thresholds as at 1 July 2018.
- Challenger annuity quote as at 26/07/2018 and based on the flexible income option, monthly payments indexed to inflation, nil adviser fees and maximum withdrawal period.
- Assumes lifetime annuities form part of defensive assets. To maintain an overall asset allocation of 50/50 growth/defensive (including the allocation to the defensive lifetime annuity), the asset allocation of the account-based pensions has been changed to 67/33 growth/defensive.
- Account-based pension growth assets return 7.70% p.a. and defensive assets, 3.70% p.a. before management fees of 0.80% and 0.60% respectively. In addition, platform fees are assumed to be 0.50%.
- Interest for the $50,000 held in cash is assumed to be nil.

Chart 5:

- Under the scenario that incorporates Challenger lifetime annuities, the asset allocation of the account-based pensions has been changed to 67/33 growth/defensive to maintain an overall asset allocation of 50/50 growth/defensive (including the allocation to the defensive lifetime annuity.
- Account-based pension growth assets return 7.70% p.a. and defensive assets, 3.70% p.a. before management fees of 0.80% and 0.60% respectively. In addition, platform fees are assumed to be 0.50%.
- Interest for the $50,000 held in cash is assumed to be nil.
- Challenger Liquid Lifetime (regular income option) quote as at 18/03/2019 with monthly payments not indexed and nil adviser fees.

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