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What happens next…

Understanding the equity and (unintended) genius of the superannuation lifecycle

Thanks to smoke screens, misinformation and the political chicanery from both sides of politics (and industry participants) there are many Australians who don't fully understand the super lifecycle, specifically, how the 'drawdown' phase of superannuation works.

InvestSMART readers are by nature, good accumulators. But taking the next step (i.e. getting up to speed on how the super rules interact in planning and managing the retirement income drawdown phase) means getting past some common misconceptions.

From where I sit, calls for additional Deferred Annuity* products lack insight and understanding; worse, they risk being interpreted as self-serving. The current system works perfectly well; and as financial services professionals we have a responsibility to ensure that the system is properly understood.

To demonstrate the misconceptions which commonly abound, I will use the example of a couple both aged 65, who we will call Simon and Anne.

Their combined super pool is $2 million ($1 million each) and based on a conservative return of 6.6% pa, Simon is planning on a combined tax free 'take home pay' of $100,000 pa from their respective Account Based Pensions# – and he is delighted with this prospect.

He is also planning on an eventual inheritance of $1 million for each of their 2 children from their super. What Simon has not taken into account, however, is that **funds in the tax-exempt pension phase of superannuation are designed to be spent**, hence there are rules around compulsory drawdowns.

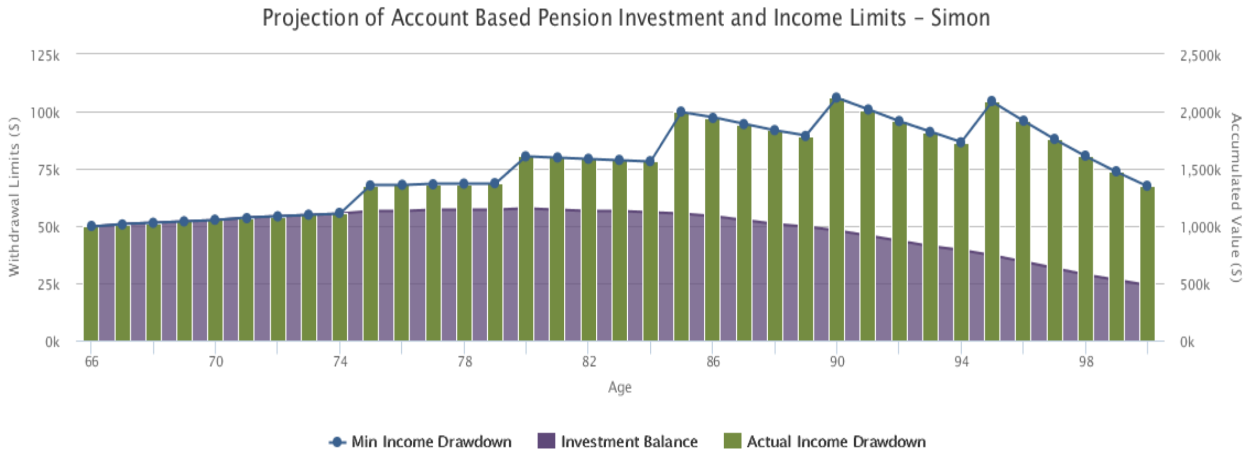
Prior to COVID-19, the minimum income levels required to be drawn from retirement income streams were based on the following percentages, in line with designated age ranges:

Age	Annual payment as % of account balance
55—64	4%
65—74	5%
75—79	6%
80—84	7%
85—89	9%
90—94	11%
95+	14%

Annual Pension Payment Rate information source: https://www.mlc.com.au/personal/retirement/super-and-retirement-rules/pension-drawdown-requirements accessed 18 July 2020.

Note: The government has recently legislated to reduce these levels by 50% to allow retirees to preserve their capital during these unusual times. This is a temporary measure, and normal limits will eventually be reinstated, as they were after the GFC.

The minimum pension drawdown rate, as mandated by the government actuary, is intended to act as retirement income ‘glide plane’ and designed to provide an indexation factor to the future income to be drawn, as illustrated by the following graph:



Projection of Account Based Pension Investment and Income Limits for a Single client with $1,000,000 balance at age 65. Assumptions: Income 3.71%, Franked 31.76%; Growth 2.859%; Total Return 6.6%, Total ongoing fee 0.3%.

Based on these projections, if the minimum pension is drawn every year, Simon and Anne should not run out of pension income well past 100 years of age. The pension income they receive in their later years will be an indexed amount equivalent to approximately the purchasing power of what they received at the start!

And here is the point – an Account Based Pension (ABP) is NOT meant to provide your income needs without touching the original capital, nor is it meant to be a tax-exempt estate planning vehicle. An ABP is designed specifically to return income and original capital, over time. If you live long enough, the demise of your capital should coincide with yours. If you don’t live long enough, your estate will receive the remaining proceeds.

Between the ages of 65 and 74, most people who are relatively fit want to travel – remember that? To enjoy the fruits of their labour, sometimes they purchase a caravan and a four-wheel drive vehicle – or perhaps, they build a beach house.

From our previous example, however, Simon fears that if he draws down more than the minimum from his ABP, he will run out of money. In reality, drawing more than the minimum in early years just means that Simon and Anne will exhaust the funds in their ABP sooner, or will receive less than the equivalent of $100,000 pa in future dollars in their later years – but that will be at a time when they will generally need less disposable income.

If they are frugal (as is the case with many retirees) and live on the prescribed ABP minimum income, what do they do if they are awash with disposable income in their later years?

Well, they could give it away; many pay their grandchildren’s private school fees. Others, with professional guidance, are contributing to the superannuation funds of their children. And some are donating to charities they care about. **A note of caution – giving money away may affect your future eligibility for any Centrelink aged pension, also part of this discussion.**

But now to another misconception.

Self-funded retirees like Simon and Anne often complain about the fact that unlike Age Pension benefit recipients “they don’t get any government support in retirement”.

Based on a taxable income of $50,000 each (instead of their combined tax exempt ABP income of $100,000) they would normally pay approximately $15,000 in tax and Medicare Levy. In contrast, they pay no tax at all on their ABP income.

Further, their ABP is also internally tax exempt (i.e., no tax is paid on investment earnings), their funds also currently receive a tax refund of the imputation credits attached to their ABP share investments, and they pay no CGT within their pension portfolio.

In other words, Simon and Anne’s $2 million within the ABP environment is completely tax exempt. Coincidentally, these combined savings are very similar to the combined age pension of around $37,000 pa.

This means regardless of whether you are 100% self-funded, receiving part age pension and part self-funded, or receiving 100% Age Pension benefits, the support Simon and Anne receive from the government (either in tax savings and/or Age Pension benefits) is remarkably similar and equitable.

Of course, if Simon and Anne have a flagrantly irresponsible early retirement and spend all but $370,000 of their capital, they may then become entitled to the Centrelink Age Pension (currently a combined benefit of approximately $36,000 pa).

So, on top of the $18,500 pa their ABP would generate (assuming annual earnings @ at 5.0%) they would have, hopefully, by this stage in their later years, an annual income of $55,500 – which would still be tax free. It is also likely they would be quite comfortable on this amount, as based on my observation, the older we get, the less we spend.

And whilst I cannot really foresee a situation where a well-advised couple with $2 million in super at age 65 would find themselves in this scenario, it is comforting to know there is a backstop built into the retirement system.

Which once again begs the question – can the so-called industry ‘experts’ please explain why we need a Deferred Annuity system when clearly, the Age Pension fulfils that role?

On Simon’s prior death, Anne will inherit any remaining ABP balance and continue to live well financially – although should she have the ‘Methuselah’ gene, as projected in the previous graph, their remaining super is on target to be exhausted by the time she turns 100+.

My advice? Don’t worry too much about providing inheritances. Hopefully, by the time your children receive your estate (including the remaining balance in your ABP) they will be in their 50s and their kids at university. However, a well-planned strategy and continued property ownership is likely to leave a substantial estate.

Relax, enjoy your retirement and ignore the self-serving critics of the superannuation and ABP system. It is well designed and fit for purpose to provide a supplement to the Age Pension, or a tax-exempt self-funded retirement income to ensure that we can ALL enjoy a fantastic retirement.

All that is needed is to understand how an ABP is meant to work, and to appropriately allocate the underlying investments (including adequate defensive assets from which to pay pension during volatile periods). An ABP should be rebalanced regularly, and the nominated minimum pension drawn each year.

**A Deferred Annuity is a contract that promises to pay the buyer a regular income or a lump sum of money at some date in the future. Immediate annuities, by contrast, start paying right away. Many deferred annuities are structured to provide income for the rest of the owner's life and sometimes for their spouse's life, as well.*

#An Account Based Pension (ABP) is simply another name for a 'Variable Annuity' (as they were originally called in the mid to late 1980s when these products first came in to being). Later Variable Annuities became 'Allocated Pensions' and now 'Account Based Pensions' but they are all one and the same.

Note: This article is written based on rules and limits which apply in July 2020.

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