HOW LIFETIME INCOME PRODUCTS CAN HELP REDUCE THE 'TAPER TRAP' FOR RETIREES

Jim Hennington and David Orford

18 March 2024

OPTIMUM PENSIONS

Table of Contents

A major issue with retirement planning for some people is the way the Centrelink assets test penalises people who have saved more.

Only 44% of Australians who have reached their Age Pension age, receive the full Age Pension.

A further 20% receive a part pension – where the amount of income they receive varies over time depending on how much their assessable assets/incomes exceeds a particular threshold.

he remainder (36%) either haven't claimed the Age Pension, don't meet other eligibility criteria (such as residency rules) or because their assets or incomes are so high that the amount payable cuts out completely.

This makes planning difficult.

The good news is that for some retirement products, only 60% of their value counts toward the means tests.

Knowing these rules can potentially help to secure a higher and more stable income from the Age Pension.

Who gets impacted by means testing?

The assets test threshold, above which a retiree starts to get a reduced Age Pension, is $451,500 for couples who own their own home ($301,750 for singles). The value of their home doesn't count towards this figure.

For non-homeowners, the assets test threshold is $693,500 for couples and $543,750 for singles. These figures are as of February 2024. An income test also applies.

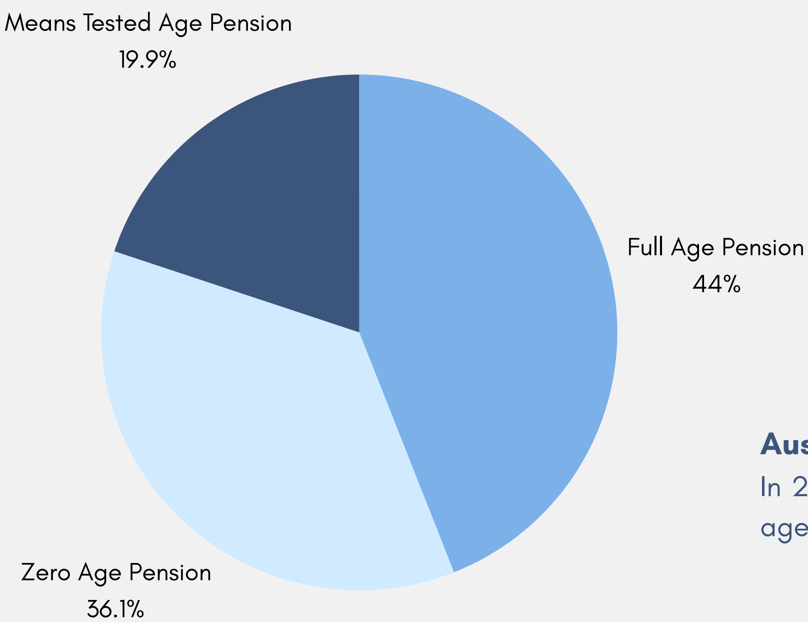
Most people also enter retirement as couples, so they need to consider all of their combined superannuation and savings when considering the means tests. The rules apply to each household's *combined total assets* including all super accounts (other than the accumulation super balance of a younger spouse), cash accounts, term deposits, shares, investment properties and personal assets such as cars and furniture.

To understand what the total assessable assets figure looks like for typical retiree, ABS statistics show the average household in the age 65-74 group has net assets of $1.05 million *plus* the value of their home, if they own one. But averages can be misleading as a small number of very wealthy people can push the figures up significantly.

The median super balance (that is, half of people are above and half are below) for males aged 60 to 64 is around $212,000 and for females it's $159,000. The median household in this group has net worth of $927,000 *including* the home, if they own one.

These figures are expected to rise rapidly as each generation of retirees spends a higher proportion of their careers subject to compulsory super contributions.

In 2023, more than half of retirees who are old enough received either a reduced Age Pension due to means testing or no Age Pension. This is shown in the following chart.



Australians on the Age Pension
In 2023 there were 4 million people aged 67 and above.

What is the ‘Taper Trap’ ?

Under the assets test, each $1,000 of assets above the thresholds means that household’s Age Pension income is reduced by $78 per year (7.8%). This is called the ‘taper rate’.

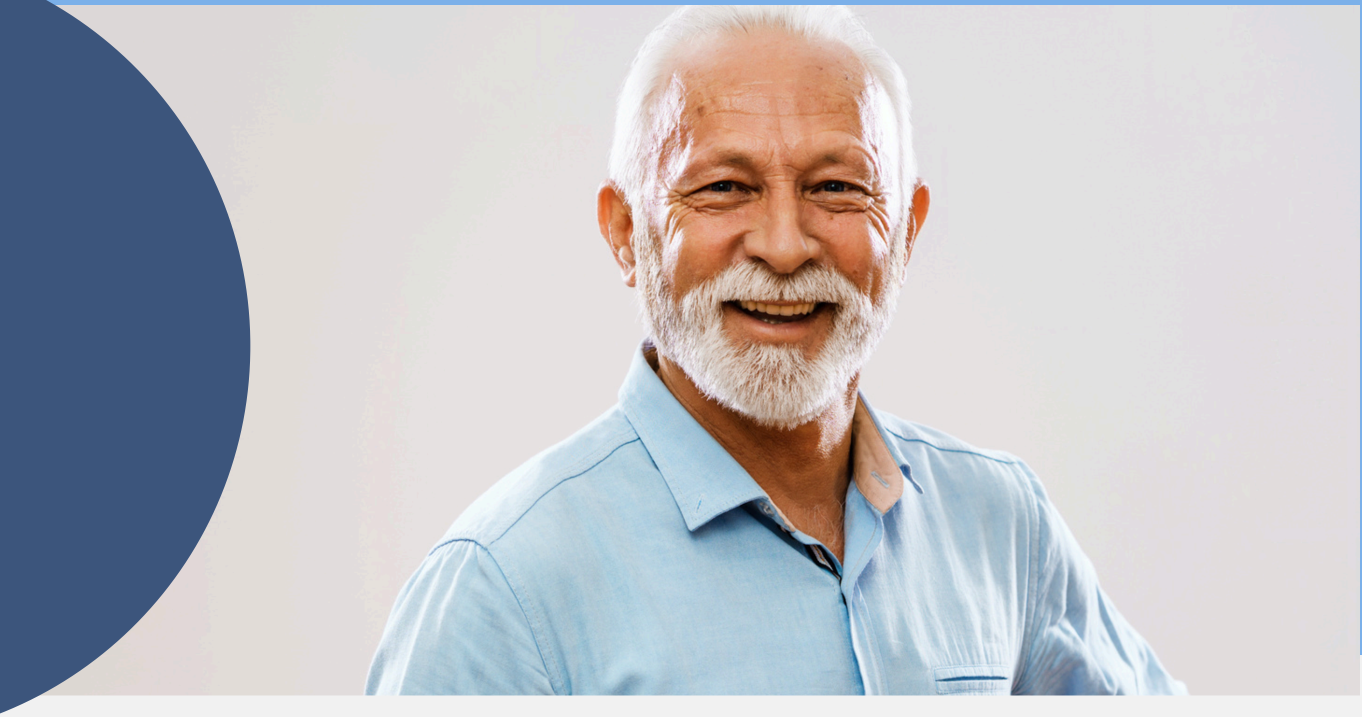
It can be difficult to reliably earn an investment return of 7.8% (net) per year in retirement, which means that people affected can lose more in Age Pension than they earn on that extra money. This issue is referred to as the ‘taper trap’. Read more about the Taper Trap.

How can new retirement products help?

In the past, the only retirement product offered by most super funds was an account-based pension (ABP). With an account-based pension, your super can remain invested in your chosen investment option(s) but you must make withdrawals from that balance each year as your retirement income.

With an account-based pension, the full balance in the account is counted towards the assets test for means-testing purposes.

Fortunately, government policy is pushing super funds to offer new products that help with these issues - and several funds and insurers have added ‘lifetime’ income products to their retirement offering.



With a lifetime income product, you transfer some of your super (or other savings) into a product that instead pays a contractually defined level of income to you for the rest of your life (and for the life of your spouse if you choose) – even if you live to age 100 or more.

For customers who experience an untimely death and the amount of income they have received is less than their initial investment, most lifetime income products can offer a lump sum benefit which protects the purchaser and their estate from losing the initial investment.

Previously referred to as annuities, rule changes have opened up a much broader range of products that pay lifetime incomes. This includes investment-linked annuities where the income payments are guaranteed to continue for life but the level of those payments varies over time to reflect the performance of your chosen investment option(s), which you can change from time to time.

Find out which funds offer income for life.

Read more about annuities.

How are lifetime products treated for the Age Pension?

Only 60% of the purchase price of a lifetime income product counts towards the assets test. After age 84 (or a minimum of five years), only 30% of the purchase price counts.
Only 60% of the income paid from all lifetime income product counts towards the income test. This means lifetime income products can help means-tested pensioners achieve higher, more predictable and more stable income from the Age Pension.

How do the calculations work?

The means-testing rules apply differently for lifetime income products than they do for account-based pensions, as follows. For ease of understanding, we have omitted additional detail that applies to rounding these figures.

In summary, there is an assets test - which takes into account your **assessable assets.** And an income test - which takes into account your **assessable Income.**

The Age Pension you receive is the lower of these two results.

Assessable Assets

Excludes your own home you live in, but includes financial investments (includes cash, term deposits, managed investments, shares, super balances), personal assets, other real estate, the value of a business and value of any annuities.

Assessable Income

Includes most types of income including employment earnings (subject to a 'work bonus'), commissions, rental income, deemed income from financial investments, income from a business interest, farm, private company and royalties.

The full Age Pension for a couple is $42,988 per year and for singles it's $28,514 per year (as at February 2024).

Account-based pension mean-testing formulas	Lifetime income product means-testing formulas
The Age Pension payable is the lower of the assets test result and the income test result, below.	**The Age Pension payable is the lower of the assets test result and the income test result, below.**
Assessable asset value = 100% of the balance **Assessable income value** = deemed amount* * Deemed income is an assumed percentage of the balance, as follows: oFirst band**: 0.25% p.a. oRemaining balance: 2.25% ** The first band for couples relates to amounts up to $100,200 and for singles it's $60,400	**Assessable asset value** = 60% of the purchase price* **Assessable income value** = 60% of the actual income paid * The percentage of purchase price gets reduced to 30% after age 84 (or a minimum of 5 years) - so less counts toward means testing.
Assets Test Result: Age pension under assets test = Full Rate per year – (assessable assets value - threshold) x 7.8% Note that with an ABP, the balance may increase for a few years but typically then declines over the course of retirement as the balance gets drawn down and can run out. This can result in a higher assets test result as the superannuation balance decreases.	**Assets Test Result:** Age pension under assets test = Full Rate per year - (assessable assets value – threshold*) x 7.8% The income test threshold for couples is currently $9,360 per year and for singles it's $5,304 per year. Note that with a lifetime income stream, the purchase price is fixed at the time of buying the product. This results in a steady assets test result over the course of retirement – which improves when the 30% rate subsequently applies.
Income Test Result: Age pension under income test = Full Rate per year – 50% x (Assessable income value – threshold) Note that the assessable income value reduces if the balance reduces. This can result in a higher income test result as the superannuation balance decreases.	**Income Test Result:** Age pension under Income Test = Full Rate per year – 50% x (assessable income value – threshold) Note that the assessable income can increase faster or slower than increases in the threshold over time – depending on the product's rules and investment returns.

Hence it can be difficult to generalise about which test applies to different household's situations over the course of retirement. See the case studies below.

To simplify the case studies, we have assumed in each case study that there are no assets or income sources other than superannuation balances and the Age Pension.

Case Study 1

Single 70-year-old homeowner with $450,000 in superannuation.

Currently, this retiree receives a reduced Age Pension because of the assets test. His assets above the applicable threshold of $301,750 are multiplied by the taper rate (7.8%) and result in a reduction in his Age Pension of $11,564 per year.

The full Age Pension calculations based on this account-based pension are as follows:

Actual assets

Account-based pension balance = $450,000

Actual income from super:

Minimum drawings from account-based pension
= 5% x $400,000
= $20,000 per annum

Assessable assets for asset test:

Assessable assets
= $450,000

Age pension under assets test
= $28,514 per year – ($450,000 - $301,750) x 7.8%
= **$16,950**

Assessable income for income test:

Assessable income from ABP is 'deemed' to be:
oFirst $60,400 x 0.25%
Remaining $389,600 balance x 2.25%
= $8,917 per annum

Age pension under income test
= $28,514 per year – 50% x ($8,917 - $5,304)
= **$26,707.50**

Is assets test or income test lower? Assets Test (left hand column)
Age Pension payable = $16,950 per year

His combined income from super and the Age Pension = $20,000 + $16,950 = **$36,950 per annum**

Single 70-year old homeowner who transfers $250,000 from his account-based pension into a new investment-linked lifetime income stream.

If he switches $250,000 into the lifetime income product then this might him pay a starting level of income of $15,500 per annum[1]. His Age Pension calculation would change significantly.

The assets test (and taper rate trap) no longer impact him.The income test is the relevant one instead, as follows:

Actual assets
-Account-based pension balance = $200,000
Lifetime product (purchase price) = $250,000

Actual Income from super:
-5% (min) x $200,000 from ABP
-$15,500 pa from lifetime income product

Total = $25,500 per annum

Assets test:

Assessable assets:
-ABP : $200,000, plus
-Lifetime product: 60% x $250,000
Total = $350,000

Age Pension under assets test
= $28,514 per year – ($350,000 - $301,750) x 7.8%
= $24,750.5

Income test:

Assessable income:
-Deemed income from ABP:
oFirst $60,400 x 0.25%, plus
oRemaining $139,600 balance x 2.25%
= $3,292, plus
-Lifetime product:
o60% x $15,500
Total = $12,592

Age Pension under income test
= $28,514 per year – 50% x ($12,592 – $5,304)
= $24,870

Assets test or income test lower? Assets test (left hand column)
Age Pension payable = $24,751 per year

His combined income from super and the Age Pension = $25,500 + $24,751 = $50,251 per annum
That's $13,301 higher than when his money was all in an account-based pension.

[1] Based on rates from Generation Life, using a 2.5% LifeBooster rate. Income increases each year at rate of investment return less charges less 2.5%. A higher income that increases at a slower rate is possible using the 5% LifeBooster rate.

To simplify the case studies, we have assumed in each case study that there are no assets or income sources other than superannuation balances and the Age Pension.

Case Study 2

A 72-year-old couple with $700,000 in superannuation.

Currently, this couple receive a reduced Age Pension because of the way the asset test applies to their account-based pension. Their assets above the applicable threshold of $451,500 are multiplied by the taper rate (7.8%) and result in a reduction from their Age Pension of $19,383 per year.

The full Age Pension calculations based on this account-based pension are as follows:

Actual assets

Account-based pension balance = $700,000

Actual income from super:

Minimum drawings from account-based pension
= 5% x $700,000
= $35,000 per annum

Assessable assets for asset test:

Assessable assets
= $700,000

Age pension under assets test
= $42,988 per year – ($700,000 - $451,500) x 7.8%
= **$23,605**

Assessable income for income test:

Assessable income from ABP is 'deemed' to be:
oFirst $100,200 x 0.25%
oRemaining $599,800 x 2.25%
= $13,746 per year

Age pension under income test
= $42,988 per year – 50% x ($13,746 - $9,360)
= **$40,795**

Is assets test or income test lower? Assets test (left hand column)
Age Pension payable = $23,605 per annum

Their combined income from super and the Age Pension = $35,000 + $23,605 = **$58,605 per year.**

Single 70-year old homeowner who transfers $250,000 from his account-based pension into a new investment-linked lifetime income stream.

If he switches $250,000 into the lifetime income product then this might him pay a starting level of income of $15,500 per annum[1]. His Age Pension calculation would change significantly.

[1] Based on rates from Generation Life, using a 2.5% LifeBooster rate. Income increases each year at rate of investment return less charges less 2.5%. A higher income that increases at a slower rate is possible using the 5% LifeBooster rate.

72-year old homeowner couple who transfer $350,000 from their account-based pensions into a new investment-linked lifetime income stream. They opt for a product that continues to pay 65% of the income level if one spouse passes away[1].

If they switch $350,000 into the lifetime income product then this might then pay a starting level of income of $22,500 per year[1]. His Age Pension calculation would then be:

Actual assets

-Account-based pension balance = $350,000
-Lifetime product (purchase price) = $350,000

Total = **$700,000**

Actual income from super:

-5% (min) x $350,000 from ABP
-$22,500 pa from lifetime income product

Total = $40,000 per year

Assets test:

Assessable assets:
-ABP : $350,000, plus
-Lifetime product: 60% x $350,000
Total = $560,000

Age Pension under assets test
= $42,988 per year –($560,000 - $451,500) x 7.8%
= $34,525

Income test:

Assessable income:
-Deemed income from ABP:
o First $100,200 x 0.25%, plus
o Remaining $249,800 x 2.25%
= $5,871, plus
-Lifetime product:
o 60% x $22,500
Total = $19,371

Age Pension under income test
= $42,988 per year – 50% x ($19,371 - $9,360)
= $37,982.50

Assets test or income test lower? Assets test (left hand column)
Age Pension payable = $34,525 per annum

Their combined income from super and the Age Pension = $40,000 + $34,525 = $74,525 per year
That's $15,920 higher than when their money was all in an account-based pension.

[1] The income level assumed is based on rates from Generation Life, using a 2.5% LifeBooster rate and a 65% reversionary spouse's pension. Income increases each year at rate of investment return less charges less 2.5%. A higher income that increases at a slower rate is possible using the 5% LifeBooster rate.

[1] Ibid (ditto)

If we consider eight different 70-year-old couples, each with different levels of superannuation, the impact of putting half their balance into the lifetime income product can be seen in the table below.Each couple own their own home and have no other assets or income.

Super Balance	100% in an account-based pension			50% in an account-based pension 50% in a lifetime income product		
	Income from super per year	Age Pension per year	Total income per year	Income from super per year	Age Pension per year	Total income per year
$200,000	$10,000	$42,988	$52,988	$11,000	$42,988	$53,988
$400,000	$20,000	$42,988	$62,988	$22,100	$42,793	$64,893
$600,000	$30,000	$31,405	$61,405	$33,100	$39,854	$72,954
$800,000	$40,000	$15,805	$55,805	$44,200	$28,285	$72,485
$1,000,000	$50,000	$2,241	$52,241	$55,200	$15,805	$71,005
$1,200,000	$60,000	$0	$60,000	$66,300	$3,325	$69,625
$1,400,000	$70,000	$0	$70,000	$77,300	$0	$77,300
$1,600,000	$80,000	$0	$80,000	$87,300	$0	$87,300

TAPER TRAP

TAPER TRAP

The need for projections

It's important to remember these figures are not static over the course of retirement. The level of income, the assessable asset value and the assessable income from an accountbased pension all change over time as the balance moves in line with investment performance and withdrawals made.

Likewise with the lifetime income product: the level of income can change over time in accordance with the product's rules. This impacts the assessable income value for means testing purposes. (The assessable asset value is based on the purchase price which is a fixed amount).

It's therefore important to consider the time dimension of these decisions.

The bottom line

You can see in the table above which is based on the current rules and rates, by allocating half their super to the lifetime product the taper trap problem is greatly reduced for these couples and their income is increased, substantially in some cases. The effect of the taper rate does persist (mainly because of the account-based pension product) but is greatly reduced. As the calculations will be different for everyone, and the projected amounts, bands and thresholds change over time, we recommend you seek financial advice before determining the most appropriate retirement income solution for your needs and circumstances.

OPTIMUM PENSIONS

About the Authors

DAVID ORFORD

David, an actuary, founded Financial Synergy, which became Australia's leading provider of superannuation administration software. After successfully selling the business to IRESS in 2016, he is now devoting his time to researching and creating innovative retirement solutions, and directing The Orford Foundation.

JIM HENNINGTON

Jim is a recognised thought leader on retirement income strategy and modelling. An actuary, he is involved in product design and developing modelling tools to make Optimum Pensions' products accessible to superannuation funds, financial planners and retirees.

FOR MORE INFORMATION

Any questions or comments regarding this document should be directed to:

PETER ROWE
GENERAL MANAGER, OPTIMUM PENSIONS

+614 0774 7802
peter@optimumpensions.com.au

Optimum Pensions was launched in 2017 with a single mission - to help Australians lead a comfortable retirement. The Optimum Pensions innovative retirement income solutions are specifically developed to address longevity risk and provide greater peace of mind for all retirees; no matter how long they live.

The Optimum Pensions, award-winning LifeSpan Calculator builds confidence around personal life expectancy and retirees' possible retirement planning horizon.

OPTIMUM PENSIONS