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How should I structure a lifetime income stream for a client?

By Michael McLean, Technical Services Manager

A lifetime income stream including a lifetime annuity, can provide secure, regular income for life, providing clients with peace of mind in retirement regardless of how long they live or how investment markets perform. Once a decision has been made to invest into a lifetime income stream, advisers can consider who owns the income stream for partnered clients and how much to allocate to it.

We approach this issue in two parts. In this article, we address some of the considerations relating to which spouse should own the lifetime income stream. The second part of this article, expected in early 2020, will further explore how to structure a lifetime income stream by discussing how much clients should invest in a lifetime income stream.

Once a decision has been made to invest into a lifetime income stream, advisers can consider who owns the income stream for partnered clients and how much to allocate to it.

Part 1 - Which spouse should own their lifetime income stream?

Whilst there is no simple answer to this question because each scenario will be different, advisers can take into account cash flow, Centrelink, capital access and tax considerations to determine the most appropriate ownership option for lifetime income streams.

It is interesting to know that 54% of Age Pensioners are partnered[1], which might help us understand how many pensioners could be affected by ownership decisions for lifetime income streams.

Rates and thresholds used in this article are as at 11/11/2019 unless otherwise stated.

1 DSS Payment Demographic Data – June 2019.

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What is a Challenger Guaranteed Annuity (Liquid Lifetime)?

The lifetime annuity world has evolved over the last few years. An important concept in the current environment is the declining capital access schedule (DCAS), which came into effect from 1 July 2017. If a lifetime annuity limits access to capital to maximums allowed under the DCAS, the income stream can be a retirement phase super income stream (when purchased with superannuation monies) and does not have to meet the super minimum payment requirements. This DCAS concept is also used for the new Centrelink means testing rules for pooled lifetime income streams which commenced from 1 July 2019. The DCAS shown in Figure 1, is a maximum level of capital which can be accessed throughout the life of the lifetime annuity.

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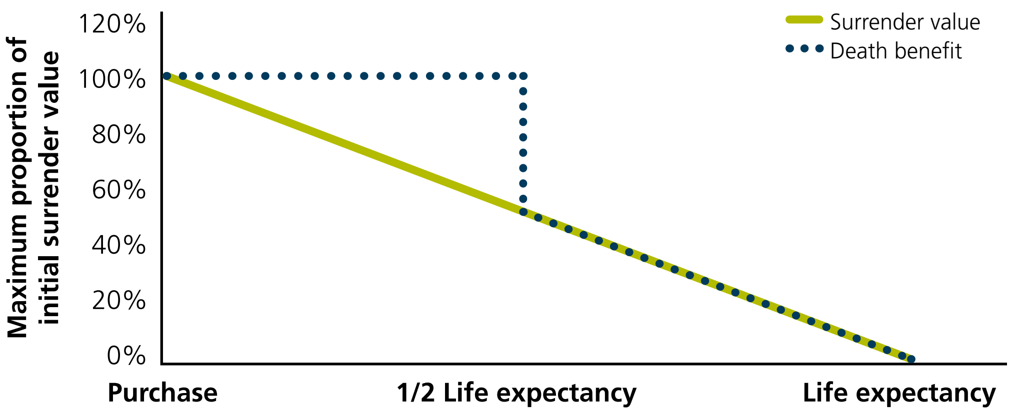
Figure 1: Declining capital access schedule



Source: Department of Social Services – Social Security Guide – 4.9.3.35.

Note: Life expectancy is based on AGA life tables 2010-12 rounded down to the nearest year for lifetime income streams purchased up to 31 December 2019. Lifetime income streams purchased from 1 January 2020 will use the AGA life tables 2015-17 which are not released yet.

There are three Liquid Lifetime options available for clients to choose from:

- Liquid Lifetime Flexible Income (Immediate)
- Liquid Lifetime Flexible Income (Deferred); and
- Liquid Lifetime Regular Income.

Liquid Lifetime Flexible Income (Immediate) will be the focus of this article, which provides lifetime income starting immediately and maximum capital access allowed under the DCAS. For more information on these options please see the Appendix on page seven, or refer to the Challenger Guaranteed Annuity (Liquid Lifetime) PDS.

What are the ownership options for a Challenger Liquid Lifetime Annuity?

Individuals can invest in a lifetime annuity with either super or non-super money. There is the option to add a spouse as a reversionary beneficiary, which means the lifetime annuity would continue for the lifetime of the spouse who lives longer. However, clients can no longer invest in a Liquid Lifetime as an asset of their self-managed super fund (SMSF), trust or company, or jointly with another individual.

We will explore various features which might affect a client's decision to invest in one spouse's name, the other's name, or with a spouse as a reversionary beneficiary.

Income

If maximising cash flow is priority for retiree clients, then the annual payment of a lifetime annuity is important.

Generally, the shorter a person is expected to live, the higher their annual payment. For a male/female couple who are the same age, on average the female will live longer, therefore the male will receive higher payments.

Where a spouse is added as a reversionary beneficiary, then payments would be lower because the lifetime annuity will last for the longer of two lives, not one. Adding a spouse as reversionary beneficiary can help to maintain a regular income level for the surviving spouse upon the death of their partner.

If maximising income is the main priority for your clients, Challenger eQuote can help to understand the annual payments for different options.

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Centrelink

For Liquid Lifetime annuities purchased before 1 July 2019, there was more focus on the Centrelink results for different spouse ownership options – the older spouse had a lower life expectancy, therefore a higher deduction amount, so usually less assessable income and a quicker reduction in assessable assets.

However, for Liquid Lifetime annuities purchased from 1 July 2019, there is less focus on Centrelink results for one spouse owning the Liquid Lifetime or the other, albeit there are some small nuances.

The Centrelink assessment for lifetime annuities, which are purchased from 1 July 2019 and meet the DCAS, such as Liquid Lifetime Flexible Income (Immediate), is:

Income test
Annual payment x 60% (assessable income can change over time with indexation).

Assets test
Purchase price x 60% until the day they turn age 84, or a minimum of five years, then 30% of purchase price thereafter.

There are two key Centrelink considerations for couples who invest in Liquid Lifetime Flexible Income (Immediate) today:

1. Threshold day

The threshold day is the day on which the Centrelink assessable asset value reduces from 60% to 30%. For clients who invest before their 79th birthday, their threshold day will be their 84th birthday. For clients who invest at age 79 or over, then the minimum 5-year rule applies, and their threshold day will be the fifth anniversary of their investment.

Spouses who are both aged 79 or over when they invest will have the same threshold day and therefore the same asset test assessment. That is, no matter which annuity, both will reduce from 60% to 30% assessment on the fifth anniversary of their investment.

For couples where at least one of the spouses is aged less than 79, then the older spouse will reach their threshold day first (either by turning age 84 or in five years' time, whichever is later). This creates an opportunity for partnered clients who prioritise Centrelink benefits. If they invest in the older spouse's name, they will receive an Age Pension increase on the older spouse's threshold day if they are asset-tested at that time.

The threshold day is the day on which the Liquid Lifetime Flexible Income (Immediate) Centrelink assessable asset value reduces from 60% to 30%.

2. Assessable income

   Clients receiving higher payments benefit from higher income, but will have higher assessable income for Age Pension. The 60% assessment of income should be considered for income-tested clients when investing in Liquid Lifetime Flexible Income (Immediate).

Access to capital

Considering the DCAS, clients with a longer life expectancy have a longer period where they can access capital. Where a reversionary beneficiary is selected, it is the annuity owner's life expectancy which is considered for the withdrawal period, not the reversionary beneficiary, and for Liquid Lifetime Flexible Income (Immediate) it does not change upon reversion.

A couple who values access to capital may want to invest more in the name of the spouse who has the longer life expectancy, and therefore the longer withdrawal period.

Tax

Generally payments made from lifetime annuities purchased with super money, whether lump sum or income payments, are received tax-free. The exception being super death benefits paid to non-dependants. However, lifetime annuities purchased with non-super money have some important considerations.

Ongoing payments

Whilst the deductible amount is no longer used for Centrelink purposes for lifetime annuities purchased today, it is still used for tax purposes. For non-super lifetime annuities, the income above the deductible amount is assessed as income. This means where the payment is less than the deductible amount, no income is assessed. Furthermore, where payments are indexed, excess deductible amounts may be carried forward to future years to be used against future years payments.

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Lump sum withdrawals

Voluntary withdrawals from a Liquid Lifetime Flexible Income (Immediate) purchased with non-super money will not create assessable income, as the whole voluntary withdrawal amount will be considered as capital. However, if the annuity owner dies within the 100% death benefit period and has not selected a reversionary beneficiary (or the reversionary beneficiary has also passed away), there will be assessable income for the estate and/or beneficiary/ies.

Please see the Challenger Tech Lifetime Annuity Technical guide for more details on the tax assessment of Liquid Lifetime.

If a couple is looking to invest with non-super money, they can consider their respective marginal tax rates. Couples may invest more into a lifetime annuity in the spouse's name who is on a lower marginal tax rate.

Personal preference

Let's not forget that some clients may just want to invest in their own name with their own money, for example couples who are not in their first marriage or where one has super money and the other does not.

The health of each spouse may come into consideration where one is particularly healthier than the other. Generally lifetime annuities are not designed for those who have health conditions which are expected to drastically reduce their life expectancy. However, keep in mind that "my parents died young" or "I don't live a healthy lifestyle" may no longer be valid considerations with life expectancy. In 1997 the most common age of death was 78 years, whereas in 2017 it was 88[2]. This is a large increase in a short timeframe, thanks largely to medical improvements. Research conducted in 2015 shows 65-69 year-olds underestimate their life expectancy on average by four years, suggesting that many retiree clients haven't caught up with these developments yet[3].

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Case study

To help understand how all the points discussed fit together, let's consider Larry (70) and Laura (67). They are couple homeowners who receive a part Age Pension and do not currently pay any personal income tax thanks to the tax-free threshold and relevant tax offsets. They currently have $300,000 each in super with similar tax component ratios, $50,000 in cash and $20,000 in personal contents. Larry and Laura have discussed with their adviser using some of their super funds to invest in a lifetime annuity in conjunction with their account-based pension (ABP) and want to understand the different ownership options.

Table 1: Comparing ownership options for Larry and Laura[4]

	Larry	Larry	Laura	Laura
Reversionary beneficiary	No	Yes	No	Yes
Term	Larry's lifetime	Longer of Larry and Laura's lifetime	Laura's lifetime	Longer of Laura and Larry's lifetime
Annual payment rate ($100,000 investment)	$5,227	$4,373	$4,435	$4,320
Withdrawal period	15 years	15 years	20 years	20 years
100% death benefit period	7 years	7 years	10 years	10 years
How long until Centrelink threshold day?	14 years	14 years	17 years	17 years

Based on this, Larry and Laura decide to invest in Laura's name with Larry as the reversionary beneficiary. The considerations they discussed with their adviser to make this decision include:

Income

After speaking with their adviser, Larry and Laura prioritise stability of income for both of their lives over cash flow today. They are comfortable that foregoing some income today will provide the surviving spouse with continuing income at a time of need.

2 Challenger Retirement Income Research September 2019 – "Understanding life expectancies – a big financial literacy gap for retirees".

3 National Seniors Australia and Challenger, August 2015 – Outlook for Australian seniors' retirement plans.

4 Challenger Liquid Lifetime Flexible Income (Immediate payments) rates as at 11/11/2019, nil adviser fees, payments indexed with inflation.

Centrelink

Larry and Laura are happy that they will receive a 40% immediate asset-test reduction by investing in Liquid Lifetime Flexible Income (Immediate). Based on a 30% investment from their ABPs, this will help them receive $5,616 more Age Pension in the first year. However, they are not concerned about the threshold day, as they realise that they aren't certain what their Centrelink position will be in 14 or 17 years.

Access to capital

Larry and Laura like the idea of a longer withdrawal period, just in case. They are happy to sacrifice an extra $53 p.a. by investing in Laura's name with Larry as reversionary beneficiary, rather than vice versa, to get a longer withdrawal period.

Tax

Because Larry and Laura are currently not paying tax, and have similar super tax components, there is not a great benefit to be gained for tax purposes by investing in either name.

Personal preference

Neither Larry or Laura have any significant health issues and are comfortable investing in either name, whichever provides them the best overall result.

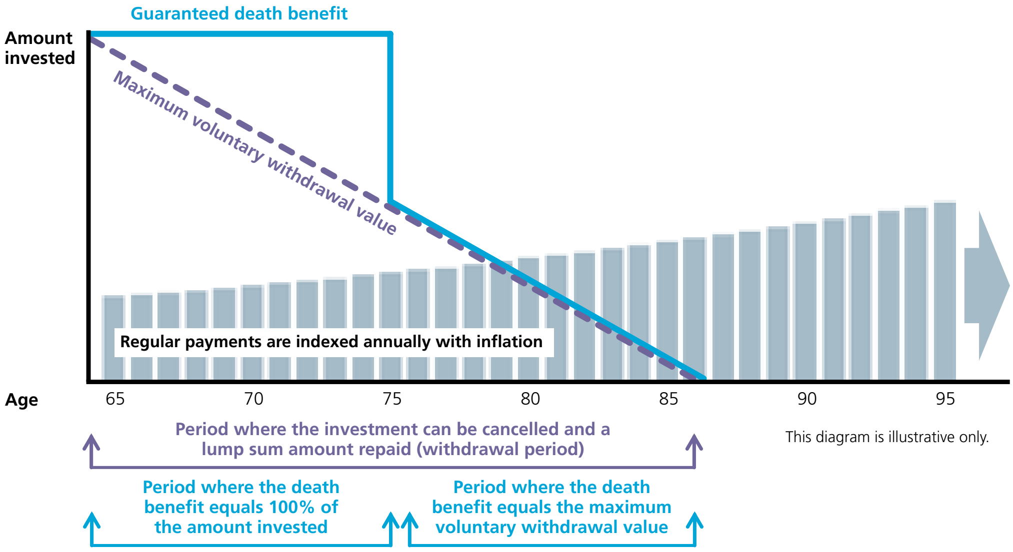
In summary, there are benefits which can be gained for partnered clients where different ownership options are considered. If there is any advantage to be gained for clients by discussing these issues, then it would be prudent to do so to ensure the best outcome is received.

Appendix – Liquid Lifetime options

Liquid Lifetime Flexible Income (Immediate)

A lifetime annuity that starts paying your client a lifelong income immediately. It has a maximum withdrawal value and a guaranteed death benefit equal to the DCAS, allowing clients to maximise their access to capital and receive an immediate Centrelink assets test reduction.

Figure 2: Liquid Lifetime Flexible Income (Immediate) example for 65-year-old female



Note, clients can remove the withdrawal period and the death benefit in return for higher starting payments, called the Enhanced Income option.

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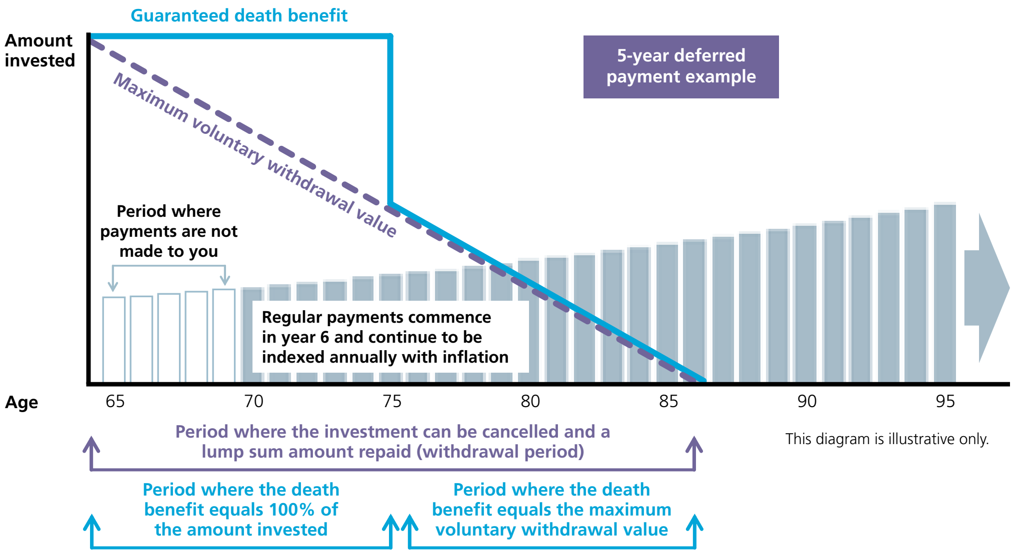
Liquid Lifetime Flexible Income (Deferred)

A lifetime annuity that starts paying your client a lifelong income after a deferral period which they choose. Starting payments will be higher than Flexible Income (Immediate payments) because payments do not start immediately. It has a maximum withdrawal value and a guaranteed death benefit equal to the DCAS, the same as Liquid Lifetime Flexible Income (Immediate).

Liquid Lifetime Flexible Income (Deferred) is only available with super money and clients can also remove the withdrawal period and the death benefit in return for higher starting payments.

Figure 3: Liquid Lifetime Flexible Income (Deferred) example for 65-year-old female

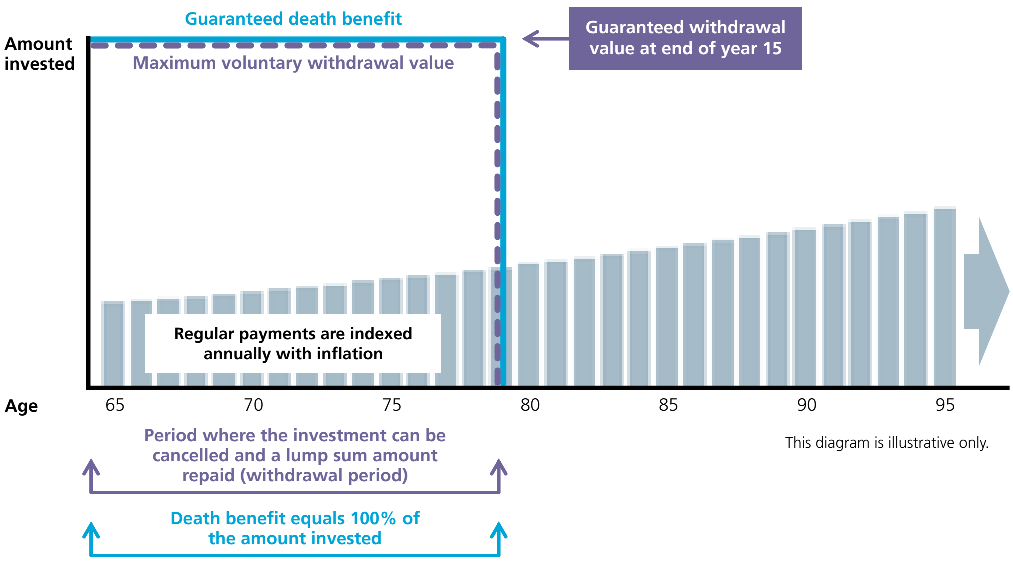


Liquid Lifetime Flexible Income (Deferred) is a suitable option for those clients wanting higher payments for life or to invest a lower amount for the same level of income for life once payments commence.

Liquid Lifetime Regular Income

Liquid Lifetime Regular Income pays lifelong income which commences immediately. It generally pays lower Income payments than Liquid Lifetime Flexible Income (Immediate), but allows a client to commute the annuity at the end of the 15th year for a guaranteed withdrawal value (chosen at commencement). There is a voluntary withdrawal value and a guaranteed death benefit during the 15-year withdrawal period.

Figure 4: Liquid Lifetime Regular Income example for 65-year-old female



Liquid Lifetime Regular Income option is an appropriate selection for clients who prioritise preserving their capital over Centrelink benefits and cash flow. Because Liquid Lifetime Regular Income features a higher withdrawal and death benefit than allowed under the DCAS these higher amounts are assessable under the assets test.

For a further understanding of these options, please see the Challenger Guaranteed Annuity (Liquid Lifetime) PDS. Or to get a clear understanding of withdrawal periods and withdrawal amounts for each client advisers can run a quote on Challenger eQuote.

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