ALLOCATED PENSIONS & TRANSITION TO RETIREMENT ALLOCATED PENSIONS

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WHAT IS AN ALLOCATED PENSION?

There are two major types of superannuation accounts in the growth phase. The first type is a defined benefit. The major examples of these are the CSS, PSS, MSBS, DFRDB and the defined benefits division of UniSuper. There are others, with most of them being government schemes. Sometimes it is possible to access the benefits as a lump sum but, generally, the form of the benefit is a pension. These funds are not considered further here.

The second, more common, type is an accumulation account. These accounts typically are set up to take your own contributions and, possibly, your employer's concessional contributions such as superannuation guarantee contributions. Your own contributions may be either pre-tax (such as salary sacrifice) or post-tax.

When an account holder becomes eligible, he or she may roll over the accumulation account (or the lump sum of a defined benefit account) into an allocated pension. In July 2017, severe financial penalties were introduced for anyone who exceeds their Transfer Balance Cap (currently $1.7 million). Full details are contained in our publication titled ***Transfer Balance Cap***.

An allocated pension is available if you meet a condition of release such as reaching preservation age and permanently retiring from the workforce, reaching age 60 and ceasing, even temporarily, an arrangement of employment or attaining age 65.

A special type of allocated pension is a Transition to Retirement Allocated Pension (TtRAP also known as a Pre-Retirement Pension) which you are able to utilise, with certain restrictions, if you have reached your preservation age and have not yet retired. A TtRAP becomes an AP when a condition of release is met.

The table below shows the differences between accumulation funds and allocated pension funds.

	Accumulation fund	Allocated pension fund	TtRAP
Tax rate for income earned inside the fund	15%	0%	15%
Are lump sum withdrawals allowed?	If meet a condition of release – for tax treatment see below	Yes – for tax treatment see below	No
Income requirements	Nil	Minimum income payments mandatory each year	Minimum mandatory and maximum (10% of account) income payments each year
Ability to add to fund	Possible	Not directly, but possible through commutation and recommencement	Not directly, but possible through commutation and recommencement
What happens to my balance if I die?	100% paid to nominated beneficiary or estate	100% paid to nominated beneficiary or estate	100% paid to nominated beneficiary or estate
Limits	\$110,000 p.a. NCC \$27,500 p.a. CC Other rules	Maximum pension transfer including DB of (currently) \$1.7 million	Not included in Transfer Balance Cap

PRESERVATION

Superannuation accounts are separated into three categories:

— Preserved amounts
— Restricted non-preserved (RNP) amounts
— Unrestricted non-preserved (URNP) amounts

RNP amounts are a fixed dollar amount equal to the amount that would have been paid in cash from superannuation on retrenchment on 30 June 1999.

Preserved amounts are all other money inside superannuation until they become eligible to be URNP.

URNP amounts are the sum of the RNP and Preserved amounts on satisfying a condition of release.

The most common conditions of release are:

— Attaining preservation age and retiring permanently from the workforce
— Attaining age 60 and ceasing an arrangement of employment (even temporarily)
— Attaining age 65.

Note that all new superannuation monies made after satisfying either of the first two conditions of release, will be preserved until again satisfying a condition of release.

PRESERVATION AGE

Preservation age is being increased from age 55 to age 60 based on date of birth as shown in the table below.

Date of birth	Preservation Age
Before 1 July 1960	55
From 1 July 1960 to 30 June 1961	56
From 1 July 1961 to 30 June 1962	57
From 1 July 1962 to 30 June 1963	58
From 1 July 1963 to 30 June 1964	59
On or after 1 July 1964	60

ALLOCATED PENSIONS

Basically, an allocated pension pays no tax on earnings compared with 15% tax on earnings in an accumulation account or a TtRAP. TtRAP and allocated pension holders are required to take a minimum annual income. The reduction of tax on earnings within the allocated pension fund from 15% to 0% is likely to result in higher annual returns, compared with the identical investment strategies inside accumulation and TtRAP funds.

The minimum pension is expressed as a percentage of the balance of the fund on commencement and each subsequent 1 July based on the balance of the fund and age of the pension recipient at that date. The percentage for each age is shown in the table below.

Age last Birthday	Percentage factor
Under 65	4%
65-74	5%
75-79	6%
80-84	7%
85-89	9%
90-94	11%
95 or more	14%

For the 2021/22 financial year, the minimum has been halved.

There is no maximum amount which can be taken as income each year. Additionally, there are no restrictions on the amount that can be taken as a lump sum each year. If the individual wishes, he or she is free to take out 100% of the pension account balance at any time.

Effectively, the only restriction with the allocated pension is that the minimum amount **must** be removed each year. The timing of the withdrawals can be fortnightly, monthly, quarterly, half yearly or annually and, if the minimum withdrawal was not required, the funds may be able to be recontributed back into superannuation, to find their way back into an allocated pension. Technically, it is impossible to re-contribute back into the same allocated pension but the contribution can be made into an accumulation fund which, together with the current pension, can then be rolled into a new allocated pension. If you have reached age 67 but are not yet 75, you must be 'gainfully employed' for at least 40 hours within 30 consecutive days in a financial year before your super fund can accept non-compulsory contributions into your super account. After age 75, only mandated contributions (such as payments of Superannuation Guarantee) can be accepted by superannuation funds.

TRANSITION TO RETIREMENT ALLOCATED PENSIONS

A Transition to Retirement Allocated Pension (or Pre-Retirement Pension) can be used when you have reached your preservation age but have not yet retired from the workforce.

Using a TtRAP allows you to access some of your superannuation funds before you retire. However, when using a TtRAP you can draw only an income stream and cannot withdraw any lump sums until such time as you meet a condition of release, such as retirement. When retirement occurs, the TtRAP reverts to a standard allocated pension (AP) with unlimited withdrawals.

A TtRAP requires that you take at least the minimum income stream as required for an allocated pension (as shown in the table on the previous page). However, the recipient is restricted to taking a maximum annual income stream of 10% of the balance of the fund.

TtRAPs are commonly used as an adjunct to a salary sacrifice strategy, allowing a greater amount of your income to be sacrificed into superannuation. Even in the 55-59 year age bracket, where the income from a pension is not yet tax exempt, the 15% tax offset that comes with a pension makes the income subject to less tax than salary, which does not attract a 15% tax offset.

This is seen in the table below.

PAYG Rate of Tax	Tax Threshold 2021/22 FY	Pension Rate of Tax
0%	$0 - $18,200	0%
19%	$18,201 - $45,000	4%
32.5%	$45,001 - $120,000	17.5%
37%	$120,001 - $180,000	22%
45%	$180,001+	30%

As the table shows, the tax rate applying on pension income (right hand column) has a consistent advantage over the income from non-rebatable sources (like salary). It is therefore logical to maximise pension payments and divert salary back into the concessionally taxed superannuation environment.

TAXATION OF AMOUNTS WITHDRAWN FROM APS, TTRAPS AND ACCUMULATION ACCOUNTS

Pension payments are available only from APs and TtRAPs whereas lump sum withdrawals can be made from both APs and, under certain circumstances, accumulation accounts.

Withdrawals for those aged 60 or over

Any withdrawals, whether they are an income stream or lump sum, will be tax exempt for those aged 60 or over. This means that no tax will be payable on income withdrawals from allocated pensions and TtRAPs nor will tax be payable on lump sum withdrawals from allocated pension and accumulation accounts, regardless of the amount.

Withdrawals for those aged Preservation Age to 59 – Income payments

Where the recipient is under 60, the taxable portion of the amount taken as income from either an allocated pension or a TtRAP will be taxed as income at the recipient's marginal tax rate. Although this is assessable income of the investor, the income carries a tax concession - a *15% tax offset.*

For pensions which commenced before 1 July 2007, the annual *deductible amount* is the undeducted purchase price (generally the sum of the post-tax contributions and pre-1 July 1983 monies) divided by life expectancy at the time the pension was commenced. This amount of the pension is tax free each year. This is a dollar amount which does not change from year to year. The difference between the pension paid and the deductible amount is the taxable portion.

At 30 June 2007, the previous eight taxation components of superannuation monies were crystallized into just two fixed-dollar components – tax-free and taxable. All monies going into a superannuation account are either tax-free or taxable. For example, personal non-concessional (post-tax) contributions increase the tax-free component whereas earnings and pre-tax contributions increase the taxable component. The taxable component is further split into taxed and untaxed elements. Generally, only Public Sector schemes (such as the Commonwealth Superannuation Scheme) will have an untaxed element.

The portion of a post-June 2007 pension (including a new pension from a commuted pre-1 July 2007 pension) which is tax free is the ratio of the tax free component of the purchase price of the pension divided by the total purchase price. That is, the percentage of the pension payment which is tax free will remain the same from year to year but the amount will change as the amount of the elected pension payment changes.

The rest of the income stream, the taxable component, will attract tax at the marginal tax rate. Because this portion of the pension has been purchased using funds which have already been taxed at 15%, it receives a 15% tax offset.

Being an offset, it directly reduces the amount of tax that is payable on the pension. This is one of the reasons why allocated pensions have become popular with the falling tax scales. As marginal rates come down, the amount of tax "wiped off" by the 15% offset becomes more significant.

Withdrawals from Preservation Age to 59 – Lump sum withdrawals (commutations)

In practical terms, **it is usually desirable to only withdraw the minimum mandated income stream from the allocated pension while in the Preservation Age to 59 age bracket.** This is not saying, however, that greater amounts cannot be removed. When more than the minimum income stream is required from the allocated pension, the strategy is to merely make a commutation (lump sum) withdrawal. This commutation should generally be tax-free unless you have exceeded your low rate cap.

To explain further, under the age of 60, your superannuation (either accumulation fund or allocated pension fund) is split into two components: the tax-free component and the taxable component (explained previously). In retirement, between preservation age and age 60, everyone is allowed to have cumulative lump sum withdrawals up to the low rate cap of their taxable component free of tax. Once the cumulative amount exceeds the threshold, the taxable component of any future withdrawal is taxed at 17%. The threshold for the 2021/22 year is $225,000 and it is indexed annually (although only increasing when it reaches the next $5,000 increment).

In making lump sum withdrawals, it is important to remember that you cannot just select to withdraw the tax free component. The tax free component and the taxable component will always be withdrawn on a pro-rata basis. This will vary over time for accumulation accounts but, for pension accounts, it will be in the same proportion as at the time the pension commenced. In making lump sum withdrawals in the preservation age to 59 age bracket, some care must be exercised so as to avoid paying unnecessary tax.

HOW LONG WILL YOUR ALLOCATED PENSION LAST?

An allocated pension (or a TtRAP) will last for as long as there are funds inside it. How long this is, simply depends on how quickly the money is being withdrawn (via income and lump sum commutations) against how quickly it is being topped up each year (via the earnings of the AP fund). To this extent the individual has some control over how long their allocated pension will last, as they can choose how much is withdrawn each year (subject to the minimum required payments), as well as the investment strategy of the allocated pension, which will determine how much it is “topped up” over its lifetime.

To demonstrate, consider an allocated pension that is taken with a commencing balance of $200,000, with the age at last birthday being 60, the minimum pension that must be taken during the year would (normally) be:

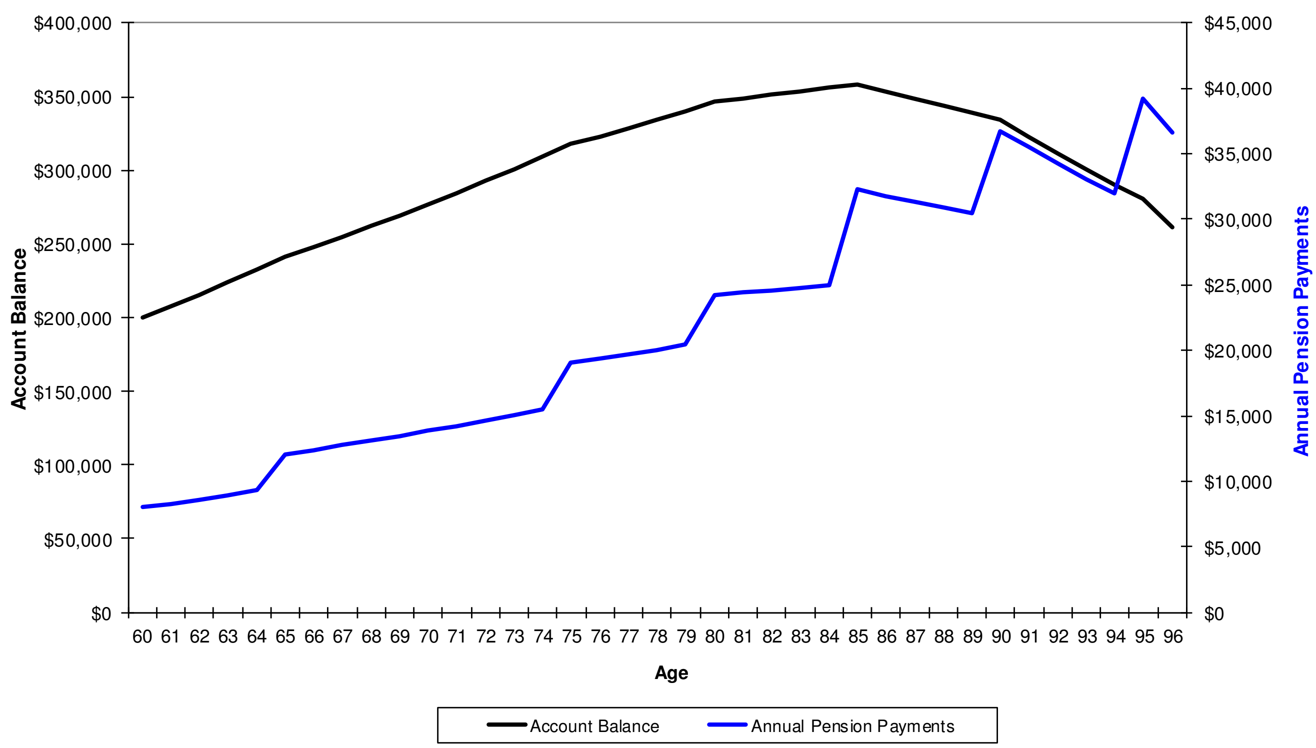
$200,000 x 4% = $8,000

Although this income is a “drain” from the allocated pension account balance, it must be remembered that the account is earning interest, effectively “topping up” the balance. How quickly the account “runs dry” depends upon these factors. This can be demonstrated graphically and, for the sake of this exercise, it is assumed that the fund earns 8% interest per annum over its lifetime.

The first graph shows that when taking the minimum pension amount, the balance of the fund increases (the black line in the graph, measured against the left hand scale), peaking at around age 85. This is because the earning rate of the fund (8% in this example) is greater than the amount drawn as an income stream until that age.

In accordance with our bucket approach, the 1st bucket must be 100% conservative as this is the part of the fund from which any payments will come. This must be invested in cash, accepting that this will not provide any sort of dynamic return. Its job is to be stable, to allow the rest of the fund to seek the higher returns.

Drawing the Minimum Pension



However as the pensioner is required to take a greater percentage of their balance as they get older (the blue line in the graph in this first example shows the pension points – scale on right hand side), this is represented by a subsequent fall in the balance of the fund. Remembering that this fund is earning 8% in interest, the amount of the withdrawal is now more than the interest earned. As the required minimum withdrawal percentage gets larger, the balance starts to decrease. However the balance would not "run out" totally until after age 100. If the pensioner were to die at (say) age 85 while there are still funds in the account, the balance of the account would revert to the spouse or to the pensioner's estate to be distributed through their will.

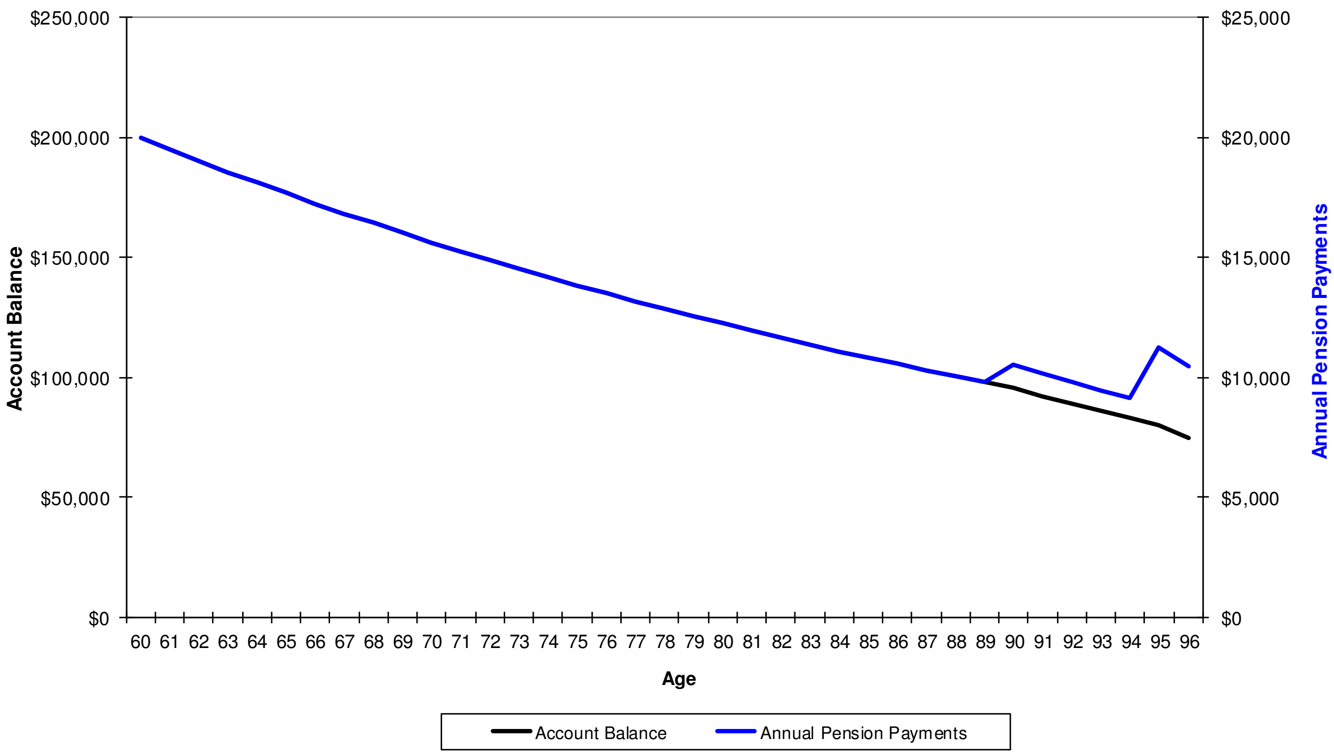
As mentioned above, this is only the ***minimum income position.***

The individual is free to take as much as they wish from the allocated pension along the way (although limited to 10% from a TtRAP); however this will obviously mean that the funds will not last as long. The beauty of the allocated pension is that it is not only tax friendly, it is very flexible. The size of the income payment can be varied at any time and lump sum withdrawals can be made whenever required. The only obligation is to take the minimum payment each year.

The graph on the following page shows the implications of taking a higher amount from the fund each year. In this example, we assume that the pensioner elects to take 10% of the fund balance each year as an income stream or combined income stream/lump sum withdrawals. Therefore the amount drawn down from the allocated pension in the first year would be:

$200,000 x 10% = $20,000

Drawing a Pension of 10% of the balance p.a.



Under this model, the fund continues to earn 8% interest, however with the pension holder removing 10% of the fund balance each year, the balance starts to decline immediately. This is simply a case of there being more outflows (10%) than inflows (8%), so the balance of the allocated pension starts to immediately decline.

This may well suit many individuals, who are keen to enjoy their funds now rather than being the richest pensioner in the graveyard. If the individual wished to maintain or grow the balance, they would need to reduce the level of annual drawings, or change the investment strategy to make the fund produce a higher annual return.

ALLOCATED PENSIONS AND CENTRELINK PENSIONS

For Centrelink Age Pensions commencing before 1 January 2015, Centrelink determined a non-assessed income portion similar to that of the tax free (or deductible amount) of the allocated pension. This annual non-income portion was determined on purchase of the pension using the formula of purchase price divided by life expectancy (as determined by the Government Actuary). Generally, this provided a better Centrelink income test result than having your investments outside of the allocated pension where they would be subject to the deeming rates by Centrelink.

From 1 January 2015, allocated pension accounts have been classified as financial assets for new pensions and new Centrelink beneficiaries so income is now deemed in the same way as for other financial assets such as shares and bank accounts. This has substantially reduced and, in many cases, removed the entitlements that would have arisen under the previous arrangements for many potential pensioners. As deeming rates are determined by the Government, entitlements will become more dependent on Government decisions.

WHAT HAPPENS WHEN YOU DIE?

If you have a superannuation account in the either the accumulation phase or allocated pension phase, there is a range of available options for payment to your nominated beneficiaries on your death.

Firstly, you are able to specify a number of beneficiaries. These can include your current spouse, any or all of your children, any person who is financially dependent upon you and/or any person with whom you have an interdependency relationship if it meets certain requirements. You are also able to elect to have different percentages of the benefit paid to each of the beneficiaries.

You are also able to nominate the executor of your estate as your beneficiary. In this case, the benefit would become part of your estate to be distributed according to your Will.

Secondly, the form of the benefit nomination may be binding or non-binding. While fund trustees take a non-binding nomination by a member into consideration, they must be satisfied that all of the deceased's possible dependents are considered when they make a decision about who should be paid a death benefit. With a binding nomination, the fund trustees' usual absolute discretion regarding the payment of superannuation death benefits is removed.

Thirdly, a death benefit nomination may be lapsing (which needs to be updated every three years) or non-lapsing (in which case the nomination remains in force until it is revoked or replaced with a new nomination).

If the benefit is paid as a lump sum, it must leave the superannuation system. There may be difficulties getting the money back into superannuation, however, if the benefit is paid in this form. For example, if the beneficiary's non-concessional cap had been fully utilised already, the superannuation payout will not be able to be re-contributed until a future year, if at all. Other restrictions could be if the payout exceeds the non-concessional cap or if the recipient is over 67 and doesn't satisfy the work test.

A solution for some will be the nomination of a reversionary benefit if this is allowed by the particular product. In both pension and accumulation accounts, you may be able to elect to have the benefit paid to an eligible beneficiary as a reversionary pension. The nominated beneficiary/ies must be a dependent under the Superannuation Industry (Supervision) Act 1993 for the benefit to be paid in this form. A financially dependent child may receive a pension provided he or she is under the age of 25 and the pension must be cashed out when the child turns 25. Conditions for disabled children, though, differ from these.

A life insurance policy held in the superannuation system will form part of the death benefit so, if this can take the form of a reversionary pension, the proceeds can stay in the superannuation system.

One complication with a reversionary benefit is the possible effect on the beneficiary's Transfer Balance Cap. If the reversionary benefit plus the beneficiary's own pension exceeds the Cap, some pension will have to be commuted back into the accumulation phase. This is explained fully in the BL&A document ***Transfer Balance Cap .***

The best option is dependent on personal circumstances so it is recommended that you discuss these with us before choosing.

Companion documents

Using the BL&A "Bucket Approach" to Investing
Transfer Balance Cap