FOR YOUR CLIENTS

Understanding annuities
Client Fact Sheet - July 2012

An annuity pays you a guaranteed income for a defined period of time. An annuity can be purchased from a super fund or a life insurance company using your super or other savings. Annuities are not as flexible as account-based pensions.

Income is guaranteed to be paid over a specified period, regardless of the investment performance of the assets supporting the annuity. Therefore the investment risk for these types of products resides with the provider.

In extreme circumstances there may be the risk that the provider does not have the capacity to meet its payment obligations.

It is imperative, therefore, to invest funds with a provider that has a good record of financial stability.

The two types of annuities available are:

- Lifetime annuities:

  Lifetime annuities are payable until the death of the principal annuitant (the purchaser) or a reversionary annuitant (eg. spouse) who is specified at the time of purchase.

- Term certain annuities:

  Term certain annuities have a specified term, usually in whole years (eg. 10 years), agreed upon at the commencement of the annuity.

How to purchase an annuity

Annuities purchased with superannuation money must only be in the name of the person who owns the superannuation.

Annuities purchased with ordinary money (ie. non-superannuation money) allows for the income to be paid to a single or joint recipients, thus allowing people to split their income for tax purposes.

Annuities may also receive tax advantages.

Options

Annuities offer a range of options to choose from so that the investment is tailored to suit your needs. The options which are selected, and the amount invested, will determine the amount of income you receive.

Typical options include:

1. **Inflation protection –** the amount of income you will receive can be increased each year, either at a fixed percentage or in line with the Consumer Price Index (CPI) to offset the effects of inflation.
2. **Payment frequency –** the annuity can usually be paid on a monthly, quarterly, half-yearly or annual basis. A payment must be made at least annually.

3. **Provision for your dependants –** you can select, when establishing an annuity, that if the original annuitant dies within the term of the annuity, the annuity will continue to be paid to a second person (ie. the reversionary annuitant such as a spouse). This income may be at either the same level as to the original annuitant, or at a reduced level (eg. 75% or 50%).
4. **Guarantee periods –**

   Lifetime annuities – The term for which income is payable under a lifetime annuity is dependent on how long the annuitant lives. The purchaser therefore takes the risk that they may die earlier than the life expectancy tables predict.

   The earlier death occurs, the lower the total income payments received will be. Lifetime annuities allow people to select a guaranteed period at the commencement of the annuity, usually in whole years for a maximum of 20 years, or life expectancy at commencement (whichever is lesser). This enables the purchaser of a lifetime annuity to obtain some protection against early death.

   If the annuitant and any reversionary annuitant die prior to the end of this guaranteed period, the present value of any remaining income payable until the end of the guaranteed period will be calculated and paid to the beneficiaries or the estate of the annuitant or reversionary annuitant. It may be possible for the annuity payments to continue until the end of the guarantee period.

   If the annuitant and any reversionary annuitant die after the expiry of the guaranteed period, the annuity will cease and no further payments will be made.

   Term certain annuities – As a term certain annuity has a guaranteed term selected at inception, no 'guarantee period' is required. If the annuitant and any reversionary annuitant die within the term selected, the present value of any remaining income payments until the end of the selected term will be calculated and paid to the beneficiaries or the estate of the annuitant or reversionary annuitant. It may be possible for the annuity payments to continue until the end of the guarantee period.
5. **Return of part of or the full purchase price –** Term certain annuities may allow for a return of all or part of the purchase price at the end of the term. This repayment of capital is known as a Residual Capital Value (RCV) and is expressed as a percentage of the original purchase price. The RCV cannot exceed the original purchase price. For instance, if a 5-year term certain annuity was purchased for $100,000 with 50% RCV, the amount of capital which would be returned at the end of 5 years would be $50,000 (ie. 50% x $100,000). The larger the RCV, the smaller the income amount paid each year.

   At the end of the fixed term, the annuitant has the option to roll over the RCV to another annuity, or to have the RCV paid out. An RCV from an annuity purchased with ordinary money is simply a return of the original capital used to purchase the annuity and is not taxed.

Centrelink treatment

Assets test

The account balance of annuities that have a term greater than 5 years is fully assessable under the assets test.

Complying annuities

"Complying annuities" refer to annuities which have met certain conditions. Depending upon which conditions have been met these complying pensions will be either 50% or 100% exempt from the Centrelink assets test. No new complying annuities have been available since 20 September 2007.

Under the assets test, depending upon the conditions met there are two exemptions available:-

› A full exemption is generally available for complying annuities purchased prior to 20 September 2004, or

› A 50% exemption is available for complying annuities purchased between 20 September 2004 and 20 September 2007.

The market value of the income stream is re-assessed by Centrelink on a bi-annual basis (unless income is paid annually, where the value is only re-assessed once a year) and then the 50% discount is applied.

Income test

Under the income test, the assessable income is dependant upon the term of the annuity which are divided into two categories:-

Long term annuities

For annuities that have a term of greater than 5 years, the assessable income is calculated according to the formula:-

Income drawn – Centrelink deductible amount

Where the Centrelink deductible amount = $\frac{\text{Purchase price – Residual Capital Value – Commutations}}{\text{Relevant Number}}$

The relevant number is either the term of the annuity or the longest life expectancy of either the owner or reversionary.

Short term annuities

Annuities that have a term of 5 years or less are assessed as financial investments under the assets test and are "deemed" under the income test.

The current deeming rates effective as at 20 March 2012 are as follows:

Asset level	Single allowee/pensioner
First $44,600	3%
Balance above $44,600	4.5%
Asset level	Couple allowee/pensioner
First $74,400	3%
Balance above $74,400	4.5%
Asset level	Non-pensioner couple
First $37,200	3%
Balance above $37,200	4.5%

Taxation concessions available

Tax-free amount

The tax-free amount is the income payment from the annuity that is not subject to tax. The tax-free amount is calculated by using the following formula:

$$\text{Tax-free amount} = \frac{\text{purchase price} - \text{residual capital value}}{\text{relevant number}}$$

Purchase price = amount invested in the complying annuity

Residual capital value = amount to be returned to client upon maturity

Relevant number = client/spouse's life expectancy

Risks associated with annuities

Taxation and legislative risk

Our information is based on current practices of government bodies such as the Australian Taxation Office and existing legislation. As with most financial related matters, there is always legislative risk that the relevant legislation or current government practices may be amended.

Liquidity and access to capital risk

Liquidity is the ability of an investment to be easily converted to cash with little or no loss of capital and minimum delay. In the case of immediate annuities, access to the capital is restricted.

Technical Services

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