Did you know?

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Income tested strategies and annuities

Recently our colleagues in the Colonial First State FirstTech team produced an article on income test strategies. Below is an excerpt from the article which specifically discusses the effective use of annuities and the income tested strategies.

Investing in annuities can provide a guaranteed income stream for a particular term. Although the capital value of the annuity cannot generally be accessed readily for the term, guaranteed income can be beneficial during adverse market conditions. The length of the term of the annuity and the amount of residual capital value chosen (RCV, the amount of capital remaining at the end of the term) will affect what is assessed under the income test.

A short term annuity has a term of less than six years (unless the client's life expectancy is less than six years). These annuities are treated as financial instruments, are asset tested and subject to deeming[1].

Annuities with terms of six years or more (long term annuities) are also asset tested[2], but are subject to different income test assessment. The income from such as annuity is reduced by a deductible amount derived from the following formula:

$$\frac{\textbf{Purchase price – commutation – RCV}}{\textbf{Relevant number}}$$

Unlike the deductible amount for account based pensions, for the long term fixed annuities the relevant number is the term of the annuity. This may be based on life expectancy, for a lifetime annuity, but is otherwise the length of any fixed term. Looking at the above formula, a long term annuity with 100 per cent RCV (i.e. equal to the annuity purchase price) will result in a deductible amount of zero. Therefore the entire annuity income payment would be assessed under the income test.

Rather than investing in a short term five year annuity, investing in a six year annuity with a nil RCV, which is just one year more could reduce the amount of income assessed under the income test. This is incorporated into the following example.

Example

The table below compares investing $200,000 in various fixed term investments and which is the most favourable for income testing purposes[3].

[1] The formula for the asset test value of asset tested short term and long term annuities – p145 FirstTech 2011-12 Super Guide
[2] As above
[3] 4.5 per cent deeming rate

Product	Investment amount	Term (years)	RCV	RCV %	Income payment	Yield %^	Deductible amount	Assessable income
Term deposit	$200,000	5	n/a	n/a	$11,400	5.70	n/a	$9,000
Short term fixed annuity (100 per cent RCV)	$200,000	5	$200,000	100	$11,780	5.90	n/a	$9,000
Short term fixed annuity (nil RCV)	$200,000	5	0	0	$46,566	5.30	n/a	$9,000
Long term annuity (100 per cent RCV)	$200,000	6	$200,000	100	$12,020	6.02	0	$12,020
Long term annuity (nil RCV)	$200,000	6	0	0	$39,986	5.47	$33,333	$6,653

^Rates as at 25 March 2012.

In this example, when comparing the investments with a five year term, as the deemed income is the same for all three investments, the higher yielding investment is a more favourable investment for an income tested strategy.

Looking at the annuities over six years (long term annuities), the yearly income received from a 100 per cent RCV annuity will be the amount that is income tested. For an annuity with a nil RCV, the amount tested under the income test is the yearly income received reduced by the deductible amount. As the term of a long term annuity increases, the deductible amount decreases therefore affecting the amount that is income tested. It can be assumed that the higher the income yield and the longer the term more will be income tested.

The annuities with a nil RCV will generate the most income in comparison to an annuity with a 100 per cent RCV with the same term and initial investment however there will be no capital at the end of the term. This option could be advantageous if there were concerns about access to capital in a 100 per cent RCV annuity or a term deposit (without breaking costs). However any excess income that is added to a cash account will be deemed.

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Summary

For more information on CommInsure annuities please visit the CommInsure adviser site CommInsure Adviser . For a copy of the full Colonial First State Strategic Update Edition 73, March-April 2012 please click on the following link www.colonialfirststate.com.au/prospects/FS3787.pdf.