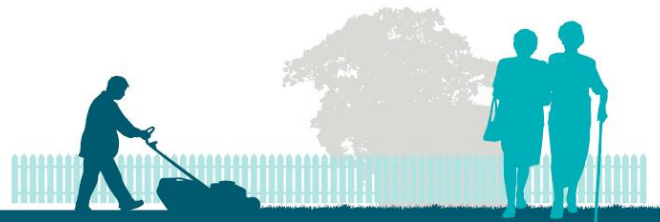




Australian Government  
Department of Social Services

# Discussion Paper: Social security means testing of retirement income streams

December 2016



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## A. Changes to superannuation regulations for retirement income products

1. The Government announced in the 2016-17 Budget that it will address superannuation rules and regulations that restrict the development of new retirement income products and act as barriers to innovation in the creation of retirement income products. Treasury is developing regulations that will allow new lifetime products to qualify for the tax exemption for superannuation earnings, providing they satisfy a *declining capital access schedule*. This schedule will limit the proportion of the initial investment capital that may be returned if the product is commuted or in the form of a death benefit and will limit these product features to the period before the purchaser reaches their life expectancy. The new superannuation rules are expected to take effect from 1 July 2017.
2. It is anticipated that these changes will facilitate the provision of deferred lifetime annuities (DLAs) and group self annuitisation (GSA) products within the superannuation environment. This will provide more choice for retirees who are concerned that they might outlive their superannuation savings by providing additional options for managing longevity risk. The Government has undertaken to consult regarding the social security means test rules that will apply to these new products.
3. The Government has also announced that it will legislate that the objective for superannuation is: *To provide income in retirement to substitute or supplement the Age Pension*. This makes it clear that superannuation is intended to provide income in retirement, rather than supporting tax minimisation or estate planning. This primary objective is supported by subsidiary objectives of the superannuation system, which include alleviating fiscal pressures on Government from the retirement income system, facilitating consumption smoothing over the course of an individual's life, and to help manage risks in retirement, including longevity risk.

## B. Means testing retirement income streams

4. Means testing is an important feature of the social security system, targeting income support to the people who most need it and helping to keep the Age Pension sustainable. For most of its hundred year history, Australia's Age Pension has used means testing to ensure that the income support system is fair and targeted to those people most in need of support. Consistent with this approach – and objective for superannuation – the means test reflects an expectation that people will draw upon their available retirement savings, including superannuation, to support themselves in retirement.
5. Australia's social security system is funded from general revenue. Unlike some overseas social insurance schemes, it is not based on past contributions but rather supported by current tax payers. As the population ages and fiscal pressures increase, fair and effective means testing is important to ensuring that the Age Pension is well-targeted and sustainable.

6. The Government has undertaken to consult about how new income stream<sup>1</sup> products are treated under the social security means test. This will inform the development of legislation detailing the income and assets test rules that will apply to new lifetime products, such as deferred lifetime annuities and group self annuitisation products, which may be brought to market under the new superannuation regulations.
7. Submissions to the Review of Retirement Income Streams by industry stakeholders highlighted that clarity regarding the means test assessment rules for income streams is important for the development of new retirement income products.
8. This process will also assess whether the means test rules for existing types of products are fit for purpose, and address any weaknesses in the current rules to ensure an effective and appropriate means test treatment for all retirement income streams into the future. This will provide certainty for industry and help forestall the need for further changes to the means test rules in the future.

## C. Objectives of the social security means test

9. The primary policy objective of the means test is to equitably and fairly target income support to those people who are most in need. This helps to ensure that the system remains sustainable, both fiscally and in terms of community support. The means test also represents an expectation that people will draw upon their own income and assets to support themselves in retirement. The means test functions to assess a person's overall capacity for self-support and target social security expenditure according to need.
10. The social security means test for social security pensions, including the Age Pension, consists of separate income and assets tests that assess the personal resources available to recipients and are used to calculate how much assistance is payable. In broad terms, both tests aim to capture all income and assets (excluding a person's principal residence). The **assets test** is designed so that people with substantial assets use these to meet their day-to-day living expenses when calling on the social security system for support. An assessable asset is any property or possession that a person owns, with the exception of a person's home which is an exempt asset.<sup>2</sup>
11. The social security **income test** seeks to capture all forms of private income that a recipient has available to support themselves, assessing all income that is earned, derived, or received.<sup>3</sup> Means testing also provides incentives for self-provision in

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<sup>1</sup> Section 9 of the *Social Security Act 1991* defines the term "income stream" as pensions paid by superannuation funds, annuities paid by life offices, pensions paid by a public sector superannuation scheme, pensions arising from a retirement savings account, and other similar arrangements designated by the Secretary of the Department of Social Services.

<sup>2</sup> The exemption of the principal residence from the assets test recognises the greater financial security that pensioners have if they live in their own home and importance placed on the family home in Australian society. Assessable assets include money, shares, financial investments, retirement income streams, investment properties, vacant land, holiday homes, motor vehicles, caravans, boats, household contents, personal effects, businesses, farms, assets held in trusts, and other personal assets (whether in Australia or overseas).

<sup>3</sup> Around 58 per cent of income support recipients over age pension age receive the maximum amount of payment. This proportion is projected to reduce slightly over time as the superannuation system matures, however, for many retirees, the Age Pension will continue to provide a meaningful contribution to their retirement income.

the form of participation and saving. The means test balances these objectives by the use of income and assets free areas and the tapered withdrawal of payment as a person's assessable income and assets increase.

## D. Scope and focus of the current review

12. Reflecting the longstanding policy framework for means testing within Australia's social security system, the following principles will guide the assessment and development of means test rules for retirement income streams:
  - **Neutrality** – the means test assessment of investments should not advantage a particular type of product or provide an incentive for people to invest in a particular asset as a result of it receiving a more favourable means test treatment.
  - **Equity** – the rules should treat people with similar means in a consistent way (horizontal equity) and those who have a greater capacity to self-provide for their retirement should receive lower income support (vertical equity).
  - **Resilience** – the rules should be able to apply to a range of products, including new products, without diminishing neutrality and equity. This will enable income stream providers to be innovative, and minimise the need for further changes to the rules as new types of products emerge.
  - **Integrity** – the rules should ensure the social security system remains targeted to assisting those people who need support and that people cannot maximise their Age Pension by engaging in strategies that minimise the extent to which their own income or assets are counted in means test assessments.
  - **Fiscal Sustainability** – the means test treatment of new retirement income stream products should have regard to the cost of the social security system.
  - **Simplicity** – the rules should be easy to understand for income support recipients, financial advisors and income stream providers. Complicated rules can result in people making poor financial decisions. Simple rules support people to make good decisions.
13. Means testing inherently presents tensions between these principles, and policy choices often involve seeking an acceptable balance between competing considerations. The key objectives of means testing – targeting assistance according to need in a fair and sustainable manner – are critical points of reference in striking this balance. Whilst means test policy necessarily focuses on assessing a person's income and assets at a particular point in time, the nature of retirement income products means that it is important to also be mindful of the impact of rules over longer periods of time. This can highlight where the rules may be unfair, risk distorting investment decisions, or have the effect of subsidising particular choices or bequest motives.
14. A number of recent reviews have considered means testing policy including the 2009 Pension Review and the 2010 Australia's Future Tax System Review. The 2015 Budget introduced changes to rebalance the social security assets test and address issues with income testing of defined benefit pensions.

15. The focus of this current review process is focused tightly on the rules for means testing retirement income stream products. Broader means testing or retirement income policy is not within scope.

## E. The current approach to means testing retirement income streams

16. The current social security means test rules were designed for existing products, particularly account-based income streams and very simple standard annuity products that meet the current superannuation regulations.
17. Whilst the broad approach to assessing income streams has been in place since 1998, a number of subsequent reforms have been introduced to improve the neutrality, equity and targeting of the means test by removing concessional treatments that advantage some types of products over others and better aligning the assessment of income stream products with other forms of savings. This includes phasing out assets test exemptions for some annuity products and extending deeming to account-based income streams. A summary of current means test rules for income streams is provided in Table 1 and **Appendix 1**. A summary of recent reforms is provided in **Appendix 2**.

### Box 1 Common types of income stream products

Type of income stream products	Description
<b>Account-based income stream</b> (also referred to as an allocated pension or account-based pension.)	An individual investment account set up with superannuation benefits from which a retiree draws a regular income. Retirees are able to select different investments, and have flexible access to their investment capital. Superannuation regulations require a minimum amount to be drawn down each year, which increases with age.
<b>Annuity</b>	An investment that pays a guaranteed regular income stream. Annuities are purchased with a single payment or regular payment instalments. Access to capital is limited – however, some products may include commutable or surrender value and/or provided a death benefit lump sum payment to a person's estate.
<b>Lifetime annuity</b>	An annuity product that provides payments for the full period of a person's lifetime after purchase (some products may cover a person and their partner for both their lifetimes).
<b>Term-certain annuity</b>	A term-certain annuity provides guaranteed regular payments for a specific period of time. Products covering the period to a person's life expectancy (at purchase) are sometimes called <b>life annuities</b> . <sup>4</sup>
<b>Group self-annuitisation (GSA)</b>	Group self-annuities are where participants contribute funds to a pool that is invested in assets. Regular payments from the pool are made to surviving members. GSAs allow members to share, but not completely eliminate, longevity risk. Unlike annuities, GSAs do not require capital to back guarantees as pool members retain investment risks.
<b>Deferred annuity</b>	A deferred annuity product is one in which payments are delayed for a set amount of time. For example, a deferred lifetime annuity (DLA) provides payments for life once a person reaches a particular age. The deferral period is the specified period before payments commence.

<sup>4</sup> Life annuities are different from lifetime annuities in that they cover the period to life expectancy. Life expectancy reflects the overall mortality level of a population cohort. It measures how long, on average, a person is expected to live based on current age and sex-specific death rates.. A term annuity that covers a person for the period to their life expectancy at the point of purchase thus provides income over a fixed period. Lifetime annuities, in contrast, offer longevity protection by providing payment for the full period of a person's lifetime.



## Current assets test assessment rules

18. The assets test currently adopts two main approaches to determining the assessable value of a retirement income stream: assessing the current market value or account balance; and the capital reduction rules.<sup>5</sup> For products with a readily identifiable **current market value** or account balance, the assets test typically uses this for the assessable asset value.<sup>6</sup> This approach presently applies to account-based income streams, and short-term based income streams with a term of 5 years or less. This approach to assessment reflects the broad use of market value by the assets test and is also consistent with the treatment of other financial investments.
19. The assets test also uses **capital reduction rules** for products which don't have a readily identifiable account balance or market value, such as annuity products. This approach assesses the purchase price in the first year, and then reduces the amount assessed over a specified period of time. This recognises that payments from the product include the return of the holder's initial capital investment over time. Where the products have a residual capital value, this amount continues to be assessed. The capital reduction rules apply differently to different types of income stream products:
  - a) For products with a specified duration or term – including products that cover a person's life expectancy – the assessable asset value is determined by reducing the purchase price on a straight-line basis over the term of the product.
  - b) For lifetime annuity products – which continue to provide payments for all of a person's lifetime – the initial purchase price is reduced over a period from purchase until a person reaches their life expectancy (at the time of purchase).<sup>7</sup>
20. It is important to the integrity of social security means test outcomes that the asset value of an income stream to the recipient is accurately captured by the assets test – both initially and over the life of the product. Failure to do so can reduce the vertical and horizontal equity of social security outcomes and the neutrality of the means test outcomes for different types of income stream products and between different classes of assets.

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<sup>5</sup> The assets test does not assess an asset value for defined benefit income stream schemes, because the payments provided by these schemes do not reflect or relate to an underlying capital investment. In general, these schemes are no longer operating for new entrants, with superannuation shifting to a defined contribution basis.

<sup>6</sup> The account balance used for assessment is updated twice yearly in March and September. Where account balances change by a significant amount, recipients are also required to inform Centrelink of these changes. These rules help ensure that a current and accurate account balance is assessed by the assets test, and provide a system that can respond to major market changes.

<sup>7</sup> This is determined at the age at which they bought the product using the relevant Australian Government Actuary's Life Tables. Some lifetime income streams also allow for a remaining partner to receive a reversionary payment should they live longer than their partner.

## Current income test assessment rules

21. The social security income test assesses all moneys that are earned, derived or received as income. As a matter of policy, the return of the original capital investment in financial products and other assets have not generally been assessed on the basis that it would be inappropriate to treat these amounts as income. This is relevant to the income test rules for income stream products, as payments typically consist of the return of the original investment capital over time, plus earnings on that original investment amount and any longevity dividend from the pooling of mortality risk (if any).
22. The current income test rules for retirement income streams differ by product type. Deeming is used for products with an account balance. A deduction amount approach is used for products such as annuities which provide scheduled payments in return for an initial investment.<sup>8</sup>
23. The **deeming** rules are a central part of the social security income test and provide a simple and fair way to assess financial investments. Deeming applies a proxy rate of return, set by the Minister for Social Services with reference to market returns from a range of financial investments. Deeming has been in place for directly held financial investments since 1996, and was extended to account-based income streams from 1 January 2015. This reform improved equity and neutrality by aligning assessment with the rules use for directly held financial investments. Deeming also applies to income streams with terms of five years or less. Under the current rules, the market value of a deferred annuity would also be used to calculate deemed income for the purposes of the income test.
24. A **deduction amount** approach is used for products such as term annuities with durations over five years and lifetime annuities. Allowing for a deduction amount acknowledges that a proportion of scheduled payments consists of a return of the original capital investment, and is consistent with the long-held policy practice of not treating the drawdown of capital as income. Treatment depends upon the term of the product:
  - a) For term-certain products the deduction amount is calculated by dividing the purchase price by the term of the product.
  - b) For life annuities the deduction amount is calculated by dividing the purchase price by the purchaser's life expectancy.

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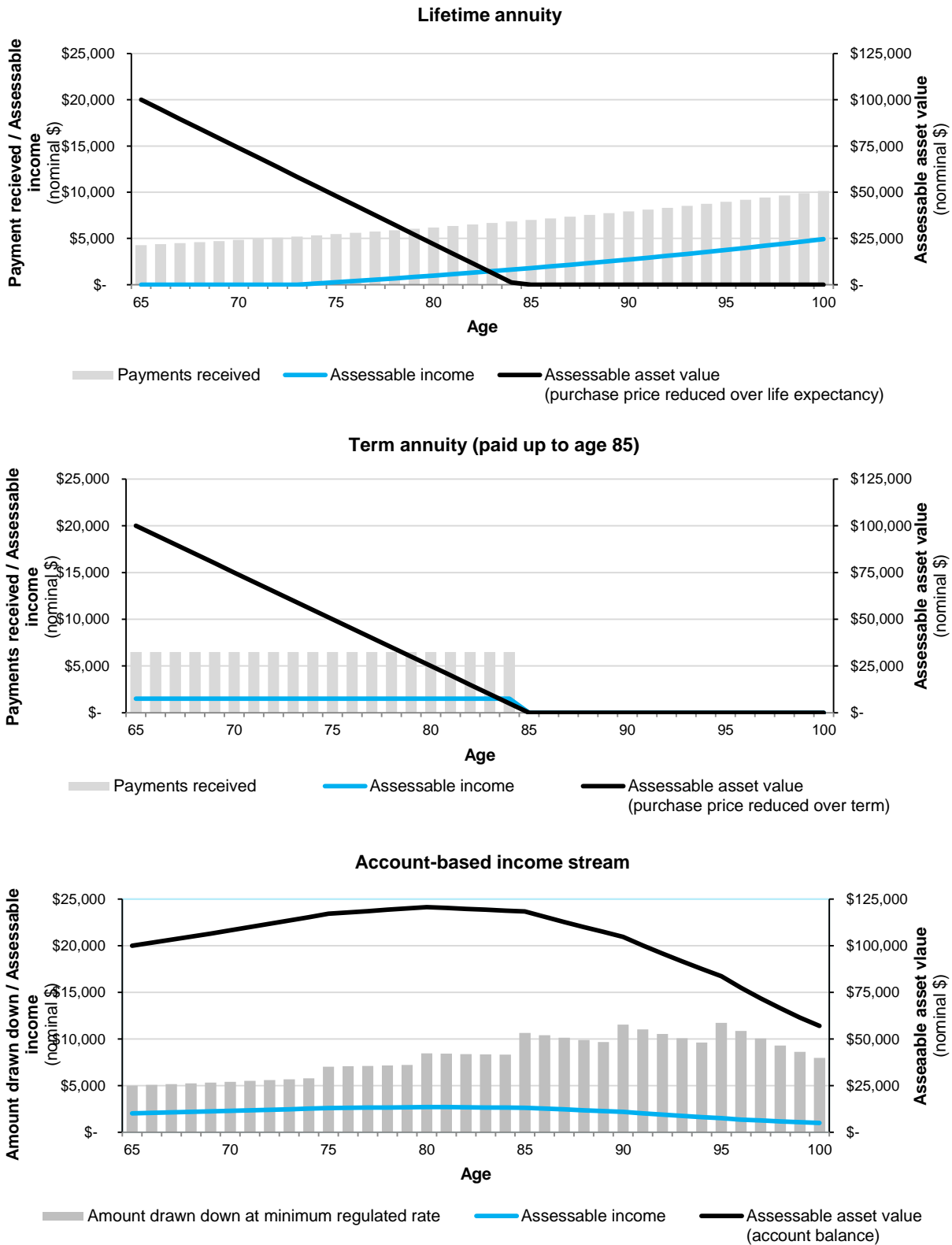
<sup>8</sup> For defined benefit pensions, regular payments are reduced by a deductible amount which is designed to reflect the return of any personal after-tax contributions made by the employee to their defined benefit income stream (that is, the person's own capital). From 1 January 2016, this deductible amount was capped at 10 per cent of the regular payments in order to better reflect an individual's personal after-tax contributions (see Appendix 2 for details).

**Table 1: Summary of the current means test rules for retirement income streams**

Current social security means test treatments		Income Test	
		<i>Deeming</i> <i>Deeming rates and thresholds are used to provide a proxy for actual income.</i>	<i>Deduction amount</i> <i>Payments less a deduction amount equal to the purchase price divided by life expectancy or the term of the product</i>
<b>Account balance</b>		Account-based income streams	
<b>Assets test</b>	<b>Current market value</b> <i>Actuarial valuation required.</i>	Deferred annuities	
	<b>Capital reduction rules</b> <i>Purchase price is reduced annually on a straight-line basis over life expectancy.</i>	Lifetime annuities	
	<b>Capital reduction rules</b> <i>Purchase price is reduced annually by a deduction amount = (purchase price – residual capital value) / term.)</i>	Short-term annuities with a term of 5 years or less	Long-term annuities with a term greater than 5 years

25. Chart 1 shows the current treatment of different products with an initial purchase price or balance of \$100,000 established at age 65. It shows the outcomes over the period to age 100 for an account-based income stream dissipated at the regulated minimum draw down amounts, a life annuity to age 100, and a term-based annuity product where the term is a male purchaser’s life expectancy. This analysis demonstrates the different outcomes produced by the current means test rules. In particular, it shows that the assets test rules for a lifetime annuity are quite concessional compared to the treatment of other products. For example, the assessable asset value of the lifetime annuity is identical to that for the term annuity for the period to life expectancy, even though the lifetime annuity continues to provide an indexed income stream after the term annuity has ceased. It also highlights that a similar amount in an account-based income stream that is drawn down at the minimum regulated rate will continue to have an assessable asset value over this period.
26. This can have implications for the amount of Age Pension that a person is entitled to. For example, assets tested pensioners with a lifetime annuity would not have their pension reduced by the annuity after they reach life expectancy, because the asset value has been reduced to zero, whereas those who were income tested may have their payment reduced by the assessable income. The extent to which a person’s payment is, or is not affected depends upon their personal circumstances, including the nature of any other assessable assets or income.

**Chart 1: Current income and assets test assessments of different income stream products<sup>9</sup>**



<sup>9</sup> Lifetime income stream assumes purchase by a 65 year old male. Payments are indexed to inflation annually, with the purchaser receiving a payment of \$4,272 in the first year. The term income stream makes payments for 20 years at a rate of \$6,500 a year. Withdrawals from account-based income streams are at minimum regulated rate, assuming earnings of 6.6 per cent per annum.

## Performance of the current means test rules

### **Assets test and income test outcomes for account-based income streams reflect people's consumption choices, investment performance, and the present capacity of the investment to generate income**

27. The current means test settings for account-based income streams are broadly appropriate.
28. The assessment of account-based income streams by the assets test is focused upon the present account balance of the product. This means that an assets tested pensioner who withdraws money for income or consumption will have a lower account balance assessed in the future. Similarly, those assessed under the assets test may experience changes in their income support payments reflecting the impact of capital losses or growth on their account balance. This reflects the flexible nature of these products, and the retention of market and longevity risk by the income stream holder.
29. The income test deeming rules were recently extended to include account-based income streams, and took effect from 1 January 2015.<sup>10</sup> This change improved the equity and neutrality of income test outcomes by aligning the assessment of these products with that for equivalent financial investments held directly by the recipient. The previous income test rules for account-based income streams – which adopted an deduction amount approach to represent the return of capital<sup>11</sup> – resulted in very concessional income test outcomes and were prone to being manipulated by financial planning strategies to maximize social security entitlements.<sup>12</sup> Deeming also addressed these issues.

### **The current assets test assessment of lifetime income streams (lifetime annuities) is highly concessional beyond life expectancy**

30. A consequence of the current rules for lifetime income streams is that they are assessed as having no asset value once a person reaches their life expectancy. However such products continue to provide significant payments beyond this point, and are of ongoing value to holders. This value is reflected in the pricing of their initial investment and in the choice of such products to manage retirement income.
31. This treatment is arguably a very concessional assets test outcome compared to the manner in which other income streams are assessed. In effect it produces a similar assets test outcome to that for a term-certain annuity product providing payments to life expectancy, despite offering payments over a much longer timeframe. Put differently, it arguably does not reflect the nature of the product. The current rules also produce more concessional assets test outcomes beyond

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<sup>10</sup> Products held by income support recipients on 31 December 2014 were grandfathered, and the former income test rules continue to apply unless they change products.

<sup>11</sup> Because deeming operates as a proxy for returns, it also avoids having to distinguish the return of capital from earnings.

<sup>12</sup> In particular, recipients were able to commute and restart their product every year in order to maximise deductible amounts, and therefore reduce the amount of income assessed by the income test. Similarly, assessment on a financial year basis made it possible for people to make very large withdrawals at the end of June which would only impact their social security payment for a few days before the new financial year rolled over.

life expectancy than for a similar amount managed in an account-based product with the intention of managing longevity risk.

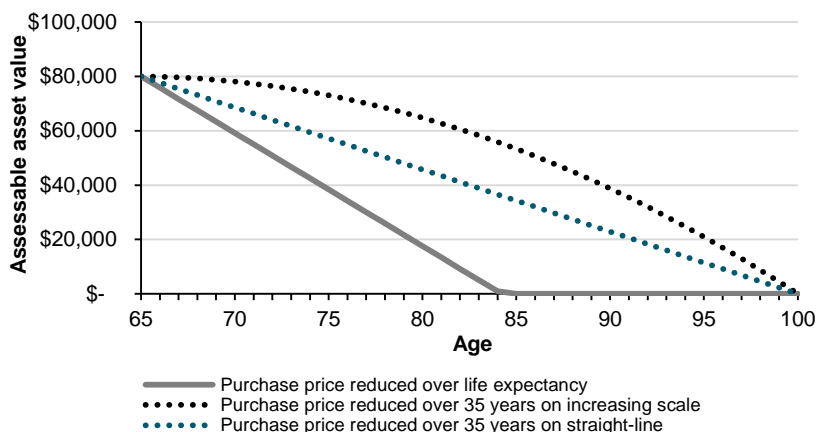
32. Whilst people most benefit from these products if they are long-lived, at least half of the population purchasing such products could be anticipated to be benefiting from them beyond life expectancy. On this basis there may be a case for modifying the existing rules to reduce the purchase price over longer timeframe (say to age 90, 95 or 100) for lifetime products. This would better acknowledge the ongoing value of lifetime products whilst retaining the simplicity of the current approach. It may also improve neutrality and equity and help reduce the extent to which the existing rules could be used to shield amounts from the assets test once a person lives past their life expectancy.

### **Assets test rules that reduce the assessable value of income streams on a straight line basis might be considered concessional**

33. The straight line reduction of the purchase price used by the capital reduction rules may also be considered to be concessional in its own right. This methodology reduces the assessable value at an even rate over time as a way of recognising the return of the original capital investment. However, a stream of payments from a financial investment may, in general, be expected to return modest amounts of capital in the early stages, with an increasing proportion of payments consisting of the return of capital (and any longevity dividends) as the earning potential of the initial investment decreases over time.
34. On the other hand, the current straight line approach may be considered to strike an acceptable balance between simplicity and accuracy for products where investors have limited access to their capital and the investment is managed at the fund level.
35. Adopting a different assets test formula for assessment that decreases the asset value by an increasing amount as time progresses arguably provides a more accurate reflection of the value of these income streams over time, compared to the current straight line reduction method. For example, a method analogous to that used to calculate accelerated depreciation for tax purposes could be used (but in reverse), by using a simple mathematical formula to apportion an increasing percentage of the nominal value of the initial purchase price each year. This would be achieved by using a fraction in which the numerator is determined by the number of years since the product was purchased and the denominator by summing the count of the total number of assessable years (that is,  $= 1 + 2 + \dots + n$ , where  $n$  is the last assessable year).
36. For illustrative purposes, if a person was to purchase a lifetime annuity at age 90 and the purchase price was to be reduced over the ten year period to age 100, the purchase price would be reduced as follows. In the first year the purchase price would be reduced by an amount equal to the purchase price multiplied by 1 divided by 55 (which is the sum of  $1 + 2 + \dots + 10$ ). In the second year, the assessable value would be reduced by a further  $2/55$  of the purchase price. Similarly, in the tenth year, the reduction from the ninth year would be  $10/55$  of the purchase price.

37. Chart 2 on the next page shows the current rules for a \$80,000 lifetime income stream compared to possible results if the assessable asset value was reduced on a straight line basis over a timeframe of 35 years to age 100, or if the asset value was reduced more rapidly as time progressed.

**Chart 2: Different assets test methods for a lifetime income stream product<sup>13</sup>**



38. Alternatively, an actuarial approach could be taken, requiring that the net present value of non-account-based income streams be calculated, either with reference to the value of the future schedule of payments (allowing for some element of mortality risk) or a valuation of the assets underpinning the product. This would most likely require product providers to produce an ongoing valuation of income stream products. The costs and benefits of such an approach would need to be carefully considered.

### **Current definitions used by the assets test may not fully cover product characteristics**

39. The current definitions used by the means test to assess product features such as residual capital value are narrow and may not fully capture amounts characterised as death benefits or other insurance-like features. It is important to the equity and neutrality of means test outcomes that product characteristics are fully captured by the rules. This will also assist in ensuring that means test provisions are robust and do not create opportunities to arbitrage the rules to maximise income support payments and shield income or assets from the means test. Ensuring that definitions are suitably broad will help ensure an assessment approach that is resilient to future product innovation.

<sup>13</sup> Assumes a lifetime income stream was purchased by a 65 year old male. Alternative treatments reduce the purchase price on a straight line basis over 35 years to age 100 (instead of life expectancy), and using the increasing reduction model described above.

## **Income test deduction amounts may not provide a realistic representation of the return of capital for non-account income stream products**

40. The current deduction amount approach for annuity products allows for the return of capital as part of the scheduled payments from the product by apportioning the initial purchase price over a specified period of time (either the term of the product or life expectancy). Because the deduction amount has a nominal value it reduces in real terms over time. Where the value of payments is indexed (for example to inflation) this means that a greater proportion of a person's payments will be assessed over time. This suggests that the current rules may not provide a particularly good representation of the return of capital over time. Generally it may be expected that payments would have an increasing proportion of capital return over time as the initial investment is slowly dissipated.
41. However, the principal weakness in the present rules relates to the deduction amount for lifetime income streams. The current rules determine the deductible amount for these products by attributing the purchase price over the period until a person reaches their life expectancy (at purchase). However, this deductible amount continues to apply indefinitely. The cumulative value of deductions can considerably exceed the initial capital investment where people live beyond their life expectancy. Because this occurs during a period in which no asset value is recognised by the assets test (once a person reaches their life expectancy), it also suggests that the income and assets tests are poorly aligned for these products. The current rules arguably do not adequately reflect the return of the original capital investment, nor provide neutral and equitable means test outcomes during this period.
42. On this basis, there may be a case for better linking income test rules representing the return of capital for lifetime income stream products to the actual characteristics of the product. This may be achieved, for example by adopting a formula that capped the maximum aggregate value of deductible amounts at the nominal value of the purchase price. There is a policy case for consistently aligning the reduction of the assessable value for the assets test and deduction amounts for income test purposes.

### **Questions for discussion**

- Q1. Given the shortcomings identified above, what changes should be made to improve the means test rules for existing income stream products to ensure that they meet the policy principles of neutrality, equity, resilience, integrity, fiscal sustainability and simplicity?
- Q2. What changes, if any, are necessary to ensure a sound foundation for new rules to assess innovative income streams?



## F. Possible directions for means test rules to assess new products

43. The new superannuation regulations will allow more complex retirement income stream products to be brought to market. Because the exact nature of these products is not yet known, and is likely to evolve, it is important to establish resilient means test rules that will continue to provide appropriate outcomes in the face of product innovation. The new superannuation rules aim to encourage innovative retirement products to be brought to market, providing more options for retirees. It may also be anticipated that people may hold a combination of these products.
44. This means that the means test rules for new products will need to be capable of providing a robust, fair and effective assessment of products with characteristics that are complex and hence more likely to be difficult to assess.

### **Assessing products with a deferral period**

45. One anticipated outcome of the new superannuation rules is the provision of retirement products with a deferral period. Products such as Deferred Annuities (DAs) and Deferred Group Self Annuities (DGSAs) can provide a stream of income that commences later in a person's life. These products provide more choices for people who are concerned that they may outlive their retirement savings and wish to purchase additional longevity protection.
46. The Age Pension intrinsically delivers a certain amount of longevity protection within Australia's Retirement Income System by ensuring a safety net minimum level of income. It also serves to supplement people's retirement income as they draw down their retirement savings, including superannuation, over time. Whether a person chooses to purchase a deferred product may depend upon their preferences regarding levels of consumption later in life and whether they consider that the minimum income defined by the maximum rate of the Age Pension to meet these objectives.
47. Reflecting the policy intent of the new superannuation rules, the exact product characteristics that innovative deferred products may exhibit is not yet clear. It is reasonable to anticipate that annuities, account-based products, and hybrid products with deferred payment may become available. Means test rules will need to be suitably flexible and robust to effectively assess a range of products.
48. In determining appropriate rules for deferred products it is necessary to consider outcomes both during the deferral phase and once the product vests and starts providing a stream of income.

### **Assessment during the deferral period**

49. Under current means test rules, existing products with similar characteristics – such as insurance bonds – are fully assessable through the deferral period. Deferred annuities would also be assessed at their market value by the assets test and deemed by the income test during the deferral period.

50. Assessing income stream products during a deferral period needs to balance a range of considerations. Products in this phase possess insurance like characteristics as well as functioning as a financial investment. On the one hand, people purchasing products with long deferral periods do so to secure a source of income should they live to an old age, but do not know the extent to which they may benefit from this in advance. On the other hand, whilst these products benefit from the pooling of mortality risk, they also function as a typical financial investment that compounds earnings during the deferral period, which contributes significantly to the size of payments once the product vests.
51. Because products may be commutable and/or provide death benefits during the deferral period they may offer differing access to a person's original capital investment during the deferral period. The new superannuation rules will require that such features are only available before a person reaches life expectancy, and must reduce to zero by this point in time. Where a person does have access to their capital during the deferral period, the commutable surrender value or death benefits available may not reflect the full value of the income stream as an investment.
52. The assets test rules during this phase present a policy balance between ensuring the horizontal equity and neutrality of outcomes compared to those who choose to invest similar amounts in other products and investments, and recognising that holders of deferred products may have significantly limited access to the invested capital for self-support during the deferral period.
53. A further consideration is that deferred products, by securing a reliable stream of income in later life, may assist people to plan to more efficiently and comprehensively draw on their other retirement savings into a stream of retirement income to support consumption during the deferral period.
54. It is sometimes suggested that deferred products should be exempt from the assets test during the deferral period, at least to the extent that a person does not have access to their capital investment. This raises important policy considerations. If means test treatment of these products during the deferral period is concessional, this can have consequences for the equity of the income support outcomes, and the neutrality of point-in-time outcomes compared to other products. For example, where people choose to manage longevity risk by holding different investment products with the intent of using them to provide income later in life, these products would be fully assessed by the assets test. This may result in lower levels of social security support compared to an exempt deferred product. There is a risk that people's investment choices could be distorted by the favourable impact of an exemption on assets test outcomes. Exemptions can also pose risks to means test integrity to the extent that they help to shield assets from the assets test. Concessional treatment of products during a deferral period risks the use of these products to fund bequests while attracting higher Age Pension to fund current needs.

55. Providing an exemption would also break with the direction of recent means test reform, which have removed exemptions for particular types of products or investments in order to improve the equity, neutrality and integrity of the means test. This reflects a policy position that it is not desirable to use means test to incentivise an individual's investment behaviour – particularly as this would be in tension with the primary policy objective of means testing to target assistance sustainably and according to need. To the extent that an exemption resulted in increased social security payments over the deferral period, it is reasonable to consider whether this is an appropriate outcome within the context of a targeted social security system with an assets test.
56. In considering these issues, it is important to recall the fundamental policy objective of the means test, which is to assess a person's overall capacity for self-support and target social security expenditure according to need. It is important that the means test rules fairly assess products which help to manage longevity risk without distorting or subsidising particular choices or risk preferences.
57. Where products have an identifiable account balance, unit value, or known market value, there is a strong case, on first principles, for assessing this amount under the assets test during the deferral period. This would treat these products similarly to other financial investments, and ensure similar means test results to a situation in which a person was to set aside a similar amount in another type of product with the intent of accumulating compounding returns in order to manage longevity risk. Allowing assessments based on the initial investment amount, or purchase price, for products that have an account balance, or allow people to manage the underlying investments in a manner similar to account-based products would create a significant disjuncture with the assessment of account-based income streams and other directly held financial investments.
58. For products without an account balance, assessments during the deferral period may be based on the purchase price, the commutable surrender value of a product (including death benefits), or an actuarial valuation of the product. A range of possible approaches are set out in Table 2.
59. As these products do not provide a stream of income during the deferral period, a key question regarding the treatment of products by the income test during the deferral period relates to whether the value of the product should be deemed. As noted above, under the current income test rules deferred annuities would also be assessed at their market value by the assets test and deemed by the income test during the deferral period. Deeming products during the deferral phase may be justified on the grounds of ensuring a neutral treatment with other product, and because the initial purchase amount is in practice providing investment returns that are being reinvested in order to support deferred consumption – even if the product is not providing a payment to investors during this period.

**Table 2: Possible assets test treatments for non-account products during the deferral period**

Policy Issues	<i>Assessing the commutable / surrender value &amp; death benefits</i>	<i>Assessing the nominal purchase price*</i>	<i>Assessing the purchase price* in real terms</i>	<i>Assessing the purchase price* adjusted to reflect earnings</i>	<i>Assessing the actuarial value of the product</i>
<b>What is assessed?</b>	<p>Commutable (surrender) value and any death benefit payable to a person's estate, during the deferral period.</p> <p>Under the capital access schedule this may be up to the purchase price until a person reaches life expectancy.</p>	Purchase price in nominal terms.	Purchase price in real terms (adjusting for inflation).	Purchase price adjusted to reflect earnings (e.g. the upper deeming rate).	Actuarial valuation of the value of the product.
<b>Policy rationale</b>	Focused on the amount of capital that the person retains access to for self-support and bequests.	Acknowledges that the product has value during the deferral period -- but places a greater focus on the initial amount invested, rather than the current value of the product or underlying investments.	<p>Acknowledges that the product has value during the deferral period.</p> <p>Acknowledges that purchase amount is invested over the deferral period by maintaining its value in real terms.</p> <p>Less concessional than assessing the nominal purchase price.</p>	<p>Acknowledges that the product has value during the deferral period.</p> <p>Acknowledges that purchase amount is invested over the deferral period by assessing its capacity to generate earnings.</p> <p>Improved neutrality with account-based products and other investments.</p>	<p>Recognises that the original investment increases in value during the deferral period.</p> <p>Arguably most neutral and comparable to assessment of account-based income streams.</p> <p>Neutrality with other investments.</p>
<b>Policy considerations</b>	<p>May not reflect the total means available for self-support throughout retirement.</p> <p>Could be highly concessional where products have limited commutability – impacting neutrality and equity.</p> <p>Risks allowing people with sufficient means to shield assets from the means test.</p>	<p>Assessable value decreases in real terms before product vests.</p> <p>Concessional compared to the value of underlying investments.</p> <p>Arguably concessional compared to other products.</p> <p>Value of product when product vests likely to be substantially higher.</p>	<p>Concessional compared to the value of underlying investments.</p> <p>Arguably concessional compared to other products.</p> <p>May not reflect the value of the product when it vests.</p>	Deemed earning rate used to inflate the initial purchase price would need to credibly reflect the nature of the product.	<p>Likely to result in an increasing assessable value over the deferral period, even when capital is not accessible.</p> <p>Implementation burden for providers needs to be evaluated.</p>

\* Where an income stream product is purchased by instalment, the aggregate of all instalments to date would be assessable as the purchase price.

## Assessment once a deferred product commences making payments

60. A related issue is how to assess deferred products once they have vested and are paying a stream of income. Key issues during this phase are establishing a reasonable assessable asset value for the assets test, and how to assess income.
61. An issue is whether the ongoing value of the asset should reflect the initial purchase price, or the present value of the income stream. The treatment of the assessable asset value during the deferral phase is critical here. If the assessable value increases during the deferral phase, in recognition of the growing value of the underlying investments, then it may be defensible to continue this asset value into the assessment of the product in the payment phase. On the other hand, assessing the initial nominal purchase price after a considerable deferral period would arguably result in an assessable value that is considerably below the actual value of the income stream. This suggests that the assessable asset value would need to be re-assessed when the product vests. The case for this becomes stronger the more concessional any treatment in the deferral phase is.
62. A related question is how the assessable value of the income stream should be reduced over time during the payment phase. A first principles approach to means testing suggests that these products should be assessed in a manner that is similar to equivalent non-deferred products once they commence making payments. From this perspective, the characteristics of the product once it has passed the deferral phase would guide assessment.
63. In considering these issues, it is important to ensure that the rules are consistent with the principles of equity and neutrality, and supports the integrity and sustainability of the income support system. It is also important that the total impact of the means test over retirement is fair.
64. With respect to the income test, it is also preferable that assessment rules for deferred products once they move into the payment phase aligns with the treatment of equivalent income stream products. This would include an acknowledgement of a return of the investor's original capital over this period to the extent that a deduction amount approach is retained. For products where payments are not based on an agreed schedule but instead varies in line with the underlying investments, a deeming approach may be more appropriate.
65. There may be a case for considering whether the unique nature of deferred products would be better represented by an assessment structure that does not deem the product during the deferral phase – that is, does not assess the reinvestment of earnings as income during this period – in return for assessing all of the income paid by these products after the product vests. The cumulative impacts at both a fiscal and individual level of this option would need to be carefully assessed.

## Questions for discussion

- Q3. What approach to income and assets testing income streams **during the deferral period** would best meet the policy principles of neutrality, equity, resilience, integrity, fiscal sustainability and simplicity?
- Q4. On what basis should deferred income stream products be assessed **once they have commenced providing payments**?
- Which approach to establishing an assessable asset value best meets the policy principles of neutrality, equity, resilience, integrity, fiscal sustainability and simplicity?
  - How should income be assessed?
- Q5. Are there other approaches or issues regarding the assessment of income streams with a deferral period that have not been canvassed above that it is important to consider?

## Assessing complex and hybrid products

66. The potential for complex and hybrid products is well demonstrated by the variety of ways in which a group self annuity product might be delivered. Such products could potentially take the form of an account-based product, a unit interest in a pooled fund, as a more traditional annuity product, or as a hybrid combining elements of these approaches. The structure of payments may also take a range of forms, including a specified schedule of pre-determined payments, a flexible payment structure, or a share of variable returns. Such products may also have elements that are best characterised as an insurance component.
67. A threshold question for the means test assessment of complex income stream products under the new rules is whether it is more appropriate to assess the product as a whole, or to separately assess the individual components of a product? This is particularly important with respect to establishing an appropriate assessable value for the purposes of the assets test.
68. A second threshold question is whether it would be appropriate to assess such products on the basis of their purchase value? Such an approach may result in these products receiving a concessional treatment compared to account-based income streams and other directly held financial investments, particularly where the value of the assets underpinning the income stream are expected to increase during the early phase of the product. Another challenge with relying on assessing the initial investment amount is that it may result in unequal means test treatments where hybrid products include an account component that provides the holder with access to some or all of their capital.

69. Basing assessment on an **actuarial value of the product as a whole** offers one approach to ensuring a defensible and comprehensive assessment of the asset value of complex and hybrid products in which all components of a product are reflected in the assessment. This approach may also be more robust in circumstances where products are paid for by instalments, or where product features change over time. The practical and cost burden for providers in supplying and updating actuarial valuations for income streams over time would need to be carefully assessed in order to ensure that this approach was proportional and implementable by industry. Where providers are required to separately report on components under the minimum draw down and capital access schedule rules specified in superannuation regulations, this may minimise any additional reporting burden. The additional transparency and resilience that this approach may provide to means testing income streams in a developing and innovative market may also mean that the benefits resulting from this approach justify any additional reporting burden.
70. Alternatively, **complex products might be assessed as bundles of individual products**, so that each component can be separately assessed using the relevant means test rules. This approach relies on being able to break down complex products into recognisable components in a manner that fully captures the characteristics of the product and results in a fair assessment of product as a whole. This would require the different components of a product to be separately identified and accounted for – either by providers or by the Department of Human Services (Centrelink). A key challenge for this approach is ensuring that the means test rules provide clarity for income stream providers and customers regarding the manner in which a complex product would be broken down and assessed. Requiring providers to itemise and account for their products in terms of simpler components may help address this, but may impose an increased regulatory burden on industry. Another key consideration is whether this approach is likely to be robust in the face of innovative and hybrid products that may not readily be segmented into discrete components.
71. A related alternative would be to adopt a **principals-based approach which offers the option of actuarial assessment**. This approach may allow for income streams to be accounted in terms of their individual components, but offers the option for providers to seek agreement to a comprehensive annual actuarial evaluation of the product where they believe that this would better reflect the nature of the product. This approach would offer providers a choice of assessment approach – and the opportunity to either articulate complex products on a component basis or comprehensive basis.

### Questions for discussion

- Q6. Does assessing the actuarial value of complex and hybrid income stream products provide the most suitable approach to ensuring that the rules for these products satisfy the policy principles of neutrality, equity, resilience, integrity, fiscal sustainability and simplicity?
- Q7. Would assessing these products in terms their individual components better achieve these objectives? Are there circumstances in which this approach would be problematic?

- Q8. Is there a need for a determination process to provide binding advice on the treatment of particular income stream products? Would this assist in the development of innovative retirement income products?
- Q9. Are there other approaches or issues not canvassed above that it is important to consider?

## Ensuring definitions adequately capture product complexity

72. Increasingly, income stream products are being brought to market which include more complex features that complicate means test assessment. The current changes to the superannuation regulations are designed to further encourage product innovation to provide more choice to retirees.
73. This may include products which insure against future healthcare or aged care costs or provide insurance which guards against longevity and market risk by guaranteeing a minimum payment amount. Products may also offer characteristics such as commutable (surrender) values, death benefits, and residual capital amounts that provide purchasers with high degrees of access to invested capital and/or may help to satisfy bequest motives.
74. It is important to the equity and neutrality of means test outcomes that product characteristics are fully captured by the rules. As outlined above, experience administering the current rules suggests that there is scope for further refinement of the definitions used by the means test to ensure that product characteristics characterised as death benefits or other insurance-like features are appropriately captured by concepts such as the residual capital value of a product and definitions of income and assets.
75. A thorough review of definitions to ensure their robustness will be particularly important as more complex and innovative products emerge, particularly if the rules do not adopt a net present value approach that provides a holistic actuarial evaluation of a product.
76. This would include ensuring that products that directly purchase or cover the costs of services are captured within the definition of income under the concept of valuable consideration.

### Questions for discussion

- Q10. Are there current legislated definitions relating to income stream products that create ambiguity regarding means test treatments?



## Interactions with the targeting of other social policy systems including residential aged care

77. In addition to income support provided through the social security system, other major social policy systems relevant to older Australians, including residential aged care services, are also provided on the basis of policy that targets assistance according to need and encourages self-provision. It is important that targeting policies are closely aligned across such systems in order to ensure fair and sustainable outcomes and that outcomes are well aligned with the underlying policy intent.
78. Where products include features which may interact with targeted services and support it will be important to carefully work through the interactions between the social security means test and other targeting and means testing arrangements to ensure that a consistent and cohesive approach is adopted across different social policy systems. It is not desirable for social security means testing rules to be developed in isolation from this broader context. The Department of Social Services will work closely with other Australian Government departments, and engage with industry as appropriate to ensure a consistent and coherent approach to means testing across major policy systems relevant to older Australians. This may include subsequent discussion papers and consultation regarding rules for products relevant to multiple policy systems, where necessary.

### Questions for discussion

- Q11. To what extent are interactions with means testing for other social policy systems, such as residential aged care important to the development of retirement income products?

## G. Timeframes for comment

79. The Department is seeking comments on the issues raised in this paper, including responses to the questions for discussion and comments on any other issues relating to the means test assessment rules for retirement income streams. Submissions will help inform the development of legislation.
80. Comments should be sent to the following address on or before 1 February 2017.
81. The Department has established a dedicated point of contact for the purposes of this process. Please direct all enquiries regarding the discussion paper and submission to: [retirementincomestreams@dss.gov.au](mailto:retirementincomestreams@dss.gov.au).

## Appendix 1: Summary of current means test rules for income streams

The following table provides a short summary of key aspects of the current means test rules for income streams. Please note that this information is a summary for the purposes of this discussion paper. It is not intended to be comprehensive. The *Social Security Act 1991* and the online *Guide to Social Security Law* should be referred to for a definitive account of the means test provisions relating to a particular type of income stream.

Type	Assets test assessment	Income test assessment
<p><b>Account-based income stream</b> (also known as account-based pensions or allocated pensions)</p> <ul style="list-style-type: none"> <li>Income stream paid each year, based on a percentage of the account balance.</li> <li>A minimum withdrawal amount (percentage) is required each year, based on a person's age.</li> <li>Capital can be withdrawn at any time.</li> </ul>	<p>The current account balance is an assessable asset.</p>	<p>The current account balance is included as a financial investment and the social security income test deeming provisions are applied.</p>
<p><b>Market-linked income stream</b> (also known as term allocated pensions)</p> <ul style="list-style-type: none"> <li>Income stream paid each year based on a percentage of the account balance.</li> <li>Minimum and maximum income withdrawal amounts apply each year (based on pension valuation factors).</li> <li>Capital cannot be withdrawn.</li> </ul>	<p><i>For products purchased from 20/7/2004 and 19/9/2007:</i> 50 per cent of the current account balance is assessed.</p> <p><i>For products purchased from 20/7/2007:</i> 100 per cent of the current account balance is assessed.</p>	<p>Assessable income is equal to the amount specified by the purchaser to be received over the financial year less an amount presenting the return of capital (deduction amount equal to the purchase price of the income stream at commencement divided by the product's term).</p>
<p><b>Lifetime income streams</b> (also known as lifetime annuities).</p> <ul style="list-style-type: none"> <li>Capital is exchanged for regular payments for the lifetime of the purchaser.</li> <li>Payments may continue for the life of a surviving partner.</li> </ul>	<p><i>For products purchased prior to 20/9/2004:</i> 100 per cent exempt from the assets test.</p> <p><i>For products purchased from 20/9/2004 to 19/9/2007:</i> 50 per cent of the purchase price at commencement is assessed in the first year; this value is then reduced on straight line basis over the number of years the purchaser is expected to live (at the time of purchase).*</p> <p><i>For products purchased from 20/9/2007:</i> 100 per cent of the purchase price is assessed in the first year; this value is then reduced on a straight line basis over the number of years the purchaser is expected to live (at time of purchase).*</p>	<p>Assessable income is equal to the amount received less a deduction amount equal to the purchase price of the income stream at commencement (less any residual capital value) divided by the number of years the purchaser is expected to live at the time of purchase.*</p>

Type	Assets test assessment	Income test assessment
<p><b>Life expectancy income streams</b> (also known as term-certain annuities)</p> <ul style="list-style-type: none"> <li>Capital is exchanged for a guaranteed income payable for a set term.</li> <li>No access to capital unless a set amount (the residual value) is agreed to be paid at the end of the term. This would reduce the amount of income received over the product's term.</li> </ul>	<p><i>For products purchased prior to 20/9/2004:</i> 100 per cent assets test exempt.</p> <p><i>For products purchased from 20/9/2004 to 19/9/2007:</i> 50 per cent of the purchase price at commencement is assessed in the first year; this value is then reduced on a straight-line basis over the product's term.</p> <p><i>For products purchased from 20/9/2007:</i> 100 per cent of the purchase price is assessed in the first year; this value is then reduced on a straight-line basis over the product's term.</p>	<p>Assessable income is equal to the amount received less a deduction amount equal to the purchase price of the income stream at commencement (less any residual capital value) divided by the product's term.</p>
<p><b>Income streams with a term of 5 year or less</b></p> <ul style="list-style-type: none"> <li>Capital is exchanged for a guaranteed income payable for a set term of 5 years or less.</li> <li>Income is typically just interest payments.</li> <li>All capital is returned at the end of the term or sometimes as part of the regular payments.</li> </ul>	<p>The assessable asset value is equal to the purchase price in the first year, and then reduced annually by a deduction amount equal to the purchase price (less any residual capital value) divided by term.</p> <p>Note: The residual capital value for many such products is equal to the purchase price, resulting in the full value of the purchase price being assessed for the product's term.</p>	<p>Assessable income is determined by applying the deeming rules to the assessable asset value.</p>
<p><b>Defined benefit income stream</b></p> <ul style="list-style-type: none"> <li>A guaranteed income payable for the lifetime of the employee that commonly reflects years of service and final salary.</li> <li>No access to capital.</li> </ul>	<p>Not assessed by the assets test.</p>	<p>Assessable income is equal to the amount received less a deductible amount that reflects the return of the person's own after-tax contributions. It is generally expressed as a percentage.</p> <p>From 1 January 2016, the deductible amount was capped at 10 per cent of amount received to address an anomaly from the 2007 Better Super package (see Appendix 2, below).</p>
<p><b>Deferred annuities</b></p> <ul style="list-style-type: none"> <li>A managed investment that pays no income until it converts to a lifetime annuity at a specified date (for example at age 85).</li> <li>Regular income payments, based on value of investment at commencement date, are payable for the lifetime of the purchaser.</li> <li>Generally, access to capital is restricted or not possible.</li> </ul>	<p>Under current rules, the current asset value is an assessable asset during the deferral period (until the income stream commences).</p>	<p>Assessable income is determined by applying the deeming rules to the current asset value during the deferral period (until the income stream commences).</p>

\* As per the relevant Australian Government Actuary's Life Tables.

## Appendix 2: Recent changes to the means test treatment rules for income streams

There have been a number of targeted changes to the means test treatment of income streams over the period from 2004, aimed at improving the fairness of means test outcomes and providing a more accurate assessment of people's means of self-support.

The asset test treatment of non-commutable **lifetime and life expectancy income streams** with no residual capital value was amended in 2004 and 2007 to improve the vertical and horizontal equity and neutrality of outcomes under the assets test. Prior to 20 September 2004, these products were granted a 100 per cent exemption for the assets test. One consequence of this rule was that such exemptions could be used to shield wealth from the assets test, resulting in a higher Age Pension payment than if different financial investments had been chosen. From 20 September 2004, the asset-test exemption was reduced from 100 per cent to 50 per cent. The 50 per cent asset test exemption was also extended to market-linked income streams at this time to support increased competition from a wider range of providers. These exemptions were removed from 20 September 2007.

From 1 January 2015, the social security income test deeming provisions were extended to **account-based income streams** (ABISs). The previous income test rules – which allowed for a deduction amount – resulted in concessional income test outcomes for investments held in an ABIS compared to identical financial investments held directly by the individual. Extending the deeming rules to ABIS improved the equity and neutrality of income test outcomes by ensuring that people with similar financial assets receive similar income test outcomes, regardless of whether their assets were held directly or in an account-based superannuation income stream. Existing account-based income streams held by income support recipients as at 31 December 2014 have been 'grandfathered' and will continue to be assessed under the existing rules, unless the account holder chooses to change products or ceases to receive an income support payment.

The 2015-16 Budget announced changes to the income test assessment for **defined benefit income streams**, which came into effect on 1 January 2016. Under the income test, the gross income from a defined benefit pension is assessed, however a deduction is allowed for based on personal after-tax contributions. From 1 January 2016, the proportion of income from that can be excluded from the income test, known as the deductible amount, was capped at 10 per cent. This reform helped to improve the equity of social security outcomes by better reflecting the income that recipients received from their defined benefit income stream. It addresses an anomaly from the 2007 Better Super package, in which changes to tax legislation had an unintended flow on effect for the calculation of the deductible amount for the social security income test.