Challenger Tech

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Fixed term annuity strategies

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Challenger offers fixed term annuities which make regular payments for a chosen term. Regular payments can increase each year by a fixed percentage or in line with increases to the CPI[1]. Capital can be returned as part of the regular payments or as a lump sum at the end of the term.

In this month's article we will look at fixed term annuity strategies within Self-Managed Super Funds (SMSFs), during peak spending in retirement, as an alternative to term deposits and for non-residents. We will use case studies to demonstrate practical applications and benefits of fixed term annuities.

For further information on fixed term annuities, see Challenger Guaranteed Annuity (Fixed Term) Product Disclosure Statement.

SMSF minimum payment

SMSF's have to meet minimum pension payment requirements each financial year for members with account- based pensions. Fixed term annuities can provide cash flow to help ensure minimum payment obligations are met without having to sell down other assets.

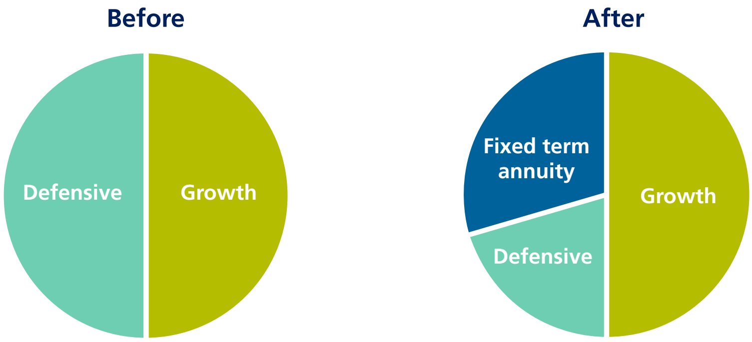
Age	Minimum payment % of account balance
Under 65	4%
65 - 74	5%
75 - 79	6%
80 - 84	7%
85 - 89	9%
90 - 94	11%
95+	14%

1 CPI indexation is only available for terms of 2 years or more where all capital is returned as part of regular payments..

Case study

Ivan and Irene are a couple, both 65 years old, have recently retired and have $1,000,000 each in their SMSF. They are both in pension phase drawing the minimum payment and have a growth/ defensive asset allocation of 50/50.

Their financial adviser recommends they invest $590,000 within the SMSF into a seven year fixed term annuity with no residual capital value. The annuity will make regular annual payments of $100,307[2] and will form part of the defensive component of the asset allocation over time. To maintain the growth/defensive asset allocation of 50/50, income is reinvested in defensive assets over time.



The fixed term annuity will provide cash flow to help ensure the SMSF can meet the 5% minimum payment for the next seven years. The annuity will also provide interest rate certainty on part of the defensive component of the asset allocation.

Peak spending in retirement

Spending in retirement tends to change as retirees progress through the three phases of retirement. The active phase of retirement is at the start when retirees are healthy and maximise their lifestyle. As retirees get older and activity starts to slow down, they move to the passive phase of retirement. The frail phase of retirement is at the end when health declines and retirees have limited physical capacity.

Peak spending in retirement generally occurs during the active phase when retirees typically have higher recreational expenditure. Fixed term annuities can provide additional cash flow during peak spending in retirement without having to draw down from other assets.

For more information about spending in retirement, see "Money in retirement: More than enough", Grattan Institute, November 2018.

Case study

Tony and Helen are a couple, both 67 years old, own their home worth $1.5m and have recently retired. They have $600,000 each invested in account-based pensions, $50,000 in cash and $20,000 of personal contents.

Tony and Helen are both in good health and want to see the world during the active years of their retirement. They plan to travel for the next 10 years and estimate they will need $20,000 p.a. of additional cash flow.

Their financial adviser recommends they rollover $180,000 from their account-based pensions into 10-year fixed term annuities with no residual capital value. The annuities will make combined annual payments of $20,302[3] in the first year which will increase each year in line with increases to the CPI.

2 Challenger eQuote as at 23/09/2024, 7 year term, annual payments, nil indexation, nil residual capital value, nil adviser fees.

3 Challenger eQuote as at 23/09/2024, 10 year term, annual payments, CPI indexation, nil residual capital value, nil adviser fees.

Assets	Before	After
Home	$1,500,000	$1,500,000
Account based pensions	$1,200,000	$1,020,000
Fixed term annuities	N/A	$180,000
Cash	$50,000	$50,000
Personal contents	$20,000	$20,000

The fixed term annuities will provide additional cash flow protected against inflation for the next 10 years to meet their travel expenditure. The annuities will also protect their account-based pensions from additional draw down during potential market downturn.

As an alternative to term deposits

Fixed term annuities can be used as an alternative to term deposits within the defensive component of an investment portfolio. When annuities are structured similarly to term deposits with 100% residual capital value, the interest rates are competitive over the same terms[4,5].

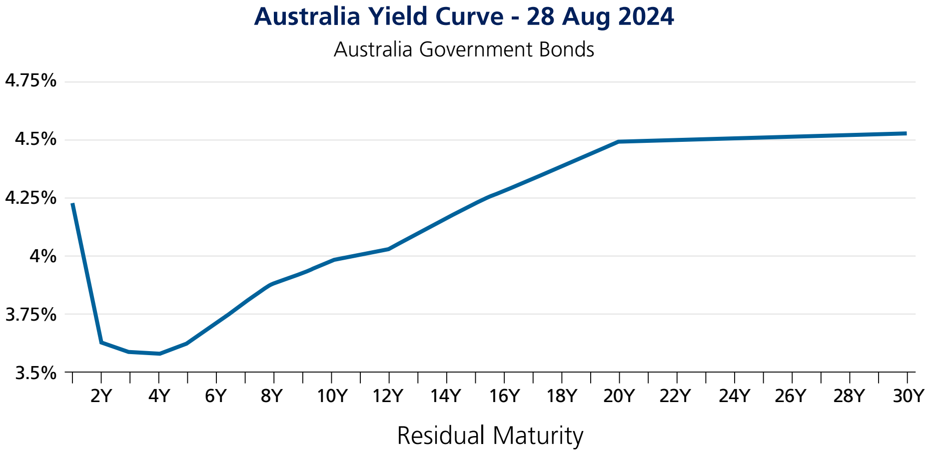
Term	Monthly payments	Annual payments
1	4.55%	N/A[6]
2	4.36%	4.45%
3	4.36%	4.45%
4	4.36%	4.45%
5	4.41%	4.5%

	CBA		NAB		ANZ		WBC	
Term	Monthly	Annual	Monthly	Annual	Monthly	Annual	Monthly	Annual
1	4.3%	4.4%	4.4%	4.5%	4.41%	4.5%	3.95%	4%
2	3.6%	3.75%	3.95%	4%	3.93%	4%	3.75%	3.8%
3	3.4%	3.5%	3.25%	3.3%	3.93%	4%	3.55%	3.6%
4	3.4%	3.5%	3.25%	3.3%	3.93%	4%	3.55%	3.6%
5	3.4%	3.5%	3.25%	3.3%	3.93%	4%	3.55%	3.6%

4 Challenger Guaranteed Annuity rates as at 23/09/2024, 100% residual capital value.
5 Term deposit rates of the Big Four Banks as at 23/09/2024.
6 Minimum regular payment frequency for 1 year fixed term annuity is half yearly.

Case study

Angelina currently invests part of the defensive component of her investment portfolio in rolling one year term deposits. She follows the Australian Government Bond yield curve and is concerned that interest rates are going to decrease over the short term[7].



Her financial adviser recommends she invest $1,000,000 into a five year fixed term annuity with 100% residual capital value. The annuity will make regular annual payments of $45,000 and the investment will be repaid at the end of the term.

The fixed term annuity will provide $225,000 of income for the next five years which can be reinvested in her portfolio. When compared with term deposits, assuming interest rates fall by 0.5% after the first year, she will earn $20,000 more income.

Year	Term deposit[8]	Fixed term annuity
1	$45,000	$45,000
2	$40,000	$45,000
3	$40,000	$45,000
4	$40,000	$45,000
5	$40,000	$45,000
Total	$205,000	$225,000

Non-residents

Fixed term annuities purchased by non-residents are taxable depending on whether there is a double tax agreement (DTA) with the country where they are a tax resident. Where the country has a DTA with Australia, the DTA usually stipulates which country has taxing rights over annuities.

Where the country doesn't have a DTA with Australia, annuities are generally subject to PAYG tax on the assessable amount of the regular payments at non-resident tax rates. The assessable amount is the regular payments received during the financial year reduced by the deductible amount.

Deductible amount = (purchase price - residual capital value) / term

Assessable amount = regular payment - deductible amount

For the list of countries which have a DTA with Australia, see Income Tax Treaties on the Treasury website Income Tax Treaties | Treasury.gov.au

7 Australia Government Bonds - Yields Curve (worldgovernmentbonds.com).
8 $1,000,000 invested at highest 1 year term deposit rate of the Big Four Banks as at 23/09/2024.

Case study

Kenzo is a Japanese tax resident and is visiting his daughter in Australia who is studying at university for three years. He is considering a short-term investment to provide her with enough cash flow to meet her living expenses of $2,500 p.m. Australia has a DTA with Japan which stipulates that annuities are only taxable in the country where the individual is a tax resident.

His financial adviser recommends he invest $700,000 into a three year fixed term annuity with 100% residual capital value. The annuity will make regular monthly payments of $2,544[9] and will not be taxable in Australia because Kenzo is Japanese tax resident.

The fixed term annuity will provide enough cash flow for Kenzo's daughter to meet her living expenses for the next three years. When compared with term deposits, the annuity provides higher cash flow because of the interest rates and term deposits are subject to non-resident withholding tax.

Year	Term deposit	Fixed term annuity
Gross payment	$27,510[10]	$30,532
Withholding tax	$2,751[11]	$0
Net payment	$24,759	$30,532

An alternative structuring arrangement for this investment could include the use of a three-year nil RCV annuity in Kenzo's name. Further, if Kenzo were prepared to allow his daughter control over the investment a three-year nil RCV annuity could be held in her name but with the assessable amount of the regular payments taxable here in Australia.

9 Challenger eQuote as at 23/09/2024, 3 year term, monthly payments, 100% residual capital value, nil adviser fees.

10 $700,000 invested at highest 3 year term deposit rate of the Big Four Banks as at 23/09/2024.

11 DTA with Japan stipulates that interest is taxable in the country where it is earned at a maximum of 10%.

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