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Making the most of 1 January 2017 Assets Test changes

By Minh Ly

In recent years, there have been a number of changes to the social security pension rules that has created opportunities for advisers providing retirement income advice.

Changes to the social security pension rules include:

- deeming of account based pensions (ABPs) from 1 January 2015
- capping deductible amounts for defined benefit income streams from 1 January 2016, and
- increasing the Centrelink/DVA Assets Test thresholds and taper rate from 1 January 2017.

From an advice perspective, the next big rule change will occur within the next 4 months and the current expectation is that Centrelink will communicate information to age pensioners in October 2016.

The next few weeks provide a great opportunity to talk with your clients about these changes, the impact it may have on their cash flow and the options that are available to help.

In this article, we explore some of these considerations and take a closer look at the short and longer term implications to a client's overall retirement outcome.

Let's start with a recap

There are two changes to the social security pension Assets Test on 1 January 2017:

1. an increase to the Assets Test thresholds (Table 1), and
2. doubling of the taper rate from $1.50 to $3 per $1,000 of assets per fortnight.

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Table 1: Assets Test thresholds[1]

Client situation	Assets Test threshold (current)	Assets Test threshold (from 1 January 2017)
Single, homeowner	$209,000	$250,000
Single, non-homeowner	$360,500	$450,000
Couple, homeowner	$296,500	$375,000
Couple, non-homeowner	$448,000	$575,000

The first of the changes relate to the increase in the Assets Test thresholds allowing clients to hold more assets before their pension starts to reduce under the Assets Test. For some clients with lower asset levels, this may lead to higher pension entitlements. For others, the Income Test will continue to determine their entitlements.

For example, Tom aged 68, a single homeowner with $10,000 in personal assets, $20,000 in savings and $200,000 in a grandfathered ABP drawing the minimum. Tom's current Age Pension entitlement is $842.40[2] per fortnight under the Assets Test. This would increase to the maximum rate, currently $873.90[2] per fortnight, on 1 January 2017 if his total assessable assets remain below $250,000.

In contrast, we have Sally, also aged 68, single, non-homeowner and who has the same level of assets as Tom, but with a deemed ABP. Sally's current Age Pension entitlement is $832.59[2] per fortnight under the Income Test. If all else remained equal, Sally's Age Pension entitlement will remain unchanged when the new Assets Test rules commence as she would continue to be income tested.

The second change relates to the increase in the taper rate. This change will reduce Age Pension entitlements at a faster rate once assessable assets exceed the new Assets Test thresholds. The largest reduction in pension entitlements will occur at the new Assets Test cut-off thresholds (estimated in Table 2). Pensioners with assessable assets above the new cut-off will see their pensions reduce to nil such as in Matt and Lynn's case below.

Table 2: Assets Test cut-off thresholds[3]

Client situation	Current cut-off thresholds	Estimated cut-off thresholds at 1 January 2017
Single, homeowner	$791,750	$541,250
Single, non-homeowner	$943,250	$741,250
Couple, homeowner	$1,175,000	$814,250
Couple, non-homeowner	$1,326,500	$1,014,250

[1] https://www.humanservices.gov.au/customer/enablers/assets
[2] Based on Centrelink rates and thresholds as at 26/08/2016
[3] https://www.humanservices.gov.au/customer/enablers/assets

Matt and Lynn

Matt and Lynn (both are age 68) are a couple who own their home. They each have $450,000 in grandfathered ABPs that commenced two years ago. Their only other assets are $10,000 in personal effects and $40,000 in the bank for liquidity purposes.

Their current Age Pension entitlement is $337.15[4] per fortnight ($8,766 per annum) and to achieve their required retirement income of $65,000 per annum, they are drawing $28,117 per annum each from their ABPs.

If their assessable assets remain the same on 1 January 2017, their pension entitlement will reduce to nil.

Cash flow and two other important effects

The immediate impact with a reduced (or lost) pension is a reduction in cash flow. However, there are also two other effects which are also important.

The first is the loss of grandfathered status on existing ABPs. ABPs that commenced prior to 1 January 2015 can only remain grandfathered if a pensioner continues to be in receipt of an income support payment such as the Age Pension. Pensioners who lose their Age Pension entitlement on 1 January 2017 because of the Assets Test changes will have their ABPs deemed. In many cases this will lead to higher levels of assessable income going forward.

The second is the loss of the Pensioner Concession Card (PCC) and the concessions it provides. The Government has put in place provisions to ensure those who lose their PCC, because of the new Assets Test changes, are automatically issued with a Commonwealth Seniors Health Card (CSHC) and the Low Income Health Care card (LIHCC) without being subject to the applicable income test.

While each card gives access to the Pharmaceutical Benefits Scheme (PBS) Schedule, the PCC and LIHCC provides access to more state, territory and local Government concessions compared to the CSHC.

Replacing some lost concessions

The LIHCC can provide some relief for those losing concessions attributed to the PCC. The LIHCC and the CSHC can be held simultaneously, providing access to benefits and concessions afforded by each card.

To qualify for the LIHCC, in cases where the LIHCC is not automatically issued, the person must have assessable income below the thresholds in Table 3 (there is no Assets Test for the LIHCC). Assessable income is assessed in a similar way as the pension Income Test but also includes any government pensions and benefits.

Table 3: Low Income Health Care Card income limits (those with no dependent children)[4]

Client situation	Weekly income	Income in an 8-week period
Single	$536	$4,288
Couple	$927	$7,416

[4] Based on Centrelink rates and thresholds as at 26/08/2016.

Managing the cash flow reduction

Some clients may simply review and tighten their budgets to offset the reduction (or loss) in their pensions. Others may find this approach challenging, particularly those facing a larger reduction in entitlements. It can also be difficult for clients who are in the early years of retirement, a period when they may be most active.

Where clients are looking to maintain their cash flow, there are a number of options and strategies that can help manage the impact of the Assets Test changes. These include:

- increased drawdowns from income streams or savings
- asset reduction strategies such as:
  - bringing forward any future gifts up to the allowable limits ($10,000 per financial year, $30,000 over five years)
  - bringing forward capital expenses or home renovations which may help reduce ongoing living expenses and/or increase comfort in retirement
  - investing up to $12,500 (per person) in a funeral bond or pre-paying funeral expenses (no limit)
- investing a portion of capital in a lifetime annuity which can help meet ongoing cash flow needs from its regular income payments, and improve Age Pension entitlements over time with its reducing asset value.

The immediate and short term outcomes

Revisiting Matt and Lynn's case, if they were to increase their income payments from their ABPs, they will need to increase their annual pension payments from $28,117 to $32,500 each from 1 January 2017. Matt and Lynn's pension entitlement will remain at $337.15 per fortnight for the remainder of 2016 and reduce to nil from 1 January 2017.

Alternatively, if Matt and Lynn decide to reduce their assessable assets (withdraw $50,000 each from their ABPs) by immediately gifting $10,000 to their grandkids, purchase a funeral bond worth $12,500 each and buy a new car for $65,000, their assessable assets will reduce by $50,000:

- $10,000 from the gift
- $25,000 from the exempt funeral bonds
- $15,000 depreciation from a new car

The reduction in assessable assets will provide an immediate increase in their Age Pension entitlement of $75 per fortnight to $412.15[5] per fortnight (increased from $337.15[5] per fortnight). However, the reduction in assets is unlikely to prevent them from losing their Age Pension on 1 January 2017. As such, over the next 12 months their total pension entitlement will likely be $3,709 (based on nine remaining fortnights in 2016). This means Matt and Lynn will still be required to increase their income payments from their ABPs to $32,500 from 1 January 2017 to maintain their cash flow.

Finally, if Matt and Lynn used 30% of their ABP ($135,000 each) to commence a lifetime annuity, their assessable assets would reduce over time based on the annuity's reducing assessable asset value. The annuity's assessable value will reduce each year by the deduction amount or by half the deduction amount every six months if income payments are at least semi-annually.

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[5] Based on Centrelink rates and thresholds as at 26/08/2016.

The deduction amount is calculated as the purchase price divided by their life expectancy (assuming no reversionary beneficiary is nominated) and would equal:

- $8,017 for Matt ($135,000 / 16.84), and
- $6,930 for Lynn ($135,000 / 19.48)

As the annuity's first reduction doesn't occur until 6 months after it commences, Matt and Lynn's Age Pension entitlement will remain at $337.15 per fortnight until 1 January 2017 where it will reduce to nil. Based on nine remaining fortnights in 2016, their total Age Pension entitlement over the next 12 months will likely be $3,034.

Table 4 summarises Matt and Lynn's Age Pension entitlements over the next 12 months under each scenario, including a case based on their current strategy and 1 January 2017 Assets Test changes not occurring for comparison.

Table 4: Impact on Age Pension over the next 12 months[6]

Scenario	Age Pension per fortnight – current	Age Pension - next 12 months[7]
No Assets Test changes	$337.15	$8,766
Increase drawdown from ABPs	$337.15	$3,034
Asset reduction strategies	$412.15	$3,709
Lifetime annuity	$337.15	$3,034

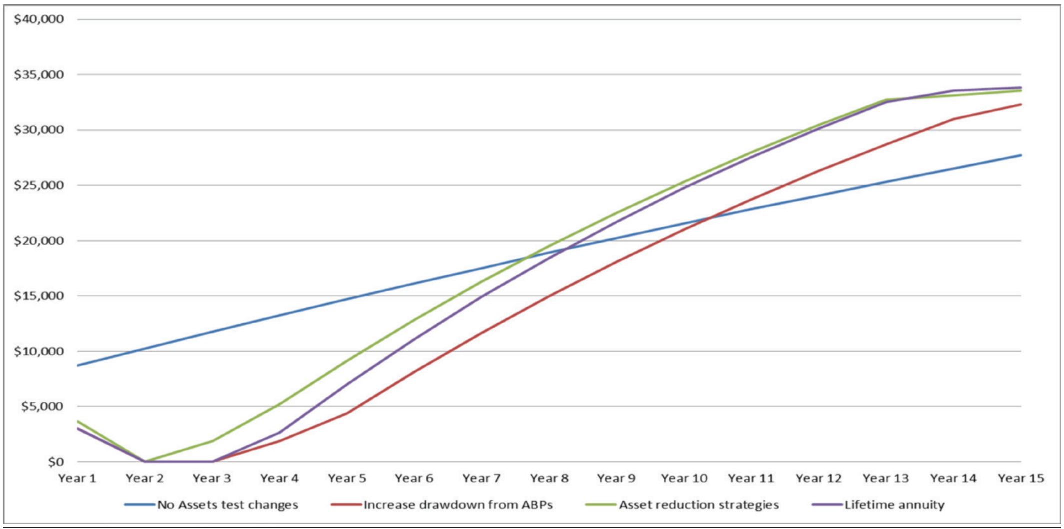
The longer term outcomes

From a longer term perspective, while the asset reduction strategies and lifetime annuity does not prevent Matt and Lynn from losing their pensions, it does help them achieve a higher pension outcome when compared to just increasing the amount drawn from their ABPs, as illustrated in Graph 1.

In terms of the total Age Pension benefit received over the illustrated 15-year period, reducing their assets provided an additional $49,135 in Age Pension entitlements in today's dollars (see Table 5).

[6] Based on Centrelink rates and thresholds as at 26/08/2016.
[7] Based on nine fortnights remaining before 1 January 2017

Graph 1: Projected Age Pension entitlements (today's dollars)



Source: Based on Challenger's Age Pension Calculator[8]

However, as Matt and Lynn have spent $100,000 from their retirement capital early on, they will have less invested throughout the 15 year period. As such, their retirement capital is lower by $51,578 (in today's dollars) after 15 years.

As for the lifetime annuity strategy, Matt and Lynn receive increases each year to their pension entitlement over the same period as the assessable asset value of the annuity is reduced in a linear fashion over time. This amounts to an additional $36,056 in total Age Pension entitlements after 15 years when compared to increasing drawdowns from their ABP.

Unlike reducing assets, Matt and Lynn's retirement capital has increased by $59,398 as the higher Age Pension entitlements each year meant less capital needs to be drawn from their ABPs, leaving more invested over the period.

Incorporating a lifetime has provided Matt and Lynn with a higher retirement portfolio value than the alternative strategies and has also significantly reduced the impact of the increased Assets Test taper rate.

[8] Matt and Lynn's asset allocation is 50/50 growth/defensive, with returns net of fees of 3.65% on their defensive assets, 6.25% on growth assets. An additional platform fee/ongoing adviser service fee of 0.50% p.a. is also applied to their portfolio. CPI is set at 2.5%. Annuity scenario assumes Matt and Lynn maintain their overall asset allocation of 50/50 by increasing their remaining ABP's asset allocation to 71/29 growth/defensive. Their Lifetime annuity is based on Challenger's liquid lifetime annuity (regular income option) as at 26/08/2016 with a purchase price of $135,000 each, an upfront adviser fee of 2.20%, monthly income payments of $562.50 each with no indexation and a 75% withdrawal guarantee. Centrelink rates and thresholds as at 26/08/2016.

Table 5: Total Age Pension and impact on retirement capital (ABP balance) after 15 years

Scenario	Cumulative Age Pension after 15 years (today's dollars)	Retirement capital after 15 years (today's dollars)
No Assets test changes	$279,424	$392,699
Increase drawdown from ABPs	$225,222	$322,668
Asset reduction strategies	$274,357	$271,090*
Lifetime annuity	$261,278	$382,066**

*Includes value of funeral bonds
**Includes value of withdrawal guarantee of lifetime annuity
Source: Based on Challenger's Age Pension Calculator[9]

Summary

The Age Pension has been the subject to a number of changes in recent years with the deeming of account based pensions from 1 January 2015, the capping of deductible amounts of defined benefits from 1 January 2016 and the Assets Test changes from 1 January 2017. Historically, each event created new advice opportunities and this seems to be no different with the upcoming changes to the Assets Test.

Some of your clients may be better off under the changes, while a number could see a reduction, or loss, in their entitlements. This provides significant opportunities to discuss what the changes mean to your affected clients, and make any necessary adjustments to their retirement plans.

Even where a loss of pension is unavoidable, the longer term outcomes of certain strategies implemented today warrant a meaningful discussion. If you require further details on the impact of these changes please contact your Challenger BDM
or visit challenger.com.au/assetstestchanges

[9] Matt and Lynn's asset allocation is 50/50 growth/defensive, with returns net of fees of 3.65% on their defensive assets, 6.25% on growth assets. An additional platform fee/ongoing adviser service fee of 0.50% p.a. is also applied to their portfolio. CPI is set at 2.5%. Annuity scenario assumes Matt and Lynn maintain their overall asset allocation of 50/50 by increasing their remaining ABP's asset allocation to 71/29 growth/defensive. Their Lifetime annuity is based on Challenger's liquid lifetime annuity (regular income option) as at 26/08/2016 with a purchase price of $135,000 each, an upfront adviser fee of 2.20%, monthly income payments of $562.50 each with no indexation and a 75% withdrawal guarantee. Centrelink rates and thresholds as at 26/08/2016.

Tech query of the month

How is income from long-term annuities assessed for Centrelink purposes?
Long-term annuities are those with a term of more than 5 years, or greater than or equal to the life expectancy of the policy owner. A lifetime annuity is a long-term annuity.

Centrelink uses the following formula to calculate assessable income for a long-term annuity:

Assessable income = Annual payment less annual deduction amount

Deduction amount = Purchase price (reduced by any allowable commutations) minus the residual capital value (if any) divided by relevant number

The relevant number is the policy owner's life expectancy for a lifetime annuity or the term of the annuity at commencement. For joint owners or where a reversionary is chosen, the relevant number used is the longer of the two life expectancies.

For example, consider Rob aged 65 who purchases a $100,000 Challenger Guaranteed Annuity (Liquid Lifetime[10]), flexible income option with his wife Mary aged 65 as reversionary. Rob chooses a withdrawal period of 19 years along with a 50% benefit reduction option and the partial indexation of payments.

This means he initially receives an annual payment of $5,010 but upon reversion to Mary, the annual payment would reduce by 50%. For example if this occurred in the first year the amount payable to her would be $2,505.

In this case, in year 1 whilst Rob is the policy holder, he will have Centrelink assessable income as follows:

$5,010 – ($100,000 / 22.05) = $475

However, should the income stream revert to Mary in year 1, she will have zero Centrelink assessable income, calculated as follows:

$2,505 – ($100,000 / 22.05) = $0

[10] Based on a Challenger liquid lifetime quote as at 31/8/2016 excluding any adviser fee.

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