Making the most of 1 January 2017 Assets Test changes

Many retirees will be required to review their current retirement income strategies in light of the rebalanced pension Assets Test from 1 January 2017. For example, homeowner couples can see a reduction in their pensions by up to $14,122 ($9,798 for single homeowners) that will need to be replaced if a particular retirement lifestyle is to be maintained.

The upcoming Assets Test changes provide profesionals with the opportunity to discuss various options available to clients and explain the various implications. 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
The rebalanced pension Assets Test on 1 January 2017 will:

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

Table 1: Assets Test thresholds

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 account based pension (ABP) (deduction amount of $10,787) drawing the minimum. Tom's current Age Pension entitlement is $845.60 per fortnight under the Assets Test. This would increase to the maximum rate, currently $877.10 per fortnight, on 1 January 2017 if his total assessable assets remain below $250,000.

In contrast, we have Sally, also aged 68, single, homeowner and who has the same level of assets as Tom, but with a deemed ABP. Sally's current Age Pension entitlement is $835.79 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 (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 current as at 20 September 2016	Estimated cut-off thresholds at 1 January 2017
Single, homeowner	$793,750	$542,500
Single, non-homeowner	$945,250	$742,500
Couple, homeowner	$1,178,500	$816,000
Couple, non-homeowner	$1,330,000	$1,016,000

Matt and Lynn

Matt and Lynn (both are age 68) own their home. They each have $450,000 in grandfathered ABPs (Matt and Lynn's deduction amounts are $25,338 and $21,676 respectively) 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 $342.15 per fortnight ($8,896 per annum) and to achieve their required retirement income of $65,000 per annum, draw $28,052 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 important effects.

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. Provisions are in place to ensure those who lose their PCC, because of the new Assets Test changes, are automatically issued with a Low Income Health Care Card (LIHCC) and a Commonwealth Seniors Health Card (CSHC) (if they are over age 65) without being subject to the relevant income test.

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 reduce the impact of the Assets Test changes. These include:

- increasing drawdowns from income streams and/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 and improve Age Pension entitlements over time.

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 $28,052 to $32,500 each from 1 January 2017. Matt and Lynn's pension entitlement will remain at $342.15 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 (using $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 $417.15 per fortnight (increased from $342.15 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 $2,503 (based on six remaining fortnights until 1 January 2017). 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.

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

- $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 $342.15 per fortnight until 1 January 2017 where it will reduce to nil. Based on six remaining fortnights in 2016, their total Age Pension entitlement over the next 12 months will likely be $2,053.

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.

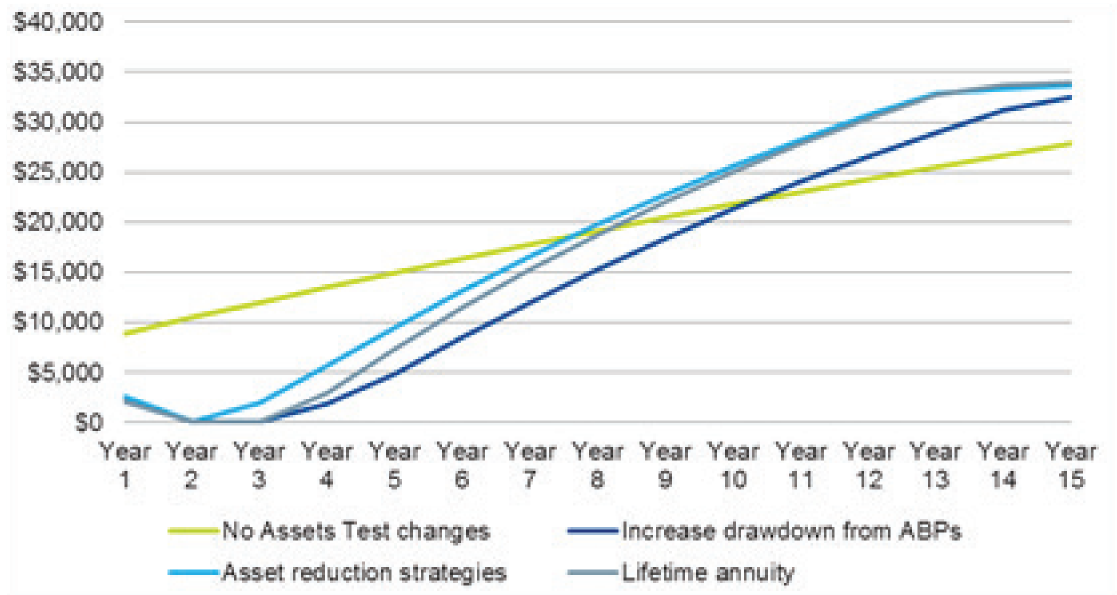
Table 4: Impact on Age Pension over the next 12 months

Scenario	Age Pension per fortnight	Age Pension - next 12 months (in today's dollars)*
No Assets Test changes	$342.15	$8,896
Increase drawdown from ABPs	$342.15	$2,053
Asset reduction strategies	$417.15	$2,503
Lifetime annuity	$342.15	$2,053

*based on six remaining fortnights before 1 January 2017.

The longer term outcomes

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



Assumptions: 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 20/09/2016 with a purchase price of $135,000 each, an upfront adviser fee of 2.20%, monthly income payments of $6,750 each with no indexation and a 75% withdrawal guarantee. Centrelink rates and thresholds as at 20/09/2016.

In terms of the total Age Pension benefit received over the illustrated 15-year period, reducing their assets provided an additional $48,863 in Age Pension entitlements in today's dollars (Table 5) when compared to increased drawdowns from their ABPs.

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 $51,487 (in today's dollars) after 15 years.

Where the lifetime annuity strategy is implemented, Matt and Lynn receives an additional $36,067 in total Age Pension entitlements after 15 years when compared to increased drawdowns from their ABPs.

Unlike reducing assets (and assuming they maintain their overall asset allocation of 50/50 growth/defensive by increasing their remaining ABP's asset allocation to 71/29 respectively), Matt and Lynn's retirement capital has increased by $59,410 as the higher Age Pension entitlements each year meant less capital would be drawn from their ABPs, leaving more of their portfolio invested over the period.

Incorporating a lifetime annuity provided Matt and Lynn with a higher retirement portfolio value than the alternative strategies and helped to reduce the impact of the increased Assets Test taper rate.

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	$282,647	$393.753
Increase drawdown from ABPs	$227,408	$322,498
Asset reduction strategies	$276,271	$271,011*
Lifetime annuity	$263,475	$381,908**

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

Summary

Cash flow is an important consideration for retirees, especially those in the earlier years of retirement. The rebalanced Assets Test on 1 January 2017 may mean some of your clients are better off, while a number of clients could see a reduction, or loss, in their entitlements. This provides significant opportunities to discuss what the changes mean to your affected clients.

Even where a loss of pension is unavoidable, the longer term outcomes of strategies implemented today warrant a meaningful discussion.

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