FIRSTTECH

DOWNSIZER CONTRIBUTION STRATEGIC CONSIDERATIONS

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From 1 July 2018, clients aged 65 or over are able to make downsizer contributions using the proceeds from the sale of their former home. A key advantage of this strategy is that it provides retiree clients with the ability to commence tax-effective income streams inside super to boost their retirement income. However a potential disadvantage is a reduction in their age pension entitlements due to the increase in assessable assets and income.

The question is, are they better or worse off overall? In this article we compare the client's overall position over the course of their retirement, taking into account additional retirement income, social security entitlements, account based pension (ABP) balances and property values.

SOCIAL SECURITY TREATMENT

Unfortunately, there are no social security exemptions for downsizer contributions. Where a client makes a downsizer contribution, regardless of whether the contribution is held in accumulation phase or used to commence an account based pension (ABP), the contribution is an assessable asset for Centrelink purposes and subject to deeming under the income test.

If we assume the client uses the proceeds from the sale of their former home which was an exempt asset and contributes the amounts to superannuation which is an assessable asset, it will increase the clients' assessable assets and income and may reduce their age pension entitlements.

Each member of a couple can contribute up to $300,000 of the sale proceeds into super as a downsizer contribution which means up to $600,000 can be added to their combined assessable assets and up to $19,500 pa can be added to their assessable income respectively .

Depending on the client's other assets and income, the downsizer contribution could significantly reduce a client's age pension entitlement or cause them to lose the age pension altogether. Under the current pension assets test, for every $1,000 of assets over the lower asset threshold (refer to column 2 of Table 1 below), the client's age pension entitlement is reduced by $3 per fortnight. For a client who already has their age pension determined by the result of the assets test, this equates to a negative 7.8%pa return on capital.

Table 1: assets test lower and cut-off threshold for the age pension as at 1 July 2018

Family situation	Asset lower threshold	Asset cut-off threshold
Single (homeowner)	$258,500	$561,250
Single (non-homeowner)	$465,500	$768,250
Couple (homeowner)	$387,500	$844,000
Couple (non-homeowner)	$594,500	$1,051,000

Where a client has their age pension determined by the result of the income test, their age pension entitlement will be reduced by 50% of assessable income over the lower income threshold. Given the upper deeming rate of 3.25% pa, this equates to a negative return of 1.625% pa on capital.

However the impact on age pension is only one consideration when assessing the benefits of a downsizer strategy. Common reasons for clients to downsize include the desire to unlock equity in their principal home to generate more retirement income or gain access to capital. Other reasons include wanting to move to a smaller place that's easier to manage. Where a client is going to downsize regardless of potential Centrelink implications, then making a downsizer contribution to super is a strategy that is likely to be flexible, easy to administer and tax effective.

What is also worth noting is that the adverse impact on age pension is likely to reduce over time as the balance of the client's ABP reduces over time.

In the case study below, we compare the cumulative amount of income generated from a downsizer strategy against the cumulative loss of Centrelink entitlements to assess the clients overall position over their retirement.

CASE STUDY

Lawrence and Issa are both 70 years of age and retired. They require approximately $60,000 pa to maintain their retirement lifestyle. They have been living off their savings in addition to the full age pension of $35,573 (combined). Their retirement savings have now depleted to $50,000 (bank account), and their only other Centrelink assessable asset is home contents of $10,000. The value of their family home is $1.4 million and they are looking to downsize to a smaller place with a purchase price of $800,000. They plan to use the remaining $600,000 sale proceeds to assist with meeting their ongoing income requirements.

If Lawrence and Issa each make a downsizer contribution of $300,000 into super and immediately use this amount to commence an ABP, their combined age pension will reduce to $13,772pa from $35,573pa. Consequently, to achieve their required annual income of $60,000 they will have to draw $45,228 from their ABPs (assuming they also receive $1,000pa interest from their bank account).

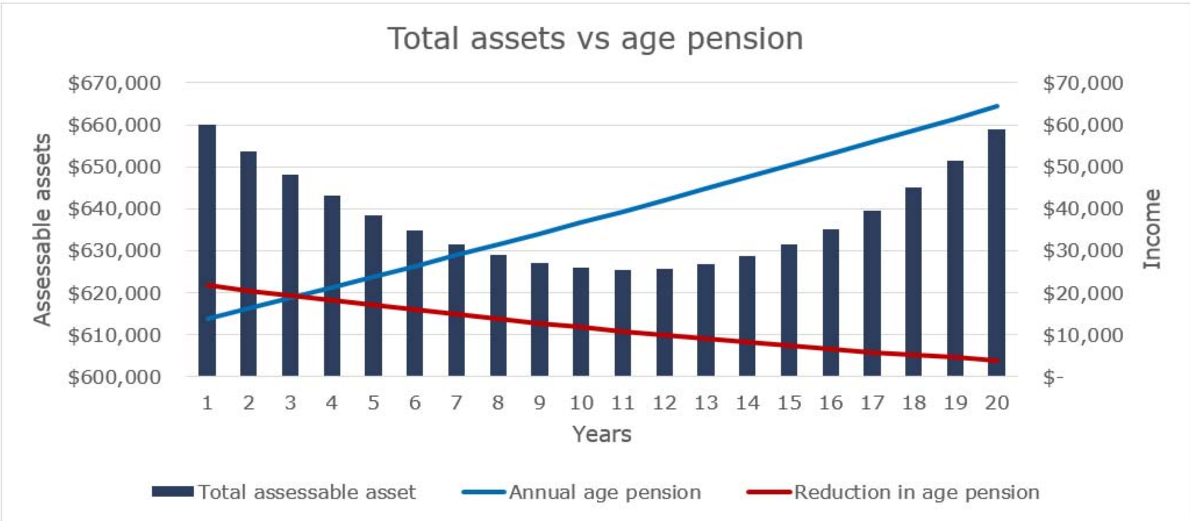
As illustrated in table 2 below, Lawrence and Issa will need to draw pension payments significantly higher than the minimum from their ABPs to achieve their income target due to the reduction in age pension.

Table 2: comparison of downsizer contribution vs retaining home and no downsizing

End of first year…	Retain home, no downsizing	Downsizer contribution
Age pension entitlement (combined)	$35,573	$13,772
Interest	$1,000	$1,000
Pension payments from ABPs	N/A	$45,228
Income for the year	**$36,573**	**$60.000**
Balance of ABPs (combined)	N/A	$593,772
Bank account	$50,000	$50,000
Value of family home	$1,442,000	$824,000
Total assets	**$1,492,000**	**$1,467,772**

Assumptions: Centrelink rates and thresholds as at 20 March 2018, net return on ABPs is 6.5% pa; Centrelink assets and income thresholds indexed at CPI of 2.5% pa; age pension entitlement is indexed to Male Total Average Weekly Earnings of 3.5 pa%, growth rate on home 3% pa. All figures are shown in future dollars.

The following graph looks at total assessable assets, annual combined age pension entitlements and reduction in age pension (compared with no downsizer strategy) over a 20 year period until Lawrence and Issa reach age 90. In this example, we assume an earning rate in the ABP of 6.5%pa which results in the balance of the ABP staying fairly constant over the period of the projection. What's interesting is that the reduction in age pension entitlements (red line in Graph 1) reduces overtime due to indexation of the assets test thresholds.



When comparing the net position after 20 years, the clients receive $237,493 ($1,005,999 vs $768,506) less in age pension cumulatively over the period if using the downsizer strategy. However they receive payments from their ABP of $744,174 over the 20 year period which more than offsets the age pension reduction and allows them to live comfortably throughout retirement.

At the end of 20 years, the downsizer contribution scenario actually puts the clients in a better position by $30,275. This comparison includes all of the payments received by the client (from both Centrelink and ABP) as well as the value of the family home and ABP at the end of the period.

The main reason behind this outcome is that the assumed rate of return of 6.5% pa on the ABP is greater than the assumed increase in the value of the family home (assumed at 3% pa). This extra return essentially offsets the loss in age pension entitlements.

Table 3: comparison of downsizer contribution vs no downsizer contribution after 20 years

After 20 years...	Retain home, no downsizing	Downsizer contribution
Cumulative age pension received	$1,005,999	$768,506
Cumulative pension payments from account based pension	N/A	$744,174
Balance of account based pensions (combined)	N/A	$607,261
Value of family home	$2,528,556	$1,444,889
Total	**$3,534,555**	**$3,564,829**
Difference	$30,275 more under downsizer contribution strategy	

Assumptions: value of family home is indexed at 3% pa. Net return on ABPs is 6.5% pa; Centrelink assets and income thresholds indexed at CPI of 2.5% pa; age pension entitlement is indexed to Male Total Average Weekly Earnings of 3.5% pa. All results shown in future dollars.

It is important to note that the results are dependent on the assumptions used. If the return on real property outweighs the return on the ABP, the client will be in a worse overall position by downsizing. Furthermore, different rates of return on the ABP can also change the result significantly. In the following table we have compared the client's position after 20 years using different assumed rates of return on the ABP. As illustrated, the downsizer contribution strategy does not always come out in front. However, the variance in result is not very large compared to the total amount invested.

Table 4: comparison of downsizer contribution – various rates of return

After 20 years...	Retain home, no downsizing	Downsizer contribution (5.5% return on ABP)	Downsizer contribution (6.5% return on ABP)	Downsizer contribution (7.5% return on ABP)
Cumulative age pension received	$1,005,999	$827,136	$768,506	$684,278
Cumulative pension payment from ABPs	N/A	$685,544	$744,174	$828,402
Balance of ABPs (combined)	N/A	$495,885	$607,261	$719,627
Value of family home	$2,528,556	$1,444,889	$1,444,889	$1,444,889
Total	$3,534,555	$3,453,453	$3,564,829	$3,677,195
Difference		($81,101)	$30,275	$142,641

On a separate note, clients should also be mindful of the potential estate planning implications when considering the strategy of downsizing and freeing up equity from sale of a former home. Inevitably, if capital is used to generate income throughout a client's lifetime, less will be available to the client's estate or beneficiaries. It is also important to review the client's overall estate planning position including considering putting in place binding death nominations on their superannuation interests.

Further information
For detailed explanation of eligibility requirements for downsizer contribution refer to FirstTech article: Downsizer Super Contribution (https://www3.colonialfirststate.com.au/firsttech/topics/super/strategic-updates/Downsizer-Super-Contributions1.html)