Pensions and divorce – looking beyond the settlement

The recent report by the Pensions Advisory Group has emphasised the need for divorce lawyers to be knowledgeable on the treatment of pensions in financial remedy cases. Importantly, the report stresses the need to be aware of current and future tax implications of pensions for divorcing couples.

Lawyers are not expected to give pension advice, but a better understanding of the key issues avoids overlooking opportunities to improve outcomes for clients.

Highlights

The 170 page report covers the key issues comprehensively, but pensions are complex, and no two cases are the same.

Here we draw attention to the key tax considerations which are outlined in the report:

- Offsetting and pension sharing to avoid the Lifetime Allowance tax charge.
- Retaining protection for larger pension pots.
- The potential implications of topping up a pension following a pension debit.

Avoiding the Lifetime Allowance Tax Charge

Pension benefits roll up free of tax. It's what makes them tax efficient. There is a limit, however, to how much rolls up tax free, known as the Lifetime Allowance (LTA). It is currently £1,055,000 and is expected to increase to £1,073,000 on 6th April 2020.

Thereafter, the LTA is set to increase in line with the Consumer Prices Index (CPI) each tax year.

If, when tested, the total value of an individual's pension benefits is greater than the LTA, there will be a lifetime allowance tax charge. It will either be 25% or 55% on the excess, depending on whether the excess pension benefits are taken as income or a lump sum.

It is important to note that the LTA will apply to benefits accrued from *any* source, including pension sharing and investment growth.

Where possible, it is preferable to avoid an LTA tax charge because:

1. The tax efficiency is partly lost on those benefits;
2. Those monies may have been allocated more efficiently elsewhere; and
3. Total benefits drawn from the pension will be reduced, potentially impacting on the level of income the pension can sustain.

Offsetting remains the most common way of dealing with pensions on divorce, but pension sharing can create more opportunities in respect of the LTA.

For example, Mr and Mrs Client, both age 50 each have their own pension arrangements. Mrs Client has an NHS dormant pension worth £20,000 per annum which, for the purpose of testing against the LTA, has a value of £400,000*, and Mr Client has a Self-Invested Personal Pension (SIPP) with a current value of £900,000.

During their divorce, Mr & Mrs Client agreed to offset the difference in pension assets. But, could there be an argument for Mr Client sharing some of his SIPP with Mrs Client?

Fast forward to Mr Client's retirement at age 60. He begins to take an income from his pension. At this point his pension benefits would be tested against the LTA which by then could be £1,340,000**.

Thanks to the investment growth of the underlying funds, his SIPP is now worth, say, £1,567,000.

Therefore, Mr Client could be subject to an LTA tax charge of up to 55% on £227,000 (the value of his pension benefits greater than the LTA).

Had Mr Client shared just 14% of his pension on divorce (c. £130,000) it is unlikely that he would have been subject to the LTA tax charge thus saving him up to £125,000***.

As Mrs Client has not made any further contributions to her pension since the age of 50, her pension benefits are below the LTA.

Offsetting may still be used to equalise pension assets but sharing some of Mr Client's pension would allow both clients to utilise their LTAs rather than just one, creating a fairer outcome for both clients.

It is often in circumstances such as these where win-win proposals can be missed.

Protecting protection

At its peak the LTA was £1,800,000 but between 2012 and 2016, it steadily dropped to £1,000,000 (before starting to increase in line with CPI from 2018 onwards).

Each time the LTA was reduced, there was an opportunity to 'protect' the previous higher LTA. This gave individuals with higher pension pots the chance to avoid the punitive LTA tax charge on excess benefits.

The different types of protection are: Primary, Enhanced, Individual and Fixed. Each type comes with certain conditions, for instance making no future pension contributions.

Care should be taken on divorce to ensure the conditions are not broken (protection would be lost) or, where appropriate, an application for pension protection is made.

When can protection be lost?

Primary Protection and Individual Protection will need to be recalculated and may be lost as a result of a pension debit. Enhanced Protection and Fixed Protection are unaffected by pension debits

That said, those with Fixed Protection would lose their protection if, for example, they made a pension contribution following a pension debit or they were required to establish a new pension arrangement to receive a pension credit. Enhanced Protection may also be lost, so understanding whether pension protection exists is imperative.

When can an application for protection be made?

There are instances during divorce when it may be possible to apply for Fixed Protection 2016 for individuals who are set to receive a pension credit but only if they already have a pension arrangement that can accept the pension credit.

A successful application for Fixed Protection 2016 would mean they could not make further contributions to their pension arrangements so it may not be appropriate for everyone. This can be overlooked where the applicant receives pension contributions or is an active member of a final salary scheme, as part of their employment.

A pension worth over a million pounds might seem like a long way off for a client who is set to receive a modest Pension Credit. But a pension worth £750,000 today could reach the LTA within 15 years, assuming no further contributions are made, and within 10 years where an individual, or their employer, makes a £5,000 pension contribution each year.

The impact of the Annual Allowance when replenishing pension assets

The Annual Allowance is a limit to the total amount of tax-efficient pension contributions that can be made in a tax-year (from all sources, including employer if applicable). Contributing more than the Annual Allowance will result in a tax charge which broadly wipes out the tax relief on personal contributions.

The total tax efficient contribution limit is the lesser of £40,000 and 100% of relevant UK earnings. Somebody with earnings below £3,600 can make a maximum gross tax relievable contribution of £3,600 per tax year.

For higher earners (broadly those with income of more than £110,000 pa), the Annual Allowance may be subject to tapering and for some the Annual Allowance could reduce to as little as £10,000 pa.

The Annual Allowance can be reduced further still if the Money Purchase Annual Allowance (MPAA) is triggered. The MPAA was introduced to prevent individuals accessing their pensions under the new flexible pension freedom rules and reinvesting in their pension fund to take further advantage of the tax relief available. This reduces the annual allowance to £4,000 pa.

This has indirectly affected individuals who, for example, are required to release capital from their pension to provide a lump sum to the other party.

It is important to note that, even with sufficient disposable income to do so, higher earners may not be able to easily replenish their pension pots.

Any Protection already in place, the Annual Allowance or the MPAA can all have major tax implications and can make it very difficult to accumulate or replace pension benefits following a pension share on divorce.

Understanding how pension assets fit into planning for future financial security and retirement is crucial to ensuring an outcome which stands the test of time.

Summary

Pensions are complex and easy to ‘get wrong’, a risk which can be avoided by engaging a pension expert.

With appropriate expert advice, pensions are an opportunity to improve outcomes for clients. And, where possible, by spotting win-win tax planning opportunities, can facilitate negotiations

How we can help

At Edison our Pension Transfer Specialists can help by:

- Determining whether an individual will be affected by the Lifetime Allowance both now and in the future;
- Proposing solutions that work for both clients in respect of a pension share;
- Advising on the impact on Pension Protection as a result of a pension debit/credit; and
- Calculating the amount that can be contributed to a pension following a pension debit in order to replenish the asset

To contact us, do not hesitate to call on 0207 287 225 or by email (help@edisonwm.com).

You can read this Briefing Note on our website. To download it or view other updates please visit our Insights page.

Important Information

The above is a simplification of the legislation. It does not constitute advice. This piece was written based on the legislation applicable at the time. The views expressed above are subject to changes in legislation. The Financial Conduct Authority does not regulate Estate Planning, tax advice, or Inheritance Tax Planning.

A pension is a long term investment. The fund value may fluctuate and can go down. Your eventual income may depend on the size of the fund at retirement, future interest rates and tax legislation

* For the LTA, the value of defined benefits pensions are calculated using a multiple of the pension income benefit. In this case £20,000 x 20 = £400,000.

** Applying annual CPI indexation to today's LTA with CPI assumed to be 2.5%

*** Tax charge calculated as 55% of £227,000. Assumed return of 7.7% p.a. net of underlying investment fund costs.

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