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Pensions on divorce:
Taking advice early saved £330,000!

There are many good reasons for taking financial advice early on pension sharing cases and often before instructing a pension sharing report. This is particularly true with larger and more complicated schemes. The Lifetime Allowance (LTA) is not increasing as fast as pension scheme valuations, so more and more of your clients will be affected. It has been possible for an individual to seek protection against the LTA over the years, but with a total of 7 different incarnations to date, this has certainly added another layer of complexity. A case we recently dealt with highlighted how important specific financial advice can be to some cases and although this was a particularly large case, the principles apply to many others. Crucially, advice and actions needed to be taken before any pension sharing was implemented.

The Lifetime Allowance (LTA)

The LTA limits the value of an individual's total pension benefits over their lifetime, with a tax charge on the excess over the LTA when benefits are taken. The standard LTA is currently £1.03M and is indexed annually with CPI. The LTA applies to both defined benefit and defined contribution schemes.
There are many ways in which an individual can have an enhanced LTA. It's a complex area with different levels and forms of protection available.

The situation

H & W (both age 65) are divorcing after a long marriage. H has a SIPP (personal pension) worth £4.7M which, as yet, has not paid any benefits (i.e. the fund is uncrystallised). H applied for Enhanced Protection in 2006 meaning that he would never pay any LTA tax charge provided that no further pension contributions were ever made. His tax-free cash (TFC) entitlement from this scheme is 25% of the LTA in 2006 (i.e. 25% of £1.5M = £375K).

W has no pension scheme other than entitlement to the State pension.

The issue

The issue here is that if W receives 50% of H's pension (her share = £2.35M), W would be subject to a LTA test when taking benefits. The current LTA is £1.03M and any fund value over this level (in this case £1.32M) will be subject to a tax charge. Tax-free cash availability is 25% of the current LTA (£257,500).

There are two options regarding how the LTA tax can be dealt with:

1. A tax charge of 55% on the excess over LTA (Tax = £726,000). The balance over the LTA is then paid to the member. In this case this equates to £594,000 as a cash lump sum.
2. Tax @ 25% on the excess over LTA (Tax = £330,000). The balance over the LTA (after 25% tax) is effectively added to the pension and withdrawals are taxed as income.

NB – In mathematical terms the above two options result in similar figures after tax as withdrawals from the remaining fund (in 2) will be subject to income tax but will depend on individual circumstances.

Both H & W will have a further (and final) LTA test at age 75. H will be exempt from any further tax however W will be subject to LTA tax on any growth in the fund since the last LTA test and this will include withdrawals taken along the way.

The solution

If H takes the maximum TFC from the fund before sharing it, the remaining fund is deemed 'crystallised' and thus is tested against the LTA. As H has Enhanced Protection no tax is payable. This £375K tax-free cash could, of course, be shared with W.

If W then receives 50% of the remaining fund she will be awarded a 'pension credit factor' to recognise that the fund that she has received has already been tested against the LTA and thus should not liable for any LTA tax. In this instance this factor is 2.09.
As this fund has already paid out TFC to H, no further TFC is available to W so the full pension fund is available to produce an income without any further LTA tax charge.
As above, there is a further LTA test at age 75 although by using W's Pension Credit Factor this test will be on 2.09 * the LTA at age 75.

Actuaries, IFA's and getting personalised advice

As regulated IFA's our pension sharing reports will include personalised financial advice where appropriate and of benefit to both parties. Actuarial reports will generally not include personalised advice but check larger cases through with us for any potential pitfalls or creative advice.

The Summary

For the purposes of the grid below it is assumed that W elects to pay a 25% LTA tax charge (option 2 above) and the remaining fund is taxed in the same manner as the rest of her pension scheme, i.e. income tax. This method gives equitable pension fund sizes and taxation liabilities so was our preferred option from a pension sharing report perspective.

	Before advice taken		After advice taken	
	H	W	H	W
50% share of CE	£2.35M	£2.35M	£2.1625M	£2.1625M
Tax-free cash	£375,000	£257,500	£187,500	£187,500
LTA tax charge	£0	£330,000	£0	£0
Net Pension fund	£1.975M	£1.7625M	£2.1625M	£2.1625M
Total funds	£2.35M	£2.02M	£2.35M	£2.35M

Taking advice as described above will have saved W £330,000 in tax and created equal pension funds, income opportunities and taxation liabilities.

Note that in this case we have shared the capital values of the scheme. In this instance there were no guaranteed benefits of the pension and H & W were a similar age with no health issues, so the same unisex annuity rates would apply to both H & W, thus yielding the same pension income. The reality of course is that H & W may not actually purchase an annuity and will be free to take benefits in a manner that suits their personal circumstances.

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