Pension Changes and Divorce Case Study

Since the sweeping pension reforms introduced in April 2015, greater flexibility has been available when drawing pension benefits. Here we consider an example of how these changes might impact upon the recipient of a pension sharing order as part of a divorce settlement.

Laura is aged 55 and has received a pension credit of £400,000 as part of her financial settlement. She has also retained her individual savings account (ISA) portfolio of £260,000 which was accumulated over the duration of her marriage. Prior to marriage and raising a family, Laura had a successful career with a FTSE-listed company and accrued a deferred, final salary pension of £26,000 per annum payable from age 60.

Laura has no desire to return to work, but does possess a desire to maintain a lifestyle that is likely to result in annual expenditure of at least £50,000 for the next 10 years, after which she anticipates a gradual reduction. Given that Laura has no current income she could extract a 25% tax-free cash entitlement from her pension credit to generate £100,000 which would sustain her for the next two years.

Ignoring any change in investment values, she could then purchase an annuity to provide a taxable income with her residual pension fund of £300,000. Unfortunately current market annuity rates would generate no more than £7,200 per annum of gross income for Laura, assuming that a single life, index linked annuity is purchased (source: FCA annuity comparison website). This would clearly leave Laura well short of her desired annual expenditure of £50,000, even once her final salary pension commences at age 60.

The new pensions legislation enhances flexibility and provides greater opportunity for tax efficient planning post divorce.

Any pension planning should be considered within the context of a broad financial plan and include the use of tax efficient assets such as ISAs.

A detailed discussion of tolerance to investment risk should be undertaken before any strategy is agreed.

Since her divorce, Laura has developed a keen interest in personal finance. She has read that the changes in pension legislation will allow her to access her entire pension fund without the need to purchase an annuity. Although she does not intend to access her entire fund, she is curious as to whether the changes could be used to good effect to address her apparent income shortfall.

The new legislation certainly offers greater flexibility. For example, instead of extracting £100,000 of tax-free cash all at once then buying an annuity, Laura could take £20,000 of tax-free cash from her pension each year until age 60. At the same time, she could draw a taxable amount of approximately £35,000 from her residual pension which after the deduction of income tax will provide her with a further £30,000. This strategy also has the advantage of ensuring that none of Laura's personal income tax allowance is wasted in each year prior to the age of 60.

Clearly, Laura's pension will be eroded over the next five years. However, once her final salary pension commences at age 60, she may wish to fund her income shortfall by drawing down upon her ISA portfolio. Given that her personal income tax allowance will be fully utilised by her final salary pension, the tax-free withdrawals from Laura's ISA portfolio will provide a tax free means to supplement her expenditure requirements from the age of 60.

The value of investments can fall as well as rise. You may not get back what you invest.

Leeds | London | Bath

Head Office
No 2 The Bourse, Leeds LS1 5DE

T: 0333 323 9060
E: enquiries@theprivateoffice.com
W: theprivateoffice.com

tpo
the private office

04/2019 FP: 031917

Chartered
Financial
Planners