Pension Flexibility - What is Changing in April 2015 ?

Issues for Family lawyers

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The changes in a nutshell

As from April 6th people will have far more freedom in the way they will be able to access their pension. In summary this means anyone over the age of 55 will have the legal right to take their DC pension benefits as they wish including as a single lump sum.

This is likely to prove attractive to many clients, family lawyers and DJs, especially if it can be used in some way to offset other assets in particular the family home.

I won't cover all of the issues here, just the ones most likely to be of interest to family lawyers, namely potential issues with withdrawing lump sums from the pension.

The rules only apply to DC pensions

If someone has a DB pension they will need to transfer it first to a DC scheme . Given this often applies to pension sharing orders for private sector schemes, surely this is not an issue?

If you are recommending a pension sharing order then I can't see an issue in itself , but if you are going to also recommend the credit member then accesses that pension there are potential issues. The same issues arise if you recommend a client accesses their own pension to raise funds, rather than a pension share.

Firstly you could be seen to be giving advice. Giving advice on pensions and not being authorised to do so can be a criminal offence under the FSMA 2000.

More importantly irrespective of whether or not what you are doing is technically a crime, it might be bad advice. Most of us are aware that a pension sharing order relating to a DB pension can be extremely bad value *for both parties.*

To give advice on pension transfers requires additional authorisation and the FCA state "a firm should start by assuming that a transfer or opt-out will not be suitable. A firm should only then consider a transfer or opt-out to be suitable if it can clearly demonstrate, on contemporary evidence, that the transfer or opt-out is in the client's best interests."

Nothing in the new rules change this, in fact they could make things worse. If because of the new rules, there is a rush to transfer DB pensions from the public as a whole, in order to protect the scheme, transfer values could be reduced.

Clients may have a legal right to access their pension– But providers don't have to offer the freedoms

Not all providers will offer the new access, especially for older policies, and whilst the member will usually be allowed to transfer their pension, there will often be cost implication of this and it might not be in the client's interest to do so. For example some older pensions have extremely valuable terms and conditions that will be lost on transfer.

For older contracts it seems many pension companies haven't finalised what they will be doing yet, but at a recent conference I attended, those providers willing to commit said that where they would allow access, it would probably be through a mechanism known as Uncrystallised Funds Pension Lump Sum (UFPLS).

The main consequence of this is that 75% of the money accessed will be treated as taxable income. This is true whether £1 or £1 million is taken out.

UFPLS v Flexible Access drawdown

This is the key part of the reforms and governs the way most people will be able to access their funds.

For anyone who hasn't already taken (crystallised) their pension, assuming the provider will allow it, and they have sufficient lifetime allowance, they will be able to access their pension as a Uncrystallised Funds Pension Lump Sum (UFPLS).

With this they draw directly from the pension fund 25% tax free cash and 75% taxable income.

Therefore a basic rate taxpayer would need to draw £59,375 to release £50,000.

- Tax free £12,500
- £46,875 less 20% tax = £37,500

However this income is added to any other income in the tax year so it could easily push someone into higher rate tax. In fact £37,500 is only £4,858 short of the level of income that most people will start paying higher rate tax in 2015/16. Therefore if a client earned £30,000 in the year the withdrawal was taken, the tax charge in the example above wouldn't be £12,500, it would be £16,273.

If the numbers get bigger, so does the tax bill , *even with no other income,* a withdrawal of £160,000 would result in a tax charge in 2015/16 of £41,403. Add £30,000 of other income and the charge goes up to £49,763.

The alternative way of access funds, Flexible Access Drawdown will not be available on all contracts and therefore may require a transfer to a pension arrangement offering this service, which in itself has advice and cost implications.

Assuming Flexible Access Drawdown is available, there are two ways of realising a lump sum. One works in a similar way as the UFPLS with the same tax treatment.

The other way is to only withdraw the cash. In order to do this the client would need to crystallise four times the amount of cash required. Therefore to release £50,000 in tax free cash they would need to crystallise £200,000. The remaining £150,000 can stay in the pension fund to be drawn at a later date, but when it does it will be treated as taxable income. It goes without saying to use this method you need a fund four times the size of the cash required.

Spreading the withdrawals

One way of potentially reducing the tax bill will be to spread the withdrawals. Apart from not achieving a clean break , the main issue to be aware of is that the pension fund remains invested. Most providers will have a cash fund that should be reasonably stable but anything other than that runs the risk of falling in value.

Also, at the moment, many pension withdrawal contracts are charged on the basis of the provider holding funds for 20 years or more. Therefore the typical charge is a small (say 0.25% / 0.35%) levied on the value of the fund. If money is taken out over a short period I can see this changing to an event fee.

You may also read about another way of spreading withdrawals known as phasing. Under this method, instalments of tax free cash and taxable income are used to generate an “income”. For someone only wanting a retirement income, it can be an efficient way of taking your pension, as you draw the tax free cash in instalments and therefore the tax free cash remaining in the fund has the potential to continue in value.

However for our purposes where the funds are likely to be drawn over a short period of time, I see little or no advantage, due to the risk of the value of fund actually falling in the short term.

Impact on future contributions.

This is a slight over simplification, but drawing from a pension plan will usually have an impact on the annual allowance. The annual allowance is the amount a person can invest in a pension before they suffer a tax clawback. Taking a pension withdrawal reduces this allowance from £40,000 to £10,000.

£10,000 is still a lot of money but it will affect certain clients, especially if they want to rebuild their pension fund. I won’t go into the detail here, but the clients this is most likely to be caught out are those with DB pensions, as the way the allowance is calculated *has no relation to either the client’s or employer’s contribution.*

Lifetime allowance

There are also issues with the Lifetime Allowance and those with Enhanced or Primary Protection, so for those with total pensions (not just the one you are looking at) valued over £1.25 million, extra care will be needed.

In summary

The changes to pensions look like a convenient way of accessing cash especially if it can help with keeping the family home, and I realise that jam tomorrow is not very relevant if you don’t have bread today.

However I see two main dangers for family lawyers. Firstly advising someone to take action with regard to their pension could be seen as giving advice and unless you are authorised to do so, this could be a criminal offence. Secondly and perhaps more importantly get it wrong and you could land your client with a nasty and unexpected tax bill.

I have only highlighted some of the bigger issues here, there are others, for example, the issue of risk transfer and even that the insurer will almost certainly have to apply a month one emergency tax code, which will result in an even bigger tax deduction (albeit one that should be recoverable) are potential catches for the unwary.

For further information

If you would like further information on this or indeed any other issue relating to pensions then don't hesitate to contact me, Trevor Goodbun, at trevor@wensumifa.com or call 01603 731170.