



A Guide to

Pensions and Divorce



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Introduction

Couples going through a divorce may be faced with a situation where their pension, or the pension of a spouse or partner is a major consideration as pension rights form part of the assets when it comes to divorce settlements.

The factors relating to pensions are often complex and there is a threat that settlements are reached where the full range of options have not been properly investigated or analyzed.

Our start point is always the same: couples should ensure they have the **full range of options**, with the **advantages and disadvantages** of each, properly mapped out and explained to them. This is not just the case prior to any settlement being reached, but probably, in most cases, before *any negotiation* towards a settlement takes place.

Pension rights form part of the assets when it comes to divorce settlements. The Court has to take them into account when the couple's affairs are assessed and a settlement agreed.

(The rules are the same when it comes to the formal dissolution of a civil partnership. Where we discuss 'divorce' throughout this guide, the same points and factors will apply to civil partners.)

A pension or pension rights can often represent one of the biggest assets. Indeed in a reasonable number of cases it may be the **biggest** asset.

The issues around pensions for people going through a divorce can often appear perplexing. We aim to provide some simple guidance throughout this guide which will help translate these complexities into easy-to-understand terms.

Our guide is *not* meant to act as a technical document. Anyone in the process of divorce, whatever the current stage who has a pension or their spouse has a pension should seek out professional advice – from a pension specialist.

This is a guide which outlines the 'top level' aspects to this subject.

Armed with this information and understanding we hope any individual reader will be better set to deal with the all the various aspects they need to consider when they discuss matters with their advisers.

Please note: the laws applying in Scotland vary from those in England, Wales and Northern Ireland. Most of the basics are the same but there are some important variations in how the different payments may be treated, we cover these and all the differences in the section Scottish Law.

The Three Options:

There are three ways that a pension can be treated in a divorce:

1. **Pension offsetting** - balancing the pension rights against other assets;
2. **Pension earmarking** - arranging that when one person's pension comes into payment part of it will be paid to the other person;
3. **Pension sharing** - splitting the pension at the time of the divorce so that both parties get their own pension pot for the future.

Which method will be best in any particular situation will be decided by a range of different factors and could be subject to negotiation as part of the wider divorce settlement. It is worth stressing that the different options could produce very different outcomes.

It is very important for any individual going through a divorce that they are properly advised which method is likely to work best for them as the decision which to use could have far reaching consequences.

To understand how the options compare and the different aspects, we need firstly to examine each option separately:

Pension Offsetting

This where the pension benefits are offset against other assets.

As an example, a husband has a pension valued at £300,000 and the couple jointly own a house valued at £600,000. Offsetting would allow for the pension to be traded against the house and the husband may keep the pension, the wife the house or some other trade-off based on the respective values. However, the pension would remain with the husband, the wife would have no future claim on it or share in it.

Pension Earmarking

Earmarking is an agreement that when a pension comes into payment, a part of it (a set percentage) is paid to the ex-spouse (or ex-partner). The relevant pension scheme provider receives a written instruction from the court to make this payment.

In England, Wales and Northern Ireland, the payment can be taken from a pension and/or cash lump sum. In Scotland, it can **only** come from the cash lump sum.

If there is a lump sum benefit on death in service, this can be earmarked. The court can order all or part of it to be paid to the ex-spouse (or ex-partner), and can order the pension member to nominate them.

If an individual has retired and chose to have a guarantee on their pension, this can also be earmarked.

The percentage to be paid is set at the time of the divorce, but either party can apply to the court to vary the amount. The percentage is paid when the ex-spouse or partner opens their pension pot.

Pension Sharing

Pension sharing means that the pension is split (as a percentage) at the time of the divorce. The court issues a Pension Sharing Order, which states the percentage of the pension which is to be given to the ex-spouse or ex-partner. This is worked out as a percentage of the pension's transfer value. The transfer value is worked out at the day before the Pension Sharing Order takes effect. This means that the value can be higher or lower than the value of the pension stated at the time the divorce proceedings started.

The pension awarded to the ex-spouse or ex-partner is called a pension credit. This can be transferred to a pension scheme chosen by the ex-spouse or partner, as long as that scheme is able to accept the transfer. If the ex-spouse or ex-partner does not make a choice, the scheme or provider may allow them to become members of the existing scheme. Alternatively, they may transfer the pension credit to a buy-out policy (sometimes called a section 32 policy).

If the pension credit remains in the existing scheme, the ex-spouse or ex-partner will receive the increases that the scheme gives to deferred pensions.

Schemes can charge a fee for dealing with the administration of pension sharing.

Pension sharing can also take place when the pension is already in payment, although the fees may be higher as the process is more complicated.

Weighing These Options Against Each Other

There are advantages and disadvantages applying to each method, which may vary in importance purely dependent on the divorcing couple's circumstances. There is also another factor, not often commented upon: the advantages to one party of one method may be a disadvantage to the other party. There can be conflicts in the interests of each party which need to be dealt with, negotiated and balanced.

This is such a specialist area that it is likely only a **pension qualified adviser** will be able to provide the required individual assessment of which method is most suitable.

In *general terms* here are some examples of the advantages and disadvantages of the three methods:

Pension Offsetting Advantages:

- *Simplicity*: This is often seen as the simplest method – the pension of one party is attributed a value (for example £100,000) and this is retained as an asset by that party, with the other party receiving £100,000 in value from some other asset.
- *Ease of administration*: the offsetting is easy for both parties to administer, in addition - there is no need for a court order.

Pension Offsetting Disadvantages:

- *One party may end up with little or no ongoing pension benefit*: a typical example would be where one party has a high pension value, an offset is agreed leaving the other party with an asset (typically maybe the family home) but no pension entitlement, which could cause problems later down the line.
- *Valuations may be difficult to agree and/or a fair offset achieved*: in theory an offset is a simple arrangement, however in practice getting the value of the pension agreed and/or the appropriate split to work can be very difficult. For example a pension may be valued at £200,000 and a property at £1,000,000, offsetting one against the other without selling or sharing the assets in some way may not work in line with the percentage split that one or both parties seek.
- *Death benefits from the pension may be lost and this may be detrimental to the ex-spouse*.



Pension Earmarking Advantages:

- *Both parties can benefit from a generous pension entitlement into the future:* the nature of earmarking favours a situation where the future pension will accrue with both parties able to benefit.
- *Pension death in service benefits can be earmarked for the ex-spouse.*
- *Where a pension is already in payment through an annuity, the ex-spouse can have a proportion of the ongoing annuity payment.*

Pension Earmarking Disadvantages:

- *Loss of control for one party:* The ex-spouse is dependent on receiving their pension entitlement whenever their former partner decides to retire. In addition the scheme may change in future years, the member may choose to reduce benefits or even in an extreme case forego the future pension in favour of other means of saving.
- *Income on a pension in payment will be taxed at the pension member's income tax rate:* The income from the pension is payable first to the member and only then paid over to the ex-spouse as part of the earmarked court order. This creates a tax charge which is based on the member's rate, which could easily be a higher rate than the ex-spouse's, creating an unnecessary tax liability (compared to other options).
- *Earmarking ceases on remarriage:* should the ex-spouse wish to remarry the earmarking will cease to apply.
- *Earmarking ceases on death of the scheme member:* the ex-spouse will lose all of his/her entitlement if he/she is pre-deceased by the ex-partner.
- *Parties will need to remain in contact to 'manage' the ongoing pension situation between them.*

Generally speaking the disadvantages of earmarking can be so great and the risks for the ex-spouse so high it has become a largely defunct option, only used when narrow circumstances apply. It is not a 'no go' but it is likely in the great majority of cases to be the least attractive option of the three available.

Pension Sharing Advantages:

- *Both parties get a pension:* this provides a completely clean arrangement where after the divorce both parties go their separate ways with their own pension entitlement. There is no ongoing attachment.
- *Both parties get to make their own decisions after the divorce:* As a consequence each party can make their own independent decisions going forward about the investment approach, when to retire and adding further contributions.
- *The ex-spouse can remarry without affecting the pension rights.*
- *Pension income will be payable at the tax rate of the receiving member.*

Pension Sharing Disadvantages:

- *For high earning individuals who may be affected by the cap of the lifetime allowance, the amount that is transferred to their ex-spouse will count towards their lifetime limit.*



Other factors and considerations:

The Pension Freedom legislation introduced in 2015

New rules were introduced in April 2015, allowing pension investors to freely access their pensions in a completely different way to before. These new rules have generally become known as “Pension Freedom” as it expresses the nature of what an individual can do with their pension, which they could not before.

In technical terms these new rules have not altered the legislation in the context of pensions and divorces. However, there may be legal challenges to come down the line which could impact case law. That remains to be seen.

Whilst the rules around divorces and the options available to divorcees with their pensions by and large are unaffected by Pension Freedoms, there are some practical implications which arise, which need to be noted:

Offsetting

Offsetting is most likely to take place where individuals aim to achieve some form of parity between the value of the pension asset and the value of other assets. Pension Freedoms can offer significant tax and potentially estate planning advantages for those who utilise the new rules, which could have an effect on perceived values when the offsetting negotiation is taking place. The greater flexibility – arguably – offers more “value” to a pension investor than before as they have better ways available to them to organise how they access their pension.

Earmarking

Put bluntly a pension investor could now bludgeon their pension, taking it all out on one day as a cash sum (with tax deducted) which could have a significant impact on the application of earmarking orders. If the order is not highly specific then this does open the door for a pension holder to avoid the terms of an order which is intended to earmark ongoing income, as an example. This complicated by the technical nature and, to some extent, by the terminology.

Pension investors can opt to take all benefits as an uncrystallised funds pension lump sum (UFPLS). If the earmarking order doesn't specifically mention "tax-free lump sum" or "PCLS", the pension investor can take the UFPLS (which doesn't pay a PCLS). There is then nothing left in the pot to “crystallise” (as it is known) and there is no income.

These examples of the issues that have now arisen are simply intended to highlight the confusing nature of the position that now exists with earmarking orders.

The reality is that in many cases even unsatisfactory orders (ones that are not especially specific or well-worded) may still work as intended, because the Pension Company has an obligation to fulfil the requirements of the order and between them and any disadvantaged party there may well be a variation of the order applied for, to correct the position.

However, there is no doubt that the earmarking option has become clouded as a result of the Pension Freedom legislation, which may have an effect on divorcing couples.

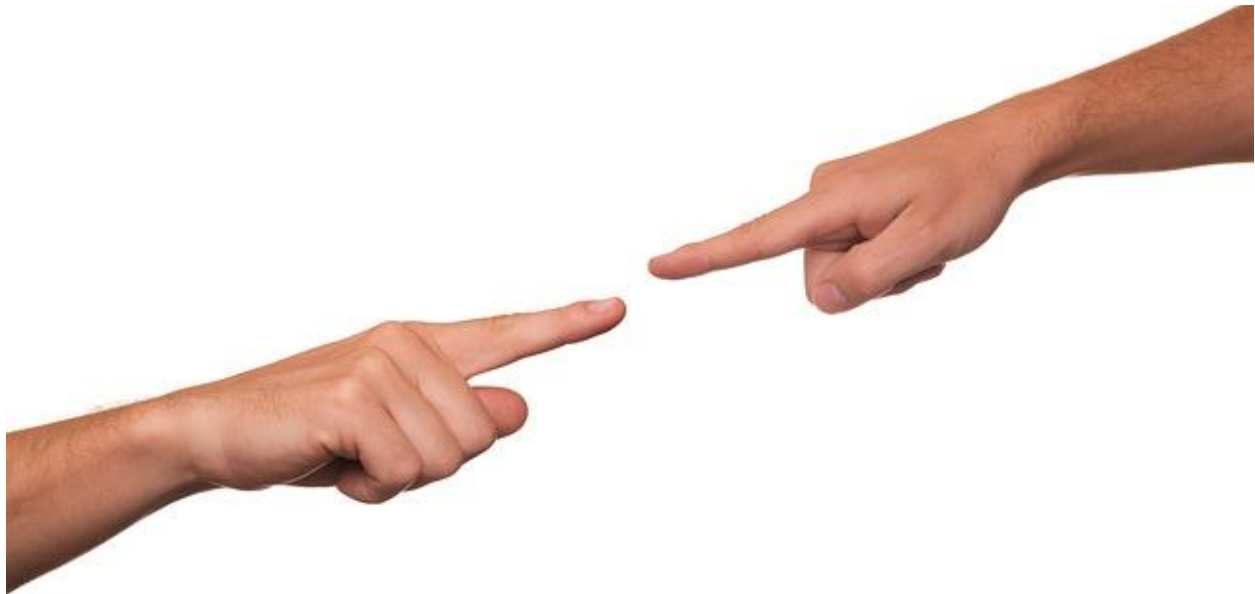
Pension Sharing

Pension Freedoms now open up the possibility that the non-pension owning spouse may prefer to have cash rather than a share of their spouse's pension fund, where the pension holder is age 55 or over. This is made possible, regardless of the age of the non-pension owning spouse because it is the age of the pension holder that is relevant.

Where the pension holder is 58 and their spouse is, say, 48 this is possible, even though the latter is under 55.

As with earmarking this becomes murky in its application in the real world, due to the nature of the tax position this could lead to (for the pension holder) and also could have a negative effect on their ability to make further contributions. So, although feasible, it does present challenges.

The Pension Freedom rules tend to present practical challenges rather than outright technical challenges and simply strengthen the case for the highest quality and specialist advice to be sought, to cover the position in its entirety.



The Lifetime Allowance

The Lifetime Allowance is the limit an individual faces on the amount of pension benefit that can be drawn from pension schemes – whether lump sums or retirement income – and can be paid without triggering an extra tax charge. If it is exceeded there are tax charges.

The lifetime allowance was introduced in 2006 at a level of £1.5 million. It has been increased since but then subsequently reduced to a figure of £1.0 million (although it is currently £1.073m and will increase in line with CPI).

As with other areas of the pension rules the way this allowance affects pension and divorce considerations varies considerably depending on individual circumstances and the route pursued. Put simply, with offsetting it really has no bearing.

Where there is an earmarking order the total benefits, pension and tax-free cash, including payments to be made through the order to the ex-spouse, are assessable against the pension owner's lifetime allowance and for **their** income tax liability - regardless of the fact that a portion of the benefits will be paid to the ex-spouse.

The amount the ex-spouse receives under the earmarking order, including income, payments are tax free. This can cause significant problems for the pension investor where an earmarking order is sought and the lifetime allowance is relevant or could become relevant. In the case of pension sharing the complications escalate where the lifetime allowance is a factor.

It is worth noting that in many cases, the lifetime allowance is subject to 'protection' which means an individual can apply to have the value of the benefits they have built up protected from tax charges. Individuals who have previously applied for protection could have done so at a time when the allowance was a higher figure.

The details of protection are not for this guide, but suffice to say, the way the lifetime allowance and protection works when a pension sharing arrangement is agreed is highly complex.

There are instances where the value of the debit created by the pension sharing reduces the value of the pension for the pension holder and this, consequently, reduces the amount of the sum for the purposes of the lifetime allowance.

Likewise, the pension credit, increases the value when considering the ex-spouses lifetime allowance. Then the way any protection, previously applied, is affected – also varies!

In most cases, pension sharing is actually quite favourable in terms of the lifetime allowance calculation as it effectively spreads the total pension value, on divorce, between two people, rather than one (and each one has a lifetime allowance).

However, as with all other factors, the position should be analysed first by a specialist.

State pension

The basic State Pension is not included in pension sharing schemes or earmarking orders. However one partner may be able to claim a basic state pension through their ex-partner's national insurance. This would only apply to the years they were together as a couple, and would not affect the ex-partner's State Pension. This entitlement would be lost if they re-married before they reach official State Pension age.

There is however also the additional State Pension, which can be **shared** in a financial settlement through the making of a pension sharing order. This means that part of the value of an additional State Pension earned could be shared with a former husband, wife or civil partner. The court will need the details of any additional State Pension entitlement.

The Additional State Pension is an amount an individual may be entitled to in addition to their basic State Pension. It is based on National Insurance (NI) contributions and earnings since April 1978. A lump sum valuation will give this information and will help the court make a decision.

If a pension sharing order is made, the additional State Pension may either increase or decrease, depending on the decision of the court.

Death Benefits

Although a pension scheme is first and foremost a retirement savings arrangement, there will be a value on death that the spouse would have been entitled to during marriage. Therefore, on divorce the death benefit will still apply should the pension member die before they draw their pension. How this is treated post-divorce and the effect this will have on each party is going to be a consideration.

The loss of the 'insurance' this provides could be very detrimental to the ex-spouse. Both parties will need to consider what impact the death benefits attached to the pension will have on their future positions and that of children or other beneficiaries. This could be influential in deciding which of the three options of dealing with the pension is preferable.

The Difficulties of Valuing a Pension

This is an exceptionally important consideration. A pension value is not necessarily set in stone.

In simple terms there are only two types of pension: defined **contribution** schemes and defined **benefit** schemes. A defined contribution scheme, such as a personal pension run by an insurance company or a SIPP, will have a value based on the underlying value of the assets or funds held.

This value is reliable, although there may need to be some attention paid to whether any penalties (for early encashment) are included and these may need to be factored in. However more often than not a defined contribution scheme is valued at the underlying value, so if the assets/funds are worth £100,000 then the pension value can reasonably be said to be £100,000.

However, with defined benefit schemes there are no such simple assumptions. A defined benefit scheme does not have a value, it has an entitlement. The most common example is the Final Salary Scheme: here the individual has a future pension entitlement based on their salary at retirement date. For example, they may be entitled to 1/60th of their final salary for each year employed.

For the purposes of a divorce settlement this entitlement may need to be turned into a cash value, which is known as a **Cash Equivalent Transfer Value (CETV)**.

The CETV is a calculation which is open to variation depending on the underlying assumptions made. We will not go into the fine detail here, the complexities are too great for this summary and overview. ***However, it is possible that two experts looking at the same pension arrangement for someone in a defined benefit scheme could come up with two very different CETV figures.***

This is an essential point to grasp, because normally the CETV is provided by the administrators of the scheme and there is nothing to state that this cannot be checked, analysed and then, if required or appropriate, questioned or challenged.

There are so many variables in calculating a CETV including whether discretionary pension benefits have been included, what discount rate has been applied, what the expected earnings escalation are likely to be for the spouse who has the pension, amongst many others.

The Different Issues Before Retirement as Against After Retirement

A reasonable proportion of divorces take place after retirement. There are different considerations to be made if a pension is already in payment. All three of the available options remain viable in some way, but the way that the offsetting, earmarking or sharing can be arranged will vary post retirement than pre-retirement.

Court Orders

Offsetting is a way of dealing with the pension that doesn't need the involvement of the court; parties can agree their offset without a court order. The other two methods however require the court to make an order to support the intended outcome.

In the case of pension sharing this is because the pension provider or scheme cannot act to divide a pension arrangement without a direction from the court.

These court proceedings do not have to be contested as in the majority of cases the parties have come to an agreement through their solicitors and only require a consent order from the court.

The same applies with earmarking - the provider must make a special provision to record the earmarking attachment as this will not be implemented until the scheme member's retirement age and this process is ratified by the court order.

Scottish Law

Scottish Law around divorce is quite distinctive, especially with regard to the overall process. Our guide is concentrated on pension's issues, not the wider ones. In this respect we simply wish to bring forward that the considerations for parties divorcing under Scottish Law and how they view their pensions could be quite different.

Just to highlight one example: Scottish Law only considers the pension benefit built up during the time of the marriage (or civil partnership). Where a CETV (the pension 'value') is obtained, in Scotland it is then proportioned based on the length of time of the marriage. This is different to English Law where the whole CETV is taken into account.

The Importance of Getting Professional Advice

Arguably the issues and complexities involved with pensions in a divorce make this **the most significant area** of financial planning for individuals, **where obtaining specialist, qualified advice is a 'must'**. Having an appropriate, suitably qualified expert working alongside the legal advice is likely to be worth its weight in gold. Here are some of the main advantages a pension's expert will be to offer in these situations:

- They will be able to help weigh up which of the three options it is best to pursue. They can present the advantages and disadvantages of each option, based on personal circumstances and requirements.
- The adviser can assess the value of any pension, especially check and evaluate a CETV.
- They can advise an individual who sees their pension entitlement fall as a result of earmarking or a pension sharing order, including how to rebuild lost benefits.
- They can help an ex-spouse assess whether or not to keep a pension with the existing company or to transfer it, when a pension sharing order is made.
- They can assess any loss of death benefits and how these should be replaced.
- They can weigh up the complexities arising from the Pension Freedom legislation and also any that come from the Lifetime Allowance.
- They can help assess the post-divorce finances of an individual facing divorce.
- They can help with wider matters than simply the pension considerations: including post-divorce investment advice where an individual receives a lump sum payment.
- They can look at the individual's financial planning goals generically and ensure that all family members (including children) are properly catered for.

About Us

Mather and Murray Financial provide truly holistic independent financial advice and create a lifetime financial plan to secure the best possible future for you and your family.

We have local advisers based in London, Reading, Swindon, Stroud, Bath and Bristol so you can choose to see an adviser at your home or place of work or at one of our locations.

Please contact us to book a meeting, at no cost to you, to see how one of our advisers can be of help.

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The information in this guide is based on our interpretation of current law and legislation and our understanding of HM Revenue and Customs (HMRC) practice as at January 2018.