Pensions and divorce

Pension rights form part of a couple's assets when it comes to divorce settlements (or dissolution of a civil partnership). Each party needs to tell the court the value of any pension they hold so that the court can take them into account. The couple's state pensions are also considered.

However, there are still concerns not enough couples are taking the full value of pensions into consideration when divorcing, possibly due to a lack of knowledge about pensions. Advisers can add value here to help all parties – including the legal profession – understand the value of the pensions and the options of how to treat them on divorce.

Through the court, the divorcing couple can choose to use:

- pension offsetting - balancing pension rights against other assets;
- pension earmarking - arranging it so when one person's pension comes into payment part of it will be paid to the other person; or
- pension sharing - splitting the pension at the time of the divorce so that each person gets their own pension pot for the future.

This factsheet gives more information on these three options.

Offsetting

Offsetting is the process where the value of the pension benefits is offset against other assets. For example, the person who has the pension may keep the whole of it, and in return the other person may be given a greater share of the other assets, such as the house.

It's the simplest and easiest way of taking account of the pension assets on divorce. But it only works effectively if the value of the pension can be balanced fairly against the value of other assets - for example, if it is the same value as the house.

The value of the pension may fluctuate more than other assets (for example property values) causing difficulties in fairly comparing them.

Earmarking

Under earmarking, the pension scheme, on instruction from the court, will pay (or promise to pay) the ex-spouse specified benefits. This could be:

- an amount of the member's pension and/or lump sum (England, Wales and Northern Ireland); or
- a specified amount of member's lump sum only (Scotland); or
- a lump sum benefit on death before retirement. The court can order all or part of it to be paid to the ex-spouse, and can order the member to nominate them.

The earmarked amount is set at the time of divorce, but either party can apply to have the amount varied. However, the payment is only made when the spouse with the pension pot retires or dies, and could stop on re-marriage for pension payments only (the right to a lump sum does not stop on remarriage). The main drawback with earmarking pension benefits on divorce is that the original pension scheme member retains control over the pension – including when to take it, as well as the investment choice – possibly to the detriment of the ex-spouse. It can also lead to difficulties when subsequently transferring benefits, both in obtaining the ex-spouse's consent and in finding a scheme willing to take on the extra administration and costs that earmarking can bring.

Pension sharing

Pension sharing could apply to any divorce where proceedings started on or after 1 December 2000. The court has the power to split pension rights between a couple, by separating the ex-spouse's benefit entitlement (as specified in court order) from the scheme member's, and so achieving a 'clean break'. The pension benefit is split in two and an amount (the pension credit) is paid to the ex-spouse. The amount paid from the member's pension is the pension debit.

The pensions are valued using the member's cash equivalent transfer value (CETV), although different valuation methods can be requested. The pension share will be a percentage of the CETV, not a fixed sum of money, except in Scottish cases where a fixed monetary sum can be used.

The CETV is first calculated for the information valuation which is used to decide on how to share assets. It's then calculated again (implementation valuation) at the day before the pension sharing order takes effect. This means the CETV – and therefore the amount shared - can be higher or lower than the value disclosed at the start of divorce proceedings.

Pensions and divorce

The ex-spouse can choose to transfer the pension credit to another pension scheme if that arrangement can accept such a transfer.

Schemes can insist on pension credits being transferred out. Alternatively, the scheme may provide an internal transfer and allow the ex-spouse to become a member of the original scheme in their own right (again, not all schemes allow that action).

Schemes are allowed to charge for dealing with administration of pension sharing.

Pension sharing orders

The pension sharing order must comply with a set legal format, and for non-Scotland cases it is always a formal court order.

In England, Wales and Northern Ireland, the annex to the pension sharing order (form P1) outlines each pension arrangement to be shared, which includes the member's (the transferor) personal details and their pension benefits, as well as the ex-spouse's (the transferee) personal details, including information about which scheme the ex-spouse would like to transfer the pension credit to.

Scotland

There are some key differences to how pensions are treated in divorce cases under Scottish Law.

In Scotland, only the value of the pension built up during the marriage or civil partnership is considered by the court. This means that the pension must be valued at the date of separation, and pension benefits built up before the marriage are excluded.

The pension sharing details are usually outlined by the court in a qualifying agreement – a court order is not necessarily issued. The qualifying agreement will give details of the provider name and reference number of the pension scheme the pension credit is to be transferred to.

The pension credit is based on the member's CETV. The credit can be a fixed sum of money or a percentage of the CETV.

Protection from the lifetime allowance charge

As a pension credit awarded to an ex-spouse will probably increase the ex-spouse's pension rights, this may mean that they could become liable to a lifetime allowance charge (because of the pension credit). To avoid this, ex-spouses acquiring pension credits may be entitled to enhance their lifetime allowance. How this is dealt with depends on whether the pension credit was acquired before or after 6 April 2006.

Post 6 April 2006 pension credits

Any pension credit arising from a pension sharing order on or after 6 April 2006 will count against the ex-spouse's lifetime allowance, and not against the original member's lifetime allowance. But it won't count against the ex-spouse's annual allowance.

If the benefits have already been crystallised, then the pension would have already been tested against the lifetime allowance when the original member crystallised it. The ex-spouse can notify HMRC that they wish to claim an enhanced lifetime allowance – the enhancement is equal to the capital value of the pension credit. The notification must be made by 31 January following the tax year in which the pension credit was paid.

Example – Angela

Angela acquires a pension credit of £300,000 on 1 September 2017, when the lifetime allowance is £1 million.

The pension credit is worked out as:
£300,000 / £1 million = 0.3

This factor is then applied to the standard lifetime allowance at any future benefit crystallisation event.

Pre 6 April pension credits

The ex-spouse might have claimed a lifetime enhancement factor known as 'the pre-commencement pension credit factor' as long as they had notified HMRC by 5 April 2009. The enhancement was worked out by increasing the pension credit by RPI from the date it was awarded to April 2006, and expressed as a factor of the standard lifetime allowance for 2006/07 (ie £1.5 million).

If the ex-spouse also claimed primary protection then the value of the pension rights from the pension credit would be included in the amount protected. So in this case, they didn't receive an enhancement to the lifetime allowance in respect of the pension credit.

Pensions and divorce

Pension planning after the divorce

For the original member, after the pension sharing order goes through then their pension benefits will be lower than before. They can now start to rebuild these if they have available funds. However, they will have to take care not to exceed any of the annual allowance, tapered annual allowance, or money purchase annual allowance (which is only £4,000 if they have flexibly accessed pension benefits). Also, if they have enhanced protection or any version of fixed protection they will lose the protection.

The ex-spouse will need help and guidance in choosing the most appropriate pension scheme for their pension credit, as well as help on how to continue contributing if this is the best action for them.

Capped drawdown

After a pension debit is paid out, the maximum income limit will be reviewed for the remaining triennial period using the date the pension sharing order takes effect. The reduced maximum income limit takes effect at the start of the next pension year in the review period. If the pension debit is made in the final pension year of the review period the income limit is just reviewed as normal at the end of the review period.

Lifetime allowance protection

If the member has applied for enhanced protection or any version of fixed protection then their protection will not be affected by the pension debit, but if they start pension contributions to rebuild their fund then they will lose protection.

If they have applied for primary or either version of individual protection, then they should notify HMRC to recalculate their protected value. If, because of the recalculation, the value falls below:

- £1.5 million for primary protection;
- £1.25 million for individual protection 2014; or
- £1 million for individual protection 2016

then their protection will be lost.

If you only read one thing read this:

- There are three different options for dealing with pensions when a couple divorce. All have advantages and disadvantages.
  - Offsetting – this is the simplest method, but it only works effectively if the value of the pension can be balanced fairly against value of other assets, for example, if it is the same value as the house.
  - Earmarking – this method doesn't achieve a clean break and the member retains control over the pension deciding when to take it and where to invest it.
  - Sharing – this is the easiest method for dealing with large pension amounts. The pension is effectively cut in two, and the ex-spouse becomes the outright 'owner' of the pension benefits and therefore has control over the pension.
- Generally, any pension credit will count towards the ex-spouse's lifetime allowance. However, if the pension was already in payment the ex-spouse may be able to claim an enhancement to their lifetime allowance.
- Any pension credit does not count towards the ex-spouse's annual allowance.
- Both the member and the ex-spouse may need to consider how to take forward their pension planning following the divorce.