The Pensions & Divorce Guide

A guide from
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Wealth for WOMEN

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Introduction

For many divorcing couples, pension benefits may represent the second biggest asset after the value of the matrimonial home.

The Pensions Act 1995 first introduced the requirement to take pensions into account on divorce under English Law. This requirement has been in place in Scotland since The Family Law (Scotland) Act 1985.

A pension is typically valued using the Cash Equivalent (CE), representing benefits accrued to date. This often includes benefits accrued prior to the marriage.

For anyone getting married later in their working life, this could be a significant sum of money. As part of the discussions on the finances on divorce, it is therefore critical that professional advice is obtained on how to best deal with pension rights.

Pension sharing rules apply to civil partners as well as to married couples. Consequently, all references in this guide to spouse or ex-spouse will also apply to civil partner or ex-civil partner.

There are three options available for dealing with a pension on divorce:

- Offsetting
- Earmarking/pension attachment
- Sharing

Each of these options is discussed in greater detail in this guide, highlighting the advantages and disadvantages of each.

If you have any questions about anything in this guide, please do get in touch. You can call us me on 01932 698150, email mary@wealth-for-women.co.uk or talk to me on Twitter @MaryWaring.

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Offsetting

Under this method, the transfer value of the pension is included with the value of all other matrimonial assets. The assets are then divided between the two parties so that the scheme member retains their pension rights intact.

The value of the pension is 'offset' against the value of other assets; typically the matrimonial home. For example, the scheme member may keep the whole of their pension fund and take a smaller share of the home. The ex-spouse will take a larger share of the non pension assets to balance this.

Advantages of offsetting

- Allows a clean break between the parties
- Relatively easy to administer
- No court order is required

Disadvantages of offsetting

- One party (often the wife) may end up with no pension assets
- Depending on the value of the assets involved, an appropriate split to retain the pension intact may be difficult to achieve
- Determining an accurate and fair valuation of the assets involved can be difficult

Earmarking/pension attachment

Earmarking was introduced for petitions on divorce filed on or after 1st July 1996. Under this method, the court allocates a specified portion of the scheme member's lump sum, death benefits and pension income entitlement to the spouse. This is evidenced by an order from the court to the trustees of the pension scheme.

The ex-spouse will then receive the relevant portion of the pension benefits when the scheme member receives their own benefits from the pension scheme. It does not give any ownership rights to the pension, as would be the case with a pension sharing order.

This means it is simply a way by which part of the benefit can be received by the spouse. The order may come into force immediately or it may not take effect until a later date. For example, it may not come into force until the retirement of the scheme member or their death.

If the member subsequently decides to transfer pension benefits which have an earmarking order attached, the order must be passed to the new pension scheme. The ex-spouse must be advised of any transfer within 14 days of the date of the transfer taking place.

What can be covered by earmarking?

- Pension income
- Pension commencement lump sum (tax-free cash)
- Lump sum payments on death before retirement

What cannot be covered?

- State pension benefits, including the State Second Pension (S2P)
- Dependants pensions payable on death (either before or after retirement)

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Advantage of earmarking

- The ex-spouse can receive a benefit if the member makes further contributions or the pension benefits grow following the divorce

Disadvantages of earmarking

- The scheme member remains the owner of the pension rights and has full control over the pension

- This means that the ex-spouse who has been granted a court order for pension earmarking has no control over the investment decisions made by the scheme member. If the scheme member has a very different attitude towards investment risk, the ex-spouse could end up with a very unsuitable pension portfolio.

- The ex-spouse is not entitled to income until the scheme member decides they wish to draw income. If ages and personal circumstances between the member and the ex-spouse are very different, this may cause big problems for the ex-spouse.

- For example, if the scheme member plans to continue working when he or she reaches retirement age, or they have other income or assets available in retirement, they may not wish to start taking pension benefits until a later age. The ex-spouse may have no other income and be reliant on the pension income at a certain age.

- Pension income drawn from the scheme is deemed to belong to the scheme member, and is therefore taxed at the scheme member's marginal tax rate. For tax purposes the scheme member is deemed to have received all of the pension benefit before passing the relevant portion to the ex-spouse. This can result in more income tax being paid than might otherwise be necessary. This additional tax is not reclaimable.

- Earmarking does not result in a clean break between the parties. Some ongoing contact will be necessary.

- The order for pension income will lapse on the death of the scheme member, even if payments have already started.

- Pension benefits will revert to the scheme member on the death of the ex-spouse.

- Pension benefits will cease on the remarriage of the ex-spouse.

As you can see from this extensive list of disadvantages, earmarking is rarely considered to be a suitable way of dealing with pension assets on divorce. There are exceptional circumstances where it might be used, but we would expect these to be very unusual.

Pension sharing/splitting

Pension sharing is available where divorce proceedings began on or after 1st December 2000. The court will split the pension fund between the two parties, and the relevant part of the pension fund or benefits will be transferred from the scheme member to the ex-spouse.

The scheme member sees their pension fund or benefits reduced by the value of the amount transferred. This creates a pension debit. The corresponding receipt by the ex-spouse is the pension credit.

The pension share will be defined as a percentage of the cash equivalent (CE). The CE is calculated as if the pension holder left service the day before the sharing order took place.

As an example, a pension share of 45% of a pension with a CE of £300,000 would transfer £135,000 to the ex-spouse and the member's pension would be reduced by the same amount to reduce their CE to £165,000. The sharing order creates a pension debit for the scheme member and a pension credit for the ex-spouse, both at a level of £135,000 in this example.

Any future pension contributions or accrual of benefits made will be outside of this split, and belong to the individual making the contribution or with membership of the pension scheme. The amount transferred will not be assessed against the scheme member's annual allowance, but it will be assessed against their lifetime allowance for tax privileged pensions savings.

What pension rights can be shared?

- All rights under occupational, personal and retirement annuity policies
- This includes pensions in payment
- State Earnings Related Pension (SERPS) and State Second Pension (S2P)
- Since 6th April 2011, pension protection fund (PPF) compensation can also be shared

What pension rights cannot be shared?

- Basic state pension
- State graduated pension

Advantages of pension sharing

- This provides a clean break between the two parties
- The ex-spouse has control over their own pension benefits (their share), both in relation to the investment decisions and when to access the pension benefits
- Pension income drawn by the ex-spouse is taxed in their own name

Disadvantages of pension sharing

- Unlike attachment orders, sharing orders cannot be varied after the decree absolute. It's therefore important that the sharing is not applied for until the financial settlement has been agreed.
- A sharing order cannot be made on a pension with an existing attachment order. Therefore if one of eth parties has been divorced before ensure there are no exposing attachment orders.

When does the pension sharing order come into force?

A pension sharing becomes effective 28 days after it has been awarded, allowing a period of time for appeal. This is in contrast to the decree absolute which becomes effective immediately.

If the scheme member were to die within the 28 day appeal period, the pension sharing order would not take effect. If the decree absolute had not been granted the spouse is still deemed to be the legal spouse and would probably be eligible for a payment.

However, if the decree absolute had already been granted the parties are no longer legal spouses and therefore failed the definition for the payment of spouse's pensions within most occupational pension schemes. The benefits would be lost completely.

If the member dies after the 28 day appeal period, and after the decree absolute but before the implementation is finalised, the implementation continues to completion. If the ex-spouse dies within the 28 day appeal period, the order will lapse.

As a result it is important that the decree absolute is not filed until 28 days after the pension sharing order has been filed. The decree absolute should not be filed until the pension sharing order has become effective.

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Financial advisers & divorce negotiations

Here are some suggested ways in which an independent financial adviser can assist you during divorce negotiations:

- Providing advice to either spouse on whether to opt for offsetting, earmarking or pension sharing. This will involve discussing the advantages and disadvantages of each option based on your specific circumstances and objectives.

- Advice on whether or not the Cash Equivalent (CE) represents fair value. The financial adviser will review the financial position of the final salary pension scheme and any under funding of the scheme. They will also consider the death benefits payable by the scheme, definition of dependent under the scheme rules, basis of revaluation within the scheme, any discretionary increases, the effect of any future salary increases for the scheme member, and any favourable early retirement provision.

- Advice on how to achieve equality of outcome. Differences in age, health, hobbies and general lifestyle will alter the annuity income available from any lump sum. Therefore splitting the pension pots equally will not necessarily result in equal income. The greater the difference between the specific annuity rates for each spouse, the greater the share will move away from a 50:50 split.

- Advice to an ex-spouse receiving a pension share. The ex-spouse will require advice on whether they should remain within the existing scheme (if that option is available) or transfer to a separate scheme.

- Advice on how the scheme member can best rebuild their pension after a pension split or earmarking order.

- Advice on putting relevant protection in place. To ensure the ex-spouse receiving maintenance does not lose any income following the death or long-term sickness of the ex-spouse paying maintenance, protection policies should be in place.

- Advice to either party on how to budget following separation of finances.

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About Wealth for Women and Informed Choice

Wealth for Women was founded by Mary Waring to provide specialist financial advice for women going through divorce. Wealth for Women is a trading style of Informed Choice Ltd. Informed Choice is a leading firm of Chartered Financial Planners, working with individuals, trustees and business owners to help them to build, manage and protect their wealth.

We were named as **IFA of the Year** at the Money Marketing Financial Services Awards 2010 and we are six times winners of the Gold Standard for Independent Financial Advice.

We are a firm of Chartered Financial Planners. This means we have satisfied rigorous criteria relating to professional qualifications and ethical good practice. It means you can be confident that you are dealing with one of the UK's leading firms that is wholly committed to providing you with the best possible advice, service and support.

Our guides provide commentary on key financial planning issues, to enable clients and professional connections to understand the implications. We welcome conversations with individuals and professional advisers on any of the issues raised in this guide.

To find out more about our advisory and planning services, please visit www.wealth-for-women.co.uk and www.icl-ifa.co.uk.

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