Pension options on divorce

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In 2021, there were 113,505 divorces in England & Wales, an increase of 9.6% from 2020, when there were 103,592 divorces. The majority (111,934) of divorces in 2021 were among opposite-sex couples, with 1,571 (1.4%) among same-sex couples.

In many cases, the pension benefits of the divorcing couple will represent one of their major assets, making it essential that the divorce settlement takes account of these in the most appropriate manner.

Same-sex couples forming civil partnerships under the Civil Partnership Act 2004 which came into effect on 5 December 2005 are treated in the same way as married couples when they separate (FA 2003 s103).

A civil partnership may be dissolved on similar grounds to divorce. There were 671 same-sex civil partnership dissolutions granted in England and Wales in 2020, a decrease of 27% from 916 in 2019. For references to husband, wife, spouse and married couple please read also civil partner and civil partners respectively.

There ae three methods by which pension benefits can be taken into account on divorce. This guide provides a very brief summary of the key aspects of each of the three options and then considers the factors to take into account when recommending which route(s) is likely to be the most attractive.

What you need to know

Offsetting

This is the oldest and still most commonly used method of dealing with pension benefits. The value of the pension assets is taken into account in valuing the couple's matrimonial assets, but the divorcing couple both keep their own pension rights with the value of the pension rights being offset against other assets. For example, if the ex-husband has the greater pension provision, he might keep that with the wife keeping the family home and other assets being used to ensure a fair overall settlement.

Earmarking

Earmarking is effectively a form of deferred maintenance payment, where all or part of the pension benefits of one of the divorcing couple are ordered to be paid to the other spouse. Earmarking orders may also be made against a member's tax-free cash benefits on retirement and in respect of lump sum death benefits. In Scotland, only lump sums can be earmarked.

Sharing

With sharing, pension is passed from one member of the couple to the other. In general, a pension sharing order will be expressed as a percentage of the member's cash equivalent transfer value under his pension scheme. A 'pension debit' will be created in relation to the member's rights and an equivalent 'pension credit' will be provided for the ex-spouse.

Depending upon the scheme providing the member's benefits, the pension credit may either be used to provide benefits for the ex-spouse under the member's scheme or be transferred to a suitable registered scheme of the ex-spouse's choice.

Many private sector pension schemes will only allow transfer out, but where the member's scheme is an unfunded statutory scheme (e.g. Civil Service scheme, etc.) the only option available to the ex-spouse will be to retain benefits under a public sector scheme.

So which option is likely to be the most attractive, and how have they been affected by the pension freedom reforms?

The following sets out some of the advantages and disadvantages of each of the approaches...

Offsetting

Offsetting may be attractive where...

- The divorcing couple are fairly young, both at work, there are no children involved and there are sufficient non-pension assets to allow offset.
- The couple's assets are such that even after the split they are still large enough to provide each party with sufficient resources to carry on with their lives.
- The ex-spouse already has a decent retirement income, which would normally make pension sharing less appropriate.

Offsetting may be less attractive where...

- The member's pension value is high compared to other assets which may make offsetting extremely difficult.
- A replacement pension will be needed for the ex-spouse, which may be difficult to provide if the time to the ex-spouse's retirement date and money are short, or if the ex-spouse is not working.
- Life assurance benefits under the member's pension scheme are lost by the ex-spouse.

How has offsetting been affected by the 'pension freedom reforms'?

- Courts assess non-pension capital, pension assets, and income when deciding how to share a couple's assets, but with the 'pension freedom reforms' now there is a blurring between capital and pensions.

- Now they are blurred, this gives the Court greater flexibility but makes it more difficult to predict what a judge is likely to do.

- For divorcees over age 55 there is now complete access to defined contribution pension funds which means there is less of an argument for discounting.

Earmarking

Earmarking enables an English or Welsh court to direct the trustees of a pension scheme to make payments to an ex-spouse from the date the member draws benefits under deferred maintenance orders.

Earmarking may be attractive where...

- The member is already in receipt of an annuity. This avoids the need to set up a new annuity for the ex-spouse (as would be required with sharing), which would need to take into account the state of health and relative ages of the annuitants at the time, possibly resulting in a lower-than-expected pension for the ex-spouse. With earmarking they will receive a maintenance payment of part of the member's annuity, though this will stop on the member's death unless it was set up on a joint-life basis.

- The divorcing couple are in their 50's and other forms of maintenance provision are inappropriate. This will particularly apply where the ex-spouse is unable to work.

- The pension scheme does not have any readily realisable assets (e.g. where a small self-administered scheme is almost wholly invested in the company's own property, this will make sharing very difficult).

However, earmarking suffers from a number of problems including...

- The dependent ex-spouse can receive no benefit until the member decides, or is forced, to retire.

- The dependent ex-spouse has no say as to how the pension is invested.

- The dependent ex-spouse has no say as to how the benefits are taken at retirement.

- The retirement benefits are taxed based on the member's tax position which may be based on a higher tax rate than the dependent ex-spouse, especially if the ex-spouse does not work.

- The dependent ex-spouse will lose all benefits if they are predeceased by the member, and pension benefits will cease if the ex-spouse remarries.

- The member may effectively be able to reduce the benefits of the deferred maintenance payment. For example, the member could opt out of their employer's scheme and make alternative provision by means of a separate savings vehicle (e.g. ISA) which would not benefit the ex-spouse.

- There is no clean break.

How has earmarking been affected by the 'pension freedom reforms'?

- Earmarking Orders were drafted at a time when 'pension freedom' was never envisioned unless the order was very specific.

- If there are no pension funds left to crystallise, there is no income left to be covered by an income earmarking order.

- It is therefore worth revisiting clients who have an earmarking order in force and if necessary to return to the Court to get the Order's intention clarified.

- In Consultation Paper 15/30, Pension Reforms; proposed changes to rules and guidance (October 2015), the FCA consulted on the issues around pension attaching/earmarking orders. In Policy Statement PS16/12 – the FCA's gave its feedback to the responses it received on CP15/30 as well as its final rules and guidance, concluding that although it recognised there was a problem, it is nonetheless up to the dependent ex-spouse to go back to the Court to vary the order.

Sharing

Pension sharing provides a clean break for the pension, and could be appropriate where…

- The ex-spouse is relatively close to retirement. The ex-spouse may find it very difficult to build up a comparable pension fund in the short remaining period to retirement.

- The divorcing couple are older. Here the ex-spouse will be able to take benefits from age 55 in respect of the "pension credit" rather than have to wait until the member retires (as would apply in respect of earmarking).

- The ex-spouse may be thinking of remarrying. Unlike earmarking, any pension sharing arrangements would be unaffected by this.

Pension sharing may be less attractive where…

- The retention of the family home is a key priority for the ex-spouse. The sharing of the member's pension rights may necessitate other assets to be shared (e.g. the family home). This could result in the sale of the matrimonial home and the need to trade down to a smaller property.

- The ex-spouse already has adequate pension provision.

How has pension sharing been affected by the ‘pension freedom reforms’?

- As a result of the ‘pension freedom reforms’, the ex-spouse may prefer to have a cash lump sum rather than a share of the pension fund. If the member is over age 55 then this is possible, even if the ex-spouse is much younger.

- The Courts may decide that an uncrystallised funds pension lump sum (UFPLS) or a series of UFPLS, should be paid instead of pension sharing. However, it is worth noting that this could potentially result in serious tax implications for the member and restrict tax relief on future contributions due to the money purchase annual allowance being triggered.

Tax considerations

It is important to understand how the earmarking and sharing options are treated under the pension tax rules.

Earmarking

- As the earmarked benefits for the ex-spouse are treated as part of the member’s benefits, the pension paid to the ex-spouse will be taxed at the rate appropriate to the member. Benefits will be assessed against the member’s Lifetime Allowance when they are drawn.

- Where the scheme administrator/trustees is obliged to pay any lump sum death benefits to an ex-spouse under a lump sum earmarking order there will be no IHT liability even though the death benefit is not being paid at the discretion of the scheme administrator/trustees.

Sharing

- Any pension credit created on or after 6 April 2006 will count against the ex-spouse’s, rather than the member’s, Lifetime Allowance. However, where the pension credit arises from benefits of the member that crystallised on or after 6 April 2006 (e.g. a scheme pension, lifetime annuity or drawdown pension) the ex-spouse is able to elect for an enhanced Lifetime Allowance in respect of the pension credit.

  This is to avoid the same benefits being tested twice against the Lifetime Allowance as the member’s benefits will have already been tested against the Lifetime Allowance at the time of benefit crystallisation.

- A special transitional rule applied so that where a pension sharing order was in place at 5 April 2006 the ex-spouse could elect by 5 April 2009 for an enhanced Lifetime Allowance in respect of the pension credit.

- Where a member's benefits as at 5 April 2006 were subject to a pension debit, the value of the debit will be ignored for the purposes of the member's Lifetime Allowance, (i.e. their Lifetime Allowance will only take account of the actual benefits they are receiving).

Sharing and public sector schemes

When a pension sharing order relates to an unfunded public sector pension scheme, there is no option for the ex-spouse to transfer out. Instead, they will be provided with pension rights in the member's scheme.