PENSIONS AND DIVORCE

Latest statistics (published December 2012) estimate that 42% of marriages in England and Wales end in divorce. It is also estimated that:

- 34% of marriages are expected to end in divorce by the 20th wedding anniversary.
- 16% of marriages reach the 60th wedding anniversary.
- The average marriage is expected to last for 32 years.

(ONS)

Like it or not, with pensions being most people’s second biggest asset, a major consideration is always going to be pension benefits.

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These notes only apply to married couples and couples who have entered into a civil partnership. At present, no consideration has been given to “co-habitant” relationships, although this is an area where much lobbying is going on.

1. LEGISLATION

Whilst the consideration of pension benefits within divorce settlements was an issue in 1969 (study by the Law Commission) the key legislation has been:

1.1 Matrimonial Clauses Act 1973

Ss 23-25 deal with the provision of a “clean break” wherever possible.

1.2 Pensions Act 1995 (PA)

The PA requires courts to take pension rights into account when assessing assets on divorce. It introduced the concepts of earmarking pension benefits as well as the basis for cash equivalent transfer values (CETVs) for assessing the value of a pension on divorce.

1.3 Pension Sharing On Divorce (including draft Harman Bill) June 1998

Came into effect in December 2000. The thrust of the legislation is to attempt a “clean break” settlement for pension funds on divorce. The legislation states that pension benefits will still be taken into account in divorce settlements. Offsetting and earmarking (now called attachment) will still be options to consider, however, a new (and probably much more appropriate) option was introduced which allows the pension benefits to be shared or split between the parties.

2. OFFSETTING TO PRESERVE PENSION RIGHTS

Simply means that the pension funds are valued, and the spouse with the greater benefits provides the other spouse with additional funds elsewhere in the settlement to compensate them for the loss in pension rights. In the ideal world this system would be by far the simplest and arguably the best solution. Unfortunately, however, many people do not have sufficient assets to enable offsetting to be applied.
3. EARMARKING (ALSO CALLED ATTACHMENT ORDERS)

Came into effect in 1996 and was changed to Attachment in the Welfare Reform and Pensions Act 1999. Attachment applies to all private pensions (including those in payment), but not basic state benefits.

In brief, “Attachment” entails the court issuing an attachment order to the pension scheme, which requires the trustees of the pension scheme to pay a proportion of the member’s benefits directly to the ex-spouse when the benefits are taken. The court can also earmark a proportion of the member’s death in service lump sum and widow(er)’s pension benefits for the protection of their ex-spouse.

Attachment has many problems, not least of which is that the pension remains under the control of the member. If he or she decides not to retire, to invest in Japanese smaller companies, or take any other action prejudicial to the ex-spouse there is nothing they can do about it.

- If the non-member ex-spouse remarries, the Attachment lapses.
- Earmarked benefits are all taxed at the highest rate of the pensioner, irrespective of the tax rate for the ex-spouse.
- Earmarking lapses when the main member dies. If the member dies in service the ex-spouse may be entitled to the lump sum death in service payment but not any form, of dependants pension.

If there is every likelihood that the petitioner will remarry prior to the respondent’s retirement age, then except for some safeguard on the life cover side, this procedure can be a costly waste of time. On the other hand if the couple are at or beyond retirement date and the ex-spouse can still qualify for widow(er)’s benefits then an attachment order could be very useful.

4. PENSION SHARING

Introduced in December 2000. Pension sharing applies to all pensions excluding the state basic old age pension.

All pension benefits are valued (see CETV below) and the petitioner with the lower funds is then granted a share of the member’s benefits so as to equalise pension provision at the date of divorce.

This system works well for personal pensions, however, occupational pension schemes and final salary schemes can be more troublesome. Whereas with a money purchase pension the share can be granted by way of a transfer to the petitioner’s own scheme, with a final salary pension the petitioner may have to become a “paid up” or “shadow” member of the respondent’s company pension scheme.
The option of a shadow membership is less often used as the retaining scheme will not wish to have the increased costs and disclosure requirements associated with additional members who are not employees. Such changes will also leave the schemes open to further grievance procedures and will also entail complex redrafting of scheme rules. The rules allow schemes to insist on buying-out the spouse’s benefits if the scheme considers this to be more appropriate, and our experience to date is that nearly all schemes are insisting on this route. The one exception is usually the government and Local Authority schemes which are “pay as you go” and hence are not keen on paying out large transfer values.

Pensions in payment can be “un-bought”, split and “re-bought” using the annuity rates for the member and petitioner at date of divorce. Indeed, if the petitioner is much younger they can use the lump sum as a pension contribution, choose pension fund withdrawal or many other alternatives.

The extent of any sharing can vary between income and funds. If, for instance, it was agreed that each party would have an equality of income, then one would expect the fund value to be unequally split because women live longer than men and hence it costs more to buy pension benefits for them.

There are many difficulties with sharing.

4.1 Costs

Schemes are entitled to charge for the calculations and administration involved in splitting the benefits. The guideline for these costs is currently in excess of £2,000. After the pension transfers fiasco of the late 1980s, few financial advisers are either qualified or willing to undertake transfer work (Swallow Financial Planning is qualified to undertake transfer work), and those that are, will charge substantial fees.

Now that it is almost impossible to get Legal Aid for divorce there will not be money available to pay for good advice which means that the recipient will either lose substantial sums via commission payments, or transfers will not proceed as they will be uneconomic.

4.2 Shadow Membership

To split benefits within many final salary schemes entails the options of “shadow membership” of the pension scheme. The trustees of the pension scheme can decide the terms which shadow members receive, these terms are usually much worse than for normal members. For some schemes shadow members are not receiving final salary benefits, other schemes only provide a single life pension, whilst many schemes have different levels of pension escalation than for normal members. All this has to be considered before the sharing order is agreed.

4.3 Default Option

If a former spouse does not specify where they want their new pension funds to go, the trustees are entitled to make the decision for them. This usually involves an unsatisfactory transfer to another provider to rid the trustees of the liabilities and administration they would otherwise have if the ex-spouse became a shadow member of the scheme.
5. THE CASH EQUIVALENT TRANSFER VALUE (CETV)

The CETV is the prescribed basis for valuing the pension benefits held by a divorcing member. This value can either be used to calculate an offset against other assets of the marriage, or as a measure to divide the pension between the member and the former spouse. For the purposes of this legislation we have to consider:

5.1 The Valuation Date

This is the date the values of the pension fund are agreed and the sharing order (or other method) decided upon.

5.2 The Transfer Day

This is the day the value of the transfer is crystallised and represented (say in number of units etc.). No further accrual can benefit the petitioner after this date.

5.3 The Valuation Day

Is the day the actual value of the transfer is calculated prior to transfer to the petitioner’s chosen pension.

In many cases, the CETV is unfair to the petitioner as it is the minimum valuation of the member’s fund. For example, on a final salary scheme the valuation is done assuming the member is divorced, hence the CETV takes no account of the widow(er)’s benefits. In the case of a money purchase scheme it will probably be the external transfer value. This sum frequently includes a charge against the fund for the accrued costs of the scheme between the date of transfer and the retirement date of the plan. In the case of some investment funds (i.e., with profits) the value will be after short term market value reductions which may not be there when the remaining member retires.

We recommend an independent actuarial assessment of the CETV to check the value being offered. Typically this costs £1,000 per case, although with nationalised schemes this may be a waste of money as regardless of how little the CETV may bear resemblance to the open market value of the pension plans, nationalised schemes seem immune to successful attack on the matter.

6. STATE BENEFITS

Whilst basic state benefits are not included within the pensions legislation State Earnings Related Pensions or State Second pensions are. It is, therefore, necessary to:

6.1 Basic State Pension

Both parties should get a state pension forecast to ascertain their basic National Insurance (NI) position. On divorce the spouse with the lower NI provision is entitled to claim the number of years benefits available to the spouse with the higher NI credits. It is advisable if some record is made of a request to make this alteration, although the DWP do maintain they do this automatically.
6.2 S2P

S2P benefits are taken into account. If a person has maximum S2P benefits they can be worth up to £200,000 in pension terms. It is essential therefore that a CETV is obtained for S2P benefits (BR20) prior to any agreement being reached. Please note accrual of S2P benefits ceases in 2016.

6.3 Safeguarded Rights

It is worth highlighting a difference between the HMRC approach to state benefits and that of the DWP. Any state benefits (i.e., contracted out benefits including protected rights and GMP benefits) become safeguarded rights when they are subject to any form of sharing order.

Whereas under the new simplified pension you can have 25% of the state benefits as a lump sum and you can take the benefits from age 55 onwards, safeguarded funds cannot provide any tax free cash and must not be taken before age 60 (and we expect this to rise with State pension ages).

7. PROCEDURES AND TIMES

As with any legal process the procedures and paperwork is extensive. The work entailed includes:

7.1 Form P

As part of the form E (financial statement) each party confirms basic information on each pension arrangement. The adviser then has to issue form P1 to each provider to obtain further details and to assess the overall position. Unfortunately form P1 is not as comprehensive as it could be so usually supplementary questions have to be asked as well. They have a month to reply - up to 3 months if a CETV is required. (At the time of this revision the NHS were not issuing CETV's so this may have to be extended in certain cases.)

7.2 State Benefits

Form BR19 and if appropriate form BR20 have to be issued to the DWP. They have 6 weeks to reply.

7.3 Other Assets

If the adviser is to consider offsetting then he needs to have access to the form E information to provide an accurate picture.

7.4 Actuarial Valuation

It often makes sense to have CETV values checked by a consulting actuary in order to check the accuracy and fairness of the values being offered. This usually costs around £1,000 per case and would take 2 to 4 weeks.
7.5 Report

When the adviser has all the information to hand he or she can provide a report for one or both clients which values the pension benefits and suggests alternative ways of providing equality (or the agreed share) between the parties.

We can undertake such reports on a collaborative or traditional basis for both or just one party.

7.6 Implementation

The pensions sharing or attachment order needs to be drafted. There must be a separate order for each pension. This cannot take place before the degree absolute and confirms who is going to pay the scheme charges (a scheme does not have to undertake any order to transfer until it has been paid).

Having got their sharing order a form M1 needs to be completed and issued to the pension provider. The provider will then require discharge forms and other paperwork to be completed by the former spouse and receiving scheme.

Where appropriate new pension plans need to be recommended and assessed as well as new nomination forms undertaken for death benefits and widow(er)'s death in service and death after retirement benefits.

Leaving aside the time it takes to prepare this paperwork the scheme has 4 months to implement the pension credit from the day they receive the documents from the court.

So as you can see this is all a very expensive and drawn out process! Nevertheless the sums are often substantial and hence to ensure due diligence one has to expect substantial charges.

8. THE LIFETIME ALLOWANCE AND PENSIONS “SIMPLIFICATION”

Prior to April 2006 a pension split on divorce had no effect on HMRC maximum benefits, i.e. the provider of the cash got no relief and the receiver was not penalised.

Post A-Day a more sensible approach has been taken entailing the recipient adding the new values to their existing pension benefits when considering their maximum lifetime allowance (LTA) and the donor deducting the values from their LTA.

With the reduction in the LTA over recent years this change makes a huge difference particularly to those who are contemplating fixed protection due to their final salary pensions exceeding the new lower level.
9. SUMMARY

Pensions sharing is probably the best option in the majority of divorce cases where offsetting is not possible. Cost will, however, remain an issue and any transfers will have to be sufficient to warrant the large costs involved in calculating and organising the new arrangements. Many solicitors and advisers will refuse to advise piecemeal on this type of work for fear of future litigation so you either do your own investigations or accept that this is going to be a very expensive exercise!

Please note that whilst every effort is made to ensure that the information contained within this explanation is correct, these notes are by necessity brief and of a generalised nature. Clients should seek specific personalised advice prior to undertaking any arrangement. These notes are named 10.2015 Pensions Divorce and was last updated in October 2015. Whilst we have done our best to ensure facts are current to this date laws and options are changing constantly so always check before action.

E.&.O.E.