

## Introduction

---

In 2007 there were 144,220 divorces in the UK, according to The Office for National Statistics (ONS). Indeed, the UK divorce rate is one of the highest in Europe. ONS projections suggest that 45% of marriages will end in divorce, with almost half of those divorces happening before couples reach their tenth wedding anniversary. It is therefore not surprising that Parliament has addressed the thorny issue of divorce and pensions twice in the past twelve years. On the first occasion, the Pensions Act 1995 introduced earmarking. This was widely viewed as an inadequate reform, driven primarily by the need to avoid imposing immediate costs on unfunded public sector schemes. Subsequently, the Welfare Reform & Pensions Act 1999 contained legislation to permit pension sharing, which became available for divorce petitions filed on or after 1 December 2000.

The arrival of pension sharing marked a major change in the way that pension issues can be resolved on divorce. However, as its predecessors of earmarking and offset were not abandoned, there are now three main ways of dealing with pensions on divorce. No one route is ideal for all situations, and it will often be the case that what suits one party is the least suitable for the other.

## Offset

---

Offset is the oldest and most widely used system for taking account of each party's pension rights on divorce. It involves placing a value on each party's pension rights (only that accrued during the period of marriage in Scotland) as part of the overall assets of the divorcing parties. Usually the transfer value of the pension would be used as a measure, although in some cases this may understate the true worth of the benefits.

Once the value has been established, the divorce settlement then divides up the matrimonial assets, leaving pensions untouched. So, for example, a common situation would be for the breadwinner to retain their pension rights, but to transfer other assets – typically an interest in the family home – to the spouse. The final result is often that one party ends up with assets but no pension, while the other has a pension but few assets, if any. This polarisation has serious drawbacks.

The pension-owning party may find it hard to re-establish any capital base, because they find themselves back at the bottom of the property ladder, probably with little or no deposit monies available. Similarly, the property-owning party may lack the resources and/or remaining working life to build up an adequate retirement fund. At least the rules for personal pensions now permit tax-relieved contributions of up to £3,600 a year to be made by non-earners.

Despite these drawbacks, offset remains a popular way to deal with pensions on divorce because:

- It creates a clean break between the parties. This can be a very important psychological factor, particularly when there are no children involved and therefore no other reason to maintain contact.
- Offset is relatively easy to implement, provided there are enough non-pension assets available.
- There is no need to adjust pension rights, which can become very complicated if there is a range of different benefits, eg from successive employments.
- It does not reduce pension entitlements.
- There is a danger in dividing up pensions, whether by earmarking or pension sharing, that the end result will be to replace one adequate pension with two inadequate pensions.

- In practice it is often not possible to rebuild pension provision after divorce because of financial constraints.
- Offset has the virtue of being widely understood.
- Solicitors' experience of earmarking is limited, although it has been available for eleven years.
- Pension splitting is also unfamiliar to some solicitors, although many more cases have now come to fruition.

Offset will not be a practical proposition where the pension is the dominant asset and there are not enough other assets available for offset. This may be the case early in married life or close to retirement, when the value of an individual's pension benefits can easily exceed that of the house in which they live. Offset will also be unsuitable where both parties wish to keep an interest in pension rights. The advent of pension sharing means the desire to retain valuable pension interests may become an increasingly common reason for not using offset.

## Earmarking

---

Earmarking was introduced by the Pensions Act 1995 and broadly speaking became available for divorce petitions presented from August 1996. Earmarking has not proved to be a popular option.

The basis of earmarking is that the court issues an order to pension scheme trustees (or the providers of personal pensions and retirement annuities) requiring that a proportion of the member's retirement benefits (pension and lump sum) is paid directly to the former spouse when the member retires. The court may also order that a proportion of the lump sum death-in-service benefits are paid to the former spouse, overriding the normal trustees' discretion. However, there is no possibility of the court apportioning widow(er)'s benefits, as these are deemed not to be the member's for the purposes of earmarking.

The court decides the proportion of benefits (expressed as a percentage, but possibly a specific amount in Scotland), although in practice it may do no more than confirm a figure already agreed between the parties. In effect, earmarking can thus be considered to be a deferred maintenance order. There is no fixed procedure for determining the split of benefits. Several high profile court cases, including some that went to the House of Lords, have prompted calls for new legislation in this area to assist judges. In practice no change is likely in the near term.

Although earmarking has been available as an option for over ten years, so far take-up has been very limited for a variety of reasons:

- From the very outset, earmarking was regarded as an unhappy compromise between pension sharing – which is what the pensions industry wanted – and minimising government expenditure on meeting transfer payments from unfunded public sector schemes.
- The pension is fully taxed as the member's income, even though the pension scheme or provider will make the proportionate payment direct to the former spouse.
- Thus a non-taxpaying ex-spouse may receive payments net of 40% tax, because the pension owner is a higher rate taxpayer.
- When earmarking was debated in Parliament, the potential loss of tax from couples deliberately divorcing was one of the reasons the government put forward for not introducing pension sharing.
- The former spouse depends on the pension scheme member's retirement for benefits to begin. This might mean waiting until the member's 75th birthday to receive any benefits. The delay could be due to sheer cussedness or the fact that the pension scheme member simply cannot afford to retire any earlier because of the impact of divorce on their finances.

- Earmarking does not extend to benefits under the State Second Pension (S2P) or its predecessor, the State Earnings Related Pension Scheme (SERPS). It does not cover the basic state pension.
- However, benefits from these state schemes can be taken into account by the court in determining the overall settlement.
- Pension benefits to the former spouse cease on the member's death, following the deferred maintenance principle.
- It is therefore possible that the former spouse will receive little or no benefit from an earmarking order, particularly if the member whose benefits are earmarked is much older or in poorer health than their spouse.
- Viewed from the member's standpoint, this may be a good reason for proposing earmarking.
- Again following the deferred maintenance principles, if the former spouse dies or remarries, the earmarked pension benefits will revert to the member. There is no reversion of earmarked lump sum benefits.
- There is no opportunity for the former spouse to pass any pension interest or lump sum to dependants. Once more, this is a reason for the member to prefer earmarking.
- There is no clean break. The ex-spouse still needs to stay in contact with the member's pension scheme and benefits remain dependent on that member's actions and/or survival.
- There is a much greater familiarity with offset among courts and solicitors.

## Pension sharing

---

Pension sharing is available for divorces where a petition for divorce or nullity was filed on or after 1 December 2000. It does not cover judicial separation (unlike earmarking). In view of the normal delays between filing and the issue of the decree absolute, experience of divorce cases that have actually ended with pension sharing as part of the settlement took a while to accumulate.

As its name suggests, under pension sharing the court is able to divide pension benefits between divorcing parties. This has a number of advantages:

- It gives each party control of their share of pension benefits. Therefore the ex-spouse does not depend on the actions of the member to determine when any benefits can be paid.
- Each party is responsible for their own tax on benefits. Both parties therefore have the chance to use their allowances, starting rate and basic rate bands to keep down the overall tax bill.
- A clean break can be achieved, as each party controls their own benefits. There is no need for continuing contact.

The rules for pension sharing differ between the types of pension arrangement involved:

- All occupational pension schemes can offer the ex-spouse independent membership of the scheme, although the pattern of benefits does not have to match those of the member.
- Personal pensions can also offer membership, but an application is required from the ex-spouse (if the ex-spouse is not already a member of that personal pension scheme in their own right).

- Alternatively, occupational schemes (other than unfunded public sector schemes) and personal pensions must offer the ex-spouse the option to transfer to another approved pension arrangement (eg personal pension).
- In many instances this is the only option offered, as the alternative of the ex-spouse becoming a scheme member is administratively complex.
- The ex-spouse has a choice of where the transfer should be paid, but if no choice is made, the member's scheme can elect to make a transfer to its nominated default provider.
- This transfer would normally be to a deferred annuity (section 32 buy out plan) because personal pensions cannot be used in the absence of an individual application, although very few deferred annuity providers are willing to accept a pension share.
- For unfunded public sector pension schemes and for S2P and SERPS, the option of an external transfer does not exist. Basic state pension is not covered by pension sharing, but there are rules that allow a former spouse's national insurance contribution (NIC) record to be taken into account when calculating entitlement.
- The ex-spouse will only be offered membership of the scheme with the appropriate pension share.

From 5 December 2005, the pension sharing rules were extended to cover members of civil partnerships. Pension sharing is widely seen as superior to earmarking because it offers a clean break and individual control. Pension sharing has already become more popular than earmarking ever was.

## Making good the shortfall

---

Whether earmarking or pension sharing is chosen as the means of dealing with pensions on divorce, the member will suffer a loss of retirement benefits. In the case of earmarking this may not be permanent, but where pensions are split there will be a definite reduction.

- Under pension sharing, the benefits of membership of an occupational or personal pension scheme are made subject to a 'pension debit' (ie the shared element).
- For pension sharing orders made before 6 April 2006, the debit reduces total benefits, while the credit is set against the recipient's lifetime allowance, although they had the opportunity to claim for a corresponding increase in their lifetime allowance by 5 April 2009.
- Since 6 April 2006, any new debit is allowed as a deduction from total benefits for the losing party, but the corresponding credit will count towards the recipient's total benefits. This could create problems if there is any chance of the value of the recipient's total benefits exceeding the lifetime allowance (£1.75m in 2009/10) at some point.
- The contribution rules introduced from 6 April 2006 largely remove previous HM Revenue and Customs (HMRC) constraints on replacing lost benefits. Financial ability, rather than HMRC restrictions, is likely to be the major factor now.
- If a debit is applied now to a pension started after 5 April 2006, the recipient spouse may claim for an increased lifetime allowance to reflect the fact that their pension increase has already been subject to a lifetime allowance test.
- Earmarking of pension benefits and offset remain available and were unaffected by simplification.

## Conclusion

---

There are now three principal ways of dealing with pensions and divorce. Each has its merits and drawbacks. Anyone involved in a divorce should ensure that their financial and legal advisers are fully conversant with, and can explain, the options and their impact. Ultimately the effect of divorce is likely to mean a diminution of retirement benefits, which will need to be addressed.

*This guide is for general information only and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking action on the basis of the contents of this publication. The guide represents our understanding of the law and HM Revenue & Customs practice as at September 2009, which are subject to change.*