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Divorce and Pensions:
Understanding Your Options

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When a marriage or civil partnership breaks down, dividing assets such as the family home, cash savings, and investments is often a financial priority. However, pensions can be one of the most valuable financial assets and should not be overlooked when reaching a financial settlement.

For some, pensions may be worth more than the family home. Arriving at the incorrect division could therefore have significant financial consequences for both individuals' financial security in retirement.

Are pensions included in a divorce settlement?

There is no set formula for how assets (including pensions) will be split in a divorce and the division can vary significantly depending on individual circumstances in order to achieve fairness. Generally, however, the starting point for any divorce is a 50:50 split in the absence of any prior agreement to the contrary.

The total value of private pensions both parties have accumulated throughout their lifetimes can be considered when reaching a financial settlement. This includes pensions built up before marriage, although this does not mean they will be automatically included.

The treatment of the State Pension on divorce depends on when an individual reaches, or reached, State Pension age and whether any transitional entitlements apply. This is a complex area and falls outside the scope of this article.

How are pensions valued in a divorce?

The starting point is to establish the value of all pension arrangements held by both parties. This usually involves requesting a Cash Equivalent Transfer Value (CETV) from each pension provider. Once issued, a CETV can generally be used in court for up to 12 months.

For Defined Contribution (DC) pensions, many will think they already know the value of their pension fund, but a CETV is still required. This is because a CETV will represent the current value of a pension fund, after deducting any applicable exit charges or market value adjustments, which are often overlooked.

Defined Benefit (DB) pensions, which provide a retirement income based on factors such as salary and length of service, can be more complex to value as there is no individual pension fund. A CETV is therefore essential.

In general terms, a DB pension's CETV is calculated by estimating the cost, in today's money, of providing the member's pension benefits over their expected lifetime, considering factors such as retirement age, life expectancy, future pension increases and spouses/dependent pension options.

How can pensions be divided?

There are three ways that pensions can be accounted for as part of a divorce settlement:

Pension offsetting

Pension offsetting allows one person to retain their pension while the other receives a greater share of other assets, such as the family home or savings.

For example, one person may retain a pension worth £100,000 while the other receives an additional £100,000 of property equity. However, this is not necessarily an equal exchange in real terms. Pension benefits may be inaccessible for many years (depending on age) and withdrawals may be subject to Income Tax, whereas property equity can provide immediate financial and non-financial benefits.

Pension offsetting can be attractive where one spouse wishes to retain the family home and the other prefers to retain their pension. This may avoid the need to sell the family home, reducing further disruption to family life, especially where children are involved.

That said, it is important to consider the longer-term financial implications of pension offsetting. By prioritising the family home over pension provision, one spouse could be left with limited or no pension savings to support their retirement. It is therefore important to strike a balance between immediate financial security and longer-term financial objectives.

Earmarking

Earmarking (also known as pension attachment) allows one person to receive an agreed proportion of the other's pension benefits when they become payable. This can include pension income and tax-free lump sums.

An advantage of earmarking is that it can provide the receiving party with an income earlier than their minimum pension age, particularly where there is a significant age difference between spouses. It also allows the existing pension arrangements to remain in place, without the need to transfer benefits to a new scheme, which may be beneficial if the scheme offers valuable benefits or guarantees.

The downside of earmarking is that the pension remains in the original member's name, meaning the receiving party has no control over the pension's investment strategy or when benefits are ultimately taken and does not provide a clean break. In addition, if the receiving party remarries, their entitlement to any earmarked pension income will generally cease. As a result, this option is rarely used.

Pension sharing

A Pension Sharing Order (PSO) transfers an agreed percentage of one person's pension to the other. The receiving party is awarded a pension credit, which can either remain with the existing provider or be transferred to a pension in their own name, depending on the pension scheme rules.

A pension share provides a clean break, as each person has their own pension benefits and is no longer reliant on the other's retirement decisions. However, pension sharing can involve additional costs, including scheme implementation charges and, where necessary, financial advice.

Pension sharing and tax-free cash

The tax-free cash rules distinguish between disqualifying and non-disqualifying pension credits.

A disqualifying pension credit arises where the original pension was crystallised (i.e. tax-free cash had already been taken) when the pension credit was created. In these circumstances, the recipient cannot normally take tax-free cash from the pension credit.

Where the original pension was uncrystallised when the credit was created, it is generally classed as a non-disqualifying pension credit. The recipient may then be entitled to withdraw tax-free cash, subject to their allowances.

It is therefore important to understand the tax implications before agreeing to a pension sharing arrangement.

Summary and conclusion:

If you receive a pension credit as part of a divorce settlement, it is worth considering how this fits into your wider financial circumstances and future retirement plans.

Regulated financial advice can help you identify your investment options, pension withdrawal choices and any associated tax consequences. Cash flow planning may also help you understand how the pension credit fits alongside any existing retirement provision to ensure that your longer-term financial plans remain on track.

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