

ADVISER GUIDE

Pension sharing orders

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The information contained in this guide is based on our understanding of current law, practice and taxation which may be subject to change. Tax treatment depends on individual circumstances and rules may change.

Background

Pension sharing orders (PSOs) were introduced as part of the Welfare Reform and Pension Act 1999 and came into force for divorce proceedings started on or after 1 December 2000. From 2007, the same rules can be applied to the dissolution of civil partnerships. References in this document to an ex-spouse apply equally to a former civil partner.

Prior to the introduction of PSOs, when couples were divorcing, the only options available in relation to pensions held were to offset the value against other assets or to have an attachment (earmarking) order. Attachment orders can be very problematic. The original pension scheme member retains control over the pension and makes all the decisions in terms of investments, when to take benefits, and the form of those benefits. The ex-spouse receives a share of the benefits when paid out, but has no control over the payments. Benefits are taxed in the hands of the member, regardless of the ex-spouse's tax position, so they may pay tax at a higher rate than otherwise. The issues associated with attachment orders have been compounded due to the introduction of pension freedoms. The member may choose never to access benefits from the pension with the attachment order, to prevent the ex-spouse from receiving anything. Depending on individual circumstances, it may be worthwhile to go back to court to replace an existing attachment order with a PSO.

Pension sharing order basics

PSOs are designed to give a clean break between ex-spouses. The member whose pension has the PSO applied to it has a pension debit, with a corresponding pension credit being awarded to the ex-spouse. The pension credit is then transferred into a pension in the ex-spouse's name, with a provider of their choosing, and they have control of that pension to the same extent as though they had built up the rights in the scheme themselves. There is no difference to how they can take benefits with the exception of a disqualifying pension credit – see later section.

A PSO can be applied to most types of pension, be it public sector, occupational or personal pension; defined benefit or defined contribution, in payment, active or with deferred membership. Many defined benefit private sector pensions will insist the ex-spouse transfers the pension credit elsewhere, but the ex-spouse will usually be required to become a pension credit member of any unfunded public sector final salary scheme (armed forces, civil service, NHS, teachers, police and firefighters). State pension is not shareable, but it may be appropriate to consider the value of benefit accrued when deciding the split of the remaining assets, including other pension provision.

It is not possible to apply a PSO to any beneficiary's pension held. In the past, it would be relatively uncommon for someone divorcing to have a beneficiary's pension as, prior to pension freedoms, they were only usually available to children under the age of 23 or to spouses. In practical terms, this would mean the divorcing member would have to have been widowed first, before remarrying. However, under the current regime, anyone can have a beneficiary's pension, so it will be increasingly common for adult children to have inherited pensions from parents at an age when they may be getting divorced.

PSOs state a percentage of the pension value that is to be transferred to the ex-spouse. It is only possible to state a monetary amount for PSOs issued in Scotland. The court order will state the split of financial assets, with the annex providing the details of the pensions involved and the percentage to be paid to the ex-spouse. This can be for any amount up to 100%. This annex will also state how the costs associated with administering the PSO should be split between the two parties.

It is not possible to state on the order which assets are to be sold or transferred.

In Scottish divorce cases, it is possible to have a legally-binding qualifying agreement to instruct the PSO rather than a court order.

Effective date

The effective date of the PSO is legally important. Legislation refers to this as the 'transfer day', although this is not the day the funds are transferred from the member to the ex-spouse.

The effective date will be the later of the date the decree absolute is issued or 28 days after the PSO is granted. Any contributions or transfers that come in after this date are not shareable rights, and any income taken by the member will not reduce the shareable value. Importantly, if the member were to die after the effective date but before the PSO has been implemented, the PSO would still go ahead with the ex-spouse receiving their pension credit before the death benefits are distributed from the deceased member's pension.

Implementation

In order to implement a PSO, the pension scheme administrator will need a copy of the PSO and annex stamped by the court, a copy of the decree absolute and the relevant paperwork, including discharge forms, to implement the transfer to the ex-spouse's chosen provider (in Scottish cases, a copy of a registered qualifying agreement may replace the court order).

Once the scheme administrator has all the necessary documents, the implementation period begins. Legislation states that the PSO must be implemented within a four-month window starting on this date. The scheme administrator can choose a valuation date anywhere within this four-month window. At AJ Bell, we use the date we receive all necessary documentation, but other providers may operate differently. It is only once the valuation of the shareable rights has been carried out that the ex-spouse will know the monetary amount they are to receive (with the exception of Scottish cases, where a monetary amount can be stated on the PSO).

Although there is a four-month window to implement the PSO, ombudsman rulings in relation to delays show that the administrator should ensure it is carried out as quickly as possible. There have been rulings where the PSO was implemented within the window where the administrator was still found to be at fault for causing delays, and conversely instances where implementation took longer and the administrator was found not to be at fault as the delay was outside its control.

Practical issues

There are a number of practical issues that should be considered before a PSO is put in place to avoid problems and delays further down the line.

Perhaps the most obvious issue is when the pension is invested in illiquid assets which make the PSO difficult to implement. Where commercial property is involved and makes up a large proportion of the pension, offsetting other assets rather than splitting the pension holding the property should be considered wherever possible. If the property is to be sold – which could be to the member or their company – then the practicalities and costs associated need to be closely looked at before the PSO is agreed.

Although not a requirement, it is good practice to send a draft PSO to the pension provider before it is finalised so it can highlight any potential issues that may arise, and solutions or alternative arrangements can be made as appropriate. This can save a lot of delays later in the process.

Because the PSO always states a percentage share (Scotland aside), it is desirable to use a valuation as close to the court date as possible to avoid large fluctuations in value between the valuation used when deciding the split and the valuation used to implement it.

A common source of delay is the ex-spouse not having made a decision on where they want their pension credit sent to and so not having sent in the relevant paperwork. When the scheme administrator has the PSO and decree absolute but this last piece of paperwork is missing, the scheme is left to a certain extent in limbo, which is not ideal for either the member or ex-spouse. The member will still control the investments, but may have restrictions imposed on taking benefits or transferring out, as the administrator needs to ensure there are sufficient funds to pay the ex-spouse. From the ex-spouse's point of view, having their ex make the investment decisions is far from ideal.

If the member has funds in capped drawdown at the time of the PSO, their maximum income will need to be recalculated as at the point the pension credit is transferred. The new maximum will take effect from the start of the new pension year.

Qualifying or disqualifying?

Whether the pension credit is 'qualifying' or 'disqualifying' will depend on whether the pension was in payment in the hands of the original member.

If the pension credit is from uncrystallised rights, it will be a qualifying pension credit. This means the ex-spouse will be able to take a pension commencement lump sum (PCLS) or uncrystallised funds pension lump sum (UFPLS) in the usual way once they reach retirement age.

If the pension credit originates from pension rights that were already in payment (crystallised rights), then it will be a disqualifying pension credit. This means the ex-spouse will not be able to take PCLS or UFPLS payments, but will still be able to take a taxable income once they reach retirement age. This reflects the fact that the member has already had the benefit of the tax-free part of their pension.

One positive element to having a disqualifying pension credit is that taking any income under flexi-access drawdown (FAD) does not trigger the money purchase annual allowance (MPAA). This is in contrast to taking FAD from a qualifying pension credit (or rights built up under their own pension).

It is possible to have a PSO which is part qualifying and part disqualifying.

When deciding a fair split of assets between the divorcing parties, it may be appropriate to take into account whether any pension credit would have qualifying rights or not.

Protection issues – original member

Primary or Individual Protection will be reduced or lost if a pension debit is applied to a member's pension. This still applies following the abolition of the Lifetime Allowance so it could still have an impact on the amount of PCLS available.

Primary protection

The reduction in protection applies from the effective date but the calculation is carried out as though the reduction happened at 5 April 2006.

Example

Pension rights of £3 million at 5 April 2006

Primary protection factor = $(£3m - £1.5m) / £1.5m = 1$

Value of primary protection prior to PSO = $£1.8m + (1 \times £1.8m) = £3.6m$

PSO pension debit of £1 million in 2020

Primary protection factor now based on holding £2m ($£3m - £1m$) at 5 April 2006 $(£2m - £1.5m) / £1.5m = 0.3333$

Rounded up = 0.34

Value of primary protection after PSO = $£1.8m + (0.34 \times £1.8m) = £2.412m$

When the member has a pension debit that reduces their protection, regulations state they must inform HMRC 'without delay'. HMRC will issue a new certificate showing the reduced level of protection. If they do not have a protected lump sum but retain their Primary Protection albeit at a lower level, they will still be entitled to PCLS up to the lower of 25% of their fund or £375,000 (25% of £1.5 million).

It is also possible for the protection to be lost altogether if the deemed pension rights at 5 April 2006 are below £1.5 million.

Example

Pension rights of £3 million at 5 April 2006

Primary protection factor = $(£3m - £1.5m) / £1.5m = 1$

Value of primary protection prior to PSO = $£1.8m + (1 \times £1.8m) = £3.6m$

PSO pension debit of £1.6 million in 2023

Protection application now based on holding £1.4m ($£3m - £1.6m$) at 5 April 2006 – does not qualify for primary protection.

The example above shows that a pension debit of £1.6 million has caused a loss of protection, this means the maximum PCLS will be the standard frozen amount of £268,275.

Enhanced protection and fixed protections

Having a PSO does not have a direct impact on any enhanced or fixed protection held; the protection will remain intact. As long as the protection was in place prior to 15 March 2023 contributions can be made from 6 April 2023 onwards to rebuild the pension and the level of protected PCLS will not be impacted.

Individual protection

Like primary protection, individual protection (IP) can be lost or reduced when a pension debit is applied to the pension. The member has 60 days to inform HMRC of the debit or they could be liable for penalties. HMRC will issue a new certificate or reference number with the reduced level of protection if it has not been lost altogether.

When calculating the new level of protection, the amount of the pension debit is reduced by 5% for each full tax year after the date of protection (i.e. 6 April 2014 for IP14 or 6 April 2016 for IP16). The date used in calculating whether a full year has passed will be the effective date. This amount is then deducted from the fund value at the date the protection was given, and the new level of protection is calculated.

Example – protection is reduced

Pension rights of £1.6 million at 5 April 2014
Individual protection 2014 (IP14) held of £1.5m (maximum permitted)
PSO pension debit of £300,000, effective date 15 June 2016
Pension debit effective two full years after protection – 10% reduction
IP14 recalculated as £1.6m – (£300,000 x 90%) = £1.33m

In this instance maximum PCLS will be reduced from 25% of £1.5m (£375,000) to 25% of £1.33m (£332,500)

Example – protection is lost

Pension rights of £1.6 million at 5 April 2014
Individual protection 2014 (IP14) held of £1.5m (maximum permitted)
PSO pension debit of £400,000, effective date 15 June 2015
Pension debit effective one full year after protection – 5% reduction
IP14 recalculated as £1.6m – (£400,000 x 95%) = £1.22m
Protection is lost (minimum value for IP14 was £1.25m). PCLS will be the standard maximum of £268,275

In the example above where IP14 is lost, the client could have applied for IP16 (applications for which are still open) assuming total pension savings were still over £1 million on 5 April 2016.

Protection issues – credit recipient

Enhanced protection and fixed protections

If the individual receiving the pension credit holds enhanced or fixed protection, then prior to 6 April 2023 the pension credit needed to be transferred into an existing arrangement to ensure there was no loss of these protections. As long as the protection was in place on 15 March 2023 then this is no longer a requirement and setting up a new arrangement to receive the transfer will not invalidate their protection.

Primary protection or individual protections

There is no direct impact of receiving a pension credit for primary or individual protection holders.