GUIDE TO PENSIONS AND DIVORCE

This is not a cheerful subject but, with recent data indicating that the average duration of a marriage is 12.3 years, divorce is likely to affect large numbers of adults in the UK, and rates can be even higher for expats. Inevitably, when partners split, there is a division of assets between parties and pension savings can often be one of the most valuable of all assets. There are several options available and our guide will help you understand the basics.

As with all significant life events, successfully navigating the options available is greatly assisted with professional advice, and if you find yourself facing divorce then it's worth making sure your financial adviser is aware and can help support you in making the choices most suitable for you.

Option one: pension attachment/earmarking

The spouse with the pension assets agrees to pay a portion of their pension monies to the other party at retirement. This was the original 'divorce settlement' and is less popular these days, most often seen with Defined Benefit pensions where a partial transfer out may not be practical or economical. The order can involve either the pension commencement lump sum, or income payments or both. The order also remains in force if the member decides to transfer their pension to a new provider.

A summary of the positives and negatives is given below:

Pros	Cons
Avoids any penalties which may apply to selling down investments, as assets remain invested. For example, market value reductions or early encashment fees.	Retains a link to the ex-spouse all the way to (and potentially through) retirement, so there is no 'clean break'.
Preserves active membership of Defined Benefit pension scheme (where applicable).	The ex-spouse controlling the pension assets controls the retirement age and investment strategy, which might not be in line with the other party's preference.
	Where income forms part of the agreement, the member may pay income tax before payments are made to their ex-spouse, depending upon the scheme arrangements.
	Expression of wishes governing death benefits can be more complex or may be in the sole control of the ex-spouse controlling the pension.
	Makes financial planning for the long term more difficult for both parties, as the net pension benefits for each are not as readily apparent (pension statements for example need to be viewed with the attachment order in mind).

Option two: pension sharing

All or part of the pension assets are transferred from one party to the other.

This option was introduced by the Welfare Reform and Pensions Act 1999. The pension is divided up between the two spouses and usually a proportion will be transferred away to the pension scheme of the ex-spouse's choosing. A Pensions Sharing Order will be produced and sent to the pension scheme who have up to four months to implement the order, once they have received all their requirements. The pros and cons of this, the most popular option, are listed below.

Pros	Cons
Clean break for both parties.	Higher earners can find it more difficult to accrue significant pension savings to 'top back up' tax efficiently owing to Annual Allowance Taper restrictions. Therefore, it can sometimes be more tax efficient to offset against other assets.
A partial transfer is made to the ex-spouse, allowing both parties to independently manage their pension monies (investment strategy, retirement age etc).	If the children are not the product of the marriage, then some of the tax efficient monies held intended for inheritance would be removed via the pension split. Other assets held might form part of estate on death.
As the divided monies are genuinely moved from one party to another, it allows the individual to consider future pension accrual to top back up their retirement savings.	
Each spouse can nominate their own beneficiaries via Expression of Wishes. Assuming that the children are the offspring of both parties here, there can be an advantage to division of the pension assets under the new Lump Sum Death Benefits Allowance (which would be essentially doubled as each spouse would hold a full allowance each). For a large pension plan, having two separate pensions can therefore present an advantage when considering efficient inheritance planning.	

Option three: offsetting

With this option, both parties get to keep their own pensions and other assets are used to achieve a fair division of overall assets. For example, the party with the smaller pension might get a greater share of the family home, or the money held in bank accounts and other investments.

The pros and cons again, are summarised below:

Pros	Cons
Clean break for both parties.	Higher earners can find it more difficult to accrue significant pension savings to 'top back up' tax efficiently owing to Annual Allowance Taper restrictions. Therefore, it can sometimes be more tax efficient to offset against other assets.
Allows each spouse to retain their own pension savings and express preference over assets to divide (it can sometimes be more tax efficient for a higher earning spouse to retain pension assets, which are less easy to re-accrue, and for a lower earning spouse to retain say a marital home which they may not be able to secure mortgage borrowing for solo). Full financial advice is strongly recommended for both parties in this scenario to ensure fair division of assets, and to ensure that short and long term financial client objectives are considered within relevant tax and legislative considerations.	If the pension is large, and primarily viewed as an inheritance vehicle, the Lump Sum Death Benefit Allowance might present a restriction on the amount of assets that can be left tax free to children (£1,073,100 as at September 2024). It should be considered whether offsetting might allow lifetime gifting in this scenario (or whether pension sharing might be more advantageous).
	Lower earners might be less likely to be able to accrue future pension savings after a divorce due to a decrease in affordability. This can lead to later life hardship if short term objectives solely are favoured during divorce separation of assets.

Conclusion

All three options have their own merits, but also potential pitfalls to look for. With SIPPs, we tend to find that pension sharing is the most popular option. It has the advantage of allowing a clean break and meaning that both parties can move on with their lives and manage their pensions accordingly. For financial advisers involved with divorce settlements it is worth however considering the pros and cons of each option, because the right one is not always clear cut.

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