Pensions and Divorce

Background

Following the Pensions Act 1995 it is now compulsory to consider the value of pension rights in a financial settlement on divorce.

What are the options?

There are three main options available to the member and ex-spouse/civil partner on divorce, these are summarised below:

1. Offsetting

This is a 'clean break' option where pension assets are taken into account in the settlement but are not allocated to the ex-spouse/civil partner. This could involve the ex-spouse/civil partner retaining the marital home (or perhaps a larger slice of the proceeds on sale), with the member retaining their pension entitlement.

Offsetting is still the most popular form of settling pensions issues on divorce due to the attractiveness of the 'clean break' principle, and the relative cheapness and simplicity of this option. However there are some disadvantages:

- The member may lose the value of more liquid assets. Furthermore, as they may lose all rights to the marital home, they may have to find a new home – meaning they may have to take out a new mortgage when they were not expecting to.
- The ex-spouse/civil partner will not have a pension in retirement. They may well have been expecting to live a comfortable life in retirement but now find that, whilst they have the marital home, they have no income in retirement unless they have a pension arrangement of their own.

Advisers can add value in revisiting the clients' circumstances and advising on new mortgages, changes to investments, and reviewing pension arrangements, plus any trusts. Where advisers continue to look after the ex-spouse/civil partner, they may also wish to consider whether they are in a position to fund for new pension contributions.

2. Earmarking (also known as 'Attachment')

Earmarking works by allocating pension assets to the ex-spouse/civil partner by virtue of an earmarking order. Benefits are payable to them on retirement of the member. With this in mind, there is **no** 'clean break' and the ex-spouse/civil partner remains dependent on the member's circumstances, in addition to the following limitations:

- The member decides when to take benefits and, where the pension arrangement is a money purchase one, also decides on the investment strategy (and could, in theory, select unwisely, and therefore reduce the ex-spouse/civil partner's ultimate benefits).
- If the ex-spouse/civil partner dies before benefits are payable, they will lose entitlement to their share of any pension benefits (unless the earmarking order extends to any lump sum death benefits).
- If the member dies before taking any benefits, the ex-spouse/civil partner will lose their entitlement (unless the earmarking order extends to any lump sum death benefit).
- Any pensions in payment will normally lapse if the ex-spouse/civil partner remarries.
- The pension paid to the ex-spouse/civil partner is taxed as though it is paid to the member.

The opportunities for advisers in these circumstances perhaps lie in ensuring that the member increases pension contributions (or makes contributions to a new pension arrangement), so that there is no shortfall on retirement.

If responsible for the interest of the ex-spouse/civil partner, will this pension entitlement be sufficient to maintain the standard of living to which they are accustomed, or do they also need to consider contributing to a pension arrangement of their own? There will also, again, be the need to review trusts, other investments, mortgages, endowments and other financial arrangements.

3. Pension sharing (or 'splitting')
This again involves a 'clean break' approach. In this situation pension sharing is triggered by a court order whereby a physical split of pension benefits takes place. This can include pensions already in payment.

Once the split has been agreed, the member will have a pension debit against their pension rights and the appropriate sum (the corresponding pension credit) will be either:

- transferred to the ex-spouse's/civil partner's own (perhaps new) pension arrangement, or
- retained within the member's scheme, but in the ex-spouse's/civil partner's name.

The treatment of the ex-spouse's/civil partner's share will be dependant on whether the scheme is funded or unfunded and whether the member's scheme is money purchase or defined benefit. For instance, for money purchase schemes and funded defined benefit schemes, the transfer option must be offered to the ex-spouse/civil partner whereas retaining them in the member's scheme does not have to be (and few schemes would choose to offer this option).

Impact on the new Lump Sum Allowance (LSA) and Lump Sum and Death Benefit Allowance (LSDBA)

A pension debit does not use up the member's LSA or LSDBA as it is not a relevant benefit crystallisation event but be aware that it can impact any protected LSA/LSDBA where the member has Primary Protection or Individual Protection (2014 or 2016) as the pension debit will reduce the Primary Protection Factor and 'protected value' respectively. In some instances, this recalculation may cause protection to be lost.

In contrast, lump sums arising from pension credit rights will normally be counted for the purposes of the ex-spouse's LSA and LSDBA. An enhancement to the their LSDBA may, however, be available to certain 'disqualifying' pension credits (i.e. pension credit rights derived from certain previously crystallised funds of the original member).

This is perhaps where advisers can add the most value using their pensions knowledge to advise clients and work with solicitors' practices. In order to ensure that the member's income in retirement does not suffer as a result of the pension debit, further contributions are likely to be necessary, and it may also involve re-assessing the member's whole attitude to risk. Where the adviser also looks after the interests of the ex-spouse/civil partner, then giving advice on which arrangement to transfer the pension credit to is crucial, as well as establishing whether this is sufficient to match their income needs in retirement. Again, a complete review of all other assets will also be necessary.

For further information on pension sharing, please refer to HMRC's PTM029000.

Key point summary
As divorce has become more commonplace over the years, so has the need for financial advice in this area. Advisers can offer considerable benefit to clients in these difficult, and sometimes confusing, circumstances.

This represents Zurich's understanding of pensions and divorce in England and Wales. This is subject to change and Zurich does not accept responsibility for any action taken or refrained from, by any person relying on this information.

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