Articles

Pensions on marital breakdown Part 4: pension offsetting

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In Part 2 of this series, published in August [2012] Fam Law 968, we touched briefly on offsetting. We now consider in some greater detail offsetting as one of the methods in resolving a pension claim. At its most basic it works on the basis that the party who has the lower-valued pension assets retains a greater amount of the non-pension assets in lieu. There are a number of fundamental issues to be considered:

(a) Are the non-pension assets in the case of sufficient size and quality to make offsetting any disparity in pension values a realistic option?
(b) Is it a 'needs' driven case? The option to offset might be limited if income in retirement is in short supply.
(c) How do we value the pension asset to formulate a 'fair' outcome on offset? Is the Cash Equivalent Value a true reflection of real value in every case?
(d) How can we 'compare' £1 of cash with £1 in a pension fund? Is that comparison easier the closer the parties are to retirement?

Comparisons

One of the greatest problems with offsetting is that we are not comparing like with like:

Cowan v Cowan [2001] EWCA Civ 679, [2001] 2 FLR 192

> 'The husband's fund is all vested and is no more and no less than a whole life fixed rate income stream.' (Thorpe LJ)

Maskell v Maskell [2001] EWCA Civ 858, [2003] 1 FLR 1138

> 'The judge [in the court below] is making the seemingly somewhat elementary mistake of confusing present capital with the right to financial benefits on retirement, only 25% of which maximum could be taken in capital terms, the other 75% being taken as an annuity stream.' (Thorpe LJ)

These cases articulate what experts often refer to as the 'utility argument' – why £1 of cash is worth more than £1 of pension fund. Again, Thorpe LJ set out the features of a pension (albeit in payment, but the difference between a pension and a pension in payment is simply an issue of timing) in *Martin-Dye v Martin-Dye* [2006] EWCA Civ 681, [2006] 2 FLR 901:

> 'A pension in payment is no more than a whole of life income-stream akin to an annuity. It cannot be sold, commuted for cash or offered as security for borrowing. It has no capacity for capital appreciation. The benefit does not survive the death of the scheme member and thus cannot form part of his estate. There are obvious distinctions between the technical value ascribed to a pension in payment and a market value ascribed to a realisable asset such as a freehold, a portfolio of shares or a work of art.'

So in cases where offsetting is used or could be used, should we always seek to apply a discount to the non-pension asset to reflect its greater utility, and if a discount is to be applied, how should it be calculated? In addition, should we use the CEV as the basis of valuation of the pension applying discounted rates for the purpose of negotiation? Is it right to presume that in all cases involving offsetting there should be a discount?

The reason for a discount to be applied, if at all, is usually to reflect the greater utility, flexibility, liquidity or accessibility of non-pension assets over and above that of pensions. Perhaps the greater the discount the more remote it is as to when the pension will vest. However, take the case where the husband retains his pension fund and the wife retains the former matrimonial home or the sale proceeds from it from which she has to re-house herself and the children. What additional utility, flexibility and/or liquidity does the wife have? Arguably she has:

- the ability to mortgage and raise funds if her circumstances support the required level of repayments; or
- the ability to rent out the house and move to live elsewhere; or
- the ability to sell up and move on in the event of cohabitation or remarriage.

So there are elements of flexibility but, in such circumstances, is a discount fair?

In *T v T (Financial Relief: Pensions)* [1998] 1 FLR 1072, Singer J provided some useful guidance:

> 'It may be helpful to explain (as did Mr Ferguson, the actuary instructed on behalf of W) that there are three stages to arriving at this "offset" value for a spouse's loss through divorce. First must be determined the quantum of the benefit which the loser would have enjoyed but for the ending of the marriage; next must be applied a discount to reflect present payment as compensation for future loss; and finally must be included a contingency factor to reflect the probabilities of survival and death at various points in the future of both husband and wife.'

Experts are asked for guidance on discounts, and each expert will have their own approach (again without any industry standard or guidance to which they can refer). But the starting point for each case is: 'What are the values of the pensions in this case, and what is the disparity between husband and wife's pensions which we are seeking to offset?' Some experts may simply use the CEV and, in some cases, especially involving those with simple money purchase funds (eg a Standard Life personal pension) this may be appropriate. However, be careful – even seemingly simple personal pensions can have a sting in the tail if they incorporate guaranteed annuity rates.

If the pension concerned is a final salary pension (defined benefit (DB) scheme), such as, say, a public sector pension (teachers, NHS, civil service, Police, Armed Forces etc) then the CEV may not be an appropriate starting point. A final salary (DB) pension provides the member with a pension promise of say a pension of one eightieth of his or her final salary as a pension and three eightieths of his or her final salary as a lump sum for each year of service. So a teacher on a salary of £40,000 pa, with 30 years of service will have accrued a preserved pension of thirty eightieths of £40,000 – ie £15,000 pa plus a lump sum of £45,000, payable at age 60.

One obvious flaw with using the CEV as the basis of valuation of final salary benefits is that the same pension promise of £15,000 pa plus a lump sum of £45,000 could be valued for divorce purposes (ie CEV) by different schemes at different amounts. The teachers' scheme may provide a CEV of £275,000 but other schemes, with the same benefits promised to the member, will come up with totally different values for the CEV. Which is right? What difference to the member does it make if the CEV of his pension promise of £15,000 pa plus a lump sum of £45,000 is £200,000, £300,000 or £400,000? Answer – it makes no difference: irrespective of the notional CEV placed upon the pension, the member will receive a pension of £15,000 pa plus a lump sum.

Example 1

To emphasise this point, take a scenario where H is that member in the teacher's scheme with a pension promise of £15,000 pa at age 60 plus a lump sum of £45,000. The CEV is £275,000. W has exactly the same pension promise (£15,000 pa at age 60 plus a lump sum of £45,000) in a final salary scheme, but this time in the private sector and the CEV is only £200,000. Should she receive £75,000 of additional non-pension assets to compensate her for the difference in CEVs?

What we are trying to emphasise is that when looking at offsetting, it may perhaps be dangerous and misleading to look simply at the CEV as a basis for valuing the pensions. The CEV does not reflect in any standard way, the cost of the pension to the member, or the 'quantum of the benefit which the loser would have enjoyed but for the ending of the marriage.' (*T v T*)

To try and standardise values of final salary pensions for offset purposes, some experts now seek to value a pension on the basis of: 'How much capital would W require now so that if invested until age 60, she has sufficient capital to enable her to buy, on the open market, an income stream which when added to her own projected pension income, will equal the projected pension income of H at that juncture?'

If we apply this approach to a male aged 50 with a pension promise of £15,000 per annum and a lump sum of £45,000 payable at age 60, using various assumptions we may conclude that the wife may require capital now of £400,000 so that she too could enjoy a pension of £15,000 pa and a lump sum of £45,000 at age 60. Therefore, had we simply used the CEV as a basis of valuation for offsetting, in lieu of the husband retaining a pension valued at £275,000 (by use of CEV) more than the wife, it would have been presumed that the wife should retain non-pension assets to the value of £275,000 more than the husband. However, based upon the above figures, it is clear that £275,000 would have been insufficient to allow the wife to receive the same pension benefit as the husband at age 60, and instead, she may need to receive around £400,000 more than the husband in non-pension assets.

Example 2

Another flaw with the use of CEVs as the basis of valuation for offsetting can be shown quite easily in the following example.

H and W are both aged 59, and will retire when their divorce proceedings are concluded. H has a Standard Life personal pension with a CEV of £300,000. W is a member of the teachers' pension scheme, also with a CEV of £300,000. At age 60, W will be permitted to retire from the teachers' pension scheme when she will receive a lump sum of £38,100 and an index linked pension of £12,700 pa.

If the CEV were used as a basis of valuation for offsetting, there would be no offset – the two pensions (the husband's £300,000 in a Standard Life pension and the wife's £300,000 in the Teachers pension) would be perceived to be of the same value.

The reality is that they are of totally different value in terms of the pension and lump sum that the parties may receive. We already know that the wife may receive in less than a year a pension of £12,700 pa increasing each year in line with CPI, plus a lump sum of £38,100. If the husband were to commute £38,100 from his Standard Life pension as a lump sum (this amount chosen so that we can compare like with like), he would be left with a fund of £261,900 with which he may choose to buy an annuity. Such a fund may allow him to buy an index-linked annuity of perhaps around £9,250 pa – only 75% of the pension enjoyed by the wife.

Thus, in this case, where reference to the CEVs would suggest there would be no need for offsetting, the reality is that an argument could be presented that the husband has pension assets substantially inferior to the wife's, and perhaps there should be some form of offset.

Let us refer back to example 1 above. Are we saying that the wife should receive £400,000 more of non-pension assets in lieu of the husband retaining £400,000 more of his pension, or should the £400,000 be discounted, and if so, by how much should the £400,000 be discounted? There is no statutory answer.

Here are just some considerations:

- What is the tax position of the wife? Is she a high earner? If yes, then it may be possible for her to recycle, over a period of time, any lump sum she were to receive by way of offset into a pension in her own name and obtain tax relief. Thus were this possible, and she were to receive £400,000, this may be converted into a pension fund substantially in excess of £400,000, at no extra cost to the wife , but simply by use of HMRC tax rules on pension contributions.
- What about timing issues? If the husband is aged 40, it may be at least 20 years, possibly longer before he can receive any benefit from his pension fund. If the husband is aged 64, then it may be a matter of only 12 months. The discount applied in these two scenarios may be totally different to reflect the proximity to retirement.
- What about the 'safety' of the pension fund? If the husband's benefits are within, say, the teachers scheme, the probability of the teachers scheme being unable to pay him benefits accrued to date due to financing problems is significantly less than if the husband's benefits were held in a pension fund, known to be in deficit, and perhaps heading for the PPF.
- What about the health of either party? If one party has health issues which may foreshorten their life expectancy, should these be taken into account?

Perfect solutions

Is there ever the 'perfect solution' to a financial dilemma? Certainly, whilst we continue to have a discretionary-based statute, certainty of outcome remains hard to find.

We steal two references from the President of the Family Division, Sir Nicholas Wall, when he addressed the Annual Resolution Conference in Leeds in March of this year. First, he referred to *Jones v Jones* [2011] 1 FLR 1723.

> 'It seems unfortunate that our law of ancillary relief should be largely dictated by cases which bear no resemblance to the ordinary lives of most divorcing couples and to the average case heard, day in and day out by district judges up and down the country'.

Secondly, he referred to *Martin v Martin* [1978] Fam 12 at p 20 and a response given to counsel by Ormrod LJ about the certainty with which lawyers can advise their clients

> '… it is a matter of trial and error and imagination on the part of those advising clients. It equally means that decisions of this court can never be better than guidelines. They are not precedents in the strict sense of the word.'

And there, the issue lies. There is a dearth of case-law on the financial consequences arising from the breakdown of the marriage but not, we suggest, on the treatment of pensions on divorce.