Share and share alike

Hazell Carr Collins' Bernard Brindley, Harry Smith and Ash Sanger consider solicitors' most frequently asked questions about pension sharing

It is now 17 months since the regulations under the Welfare Reform and Pensions Act 1999 came into force. These regulations introduced the new concept of pension sharing, thus increasing the range of options open to allow the settlement of pension rights on divorce. In that time, we at Hazell Carr Collins have been involved in assisting family lawyers in hundreds of cases, and have amassed considerable experience of the problems that are arising. It has also become clear that there are many potential pitfalls that are not fully understood.



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This article deals with some of the most common aspects that we have been consulted about. It is far from the complete list.

The 'moving target' issue

This is a problem of dates. In England and Wales, the difficulty arises because there are two dates at which the Cash Equivalent Transfer Value (CETV) will be calculated. (In Scotland, there is an even more convoluted problem, but this article does not deal with the Scottish version.)

The first date is decided by the court, or the couple themselves, during the process of coming to an agreement regarding the pension share.

The Divorce etc (Pensions) Regulations state in regulation 3(1) that:

> For the purposes of the court's functions in connection with the exercise of any of its powers under Part II of the Matrimonial Causes Act 1973, benefits under a pension arrangement shall be calculated and verified in the manner set out in regulation 3 of the Pensions on Divorce etc (Provision of Information) Regulations 2000(a), and –
>
> (a) the benefits shall be valued as at a date to be specified by the court (being not earlier than one year before the date of the petition and not later than the date on which the court is exercising its power);
>
> (b) in determining that value the court may have regard to information furnished by the person responsible for the pension arrangement pursuant to any of the provisions set out in paragraph (2); and
>
> (c) in specifying a date under sub-paragraph (a) above the court may have regard to the date specified in any information furnished as mentioned in sub-paragraph (b) above.

In practice, this is likely to be the date on which the CETV used by the court was calculated. This is the CETV that the couple will have used in their negotiation and agreement, possibly after much argument.

When the agreement has been reached and the order has been made, the order will go to the pension scheme for implementation. At that stage another date comes into play, this time as set out in s29(7) of the Welfare Reform and Pensions Act 1999:

> For the purposes of this section, the valuation day is such day within the implementation period for the credit under subsection (1)(b) as the person responsible for the relevant arrangement may specify by notice in writing to the transferor and transferee.

The definition of the 'implementation period' is given in s34(1) of the Welfare Reform Act. This definition is:

> For the purposes of this Chapter, the implementation period for a pension credit is the period of four months beginning with the later of:
>
> (a) the day on which the relevant order or provision takes effect; and
>
> (b) the first day on which the person responsible for the pension arrangement to which the relevant order or provision relates is in receipt of (i) the relevant matrimonial documents, and (ii) such information relating to the transferor and transferee as the Secretary of State may prescribe by regulations.

The CETV may change significantly after the court date and the date chosen by the pension scheme. This can arise because there is:

- a delay in submitting the order;
- a change in the pension scheme member's situation, for example a salary increase; and
- a change in stockmarket levels.

For large expected changes in the CETV (for example, more than a year between the two dates, or a large jump in salary), an actuary can adjust the percentage share to allow for changes to the CETV between the two dates.

However, we have had examples reported to us that in practice some schemes are ignoring this point. They are simply using the CETV as at the date previously quoted despite it not falling within the required four months.

When should a value other than the CETV be used?

There are quite a number of sets of circumstances in which the CETV can be an unfair value to use. Probably the most frequent cases are when acting for the spouse of an active member of the uniformed services. (See table below).

The complication stems from the different ages at which the pensions can start. For example, supposing the pension scheme member is the husband, the possibilities are:

- if he remains in service until retirement – the pension starts at the ages shown below; and
- if he leaves service before retirement – his pension starts at age 60.

The CETV is always calculated on the basis that the member is leaving service. This is because CETVs were originally designed for use when an employee was changing jobs and the CETV was what was needed to transfer the pension liability from the old employer to the new employer.

One does not need to be an actuary to realise that the value of a pension starting at age 40, 50 or 55, depending on the scheme, is worth a good deal more than one based on a pension starting at age 60. An independent actuarial value of the pension will be based on the actual expected retirement age and will therefore be a fair value. Usually in these pension schemes the member will be the husband, and so the use of the CETV amounts to sex discrimination.

> 'CETVs were originally designed for use when an employee was changing jobs and the CETV was what was needed to transfer the pension liability from the old employer to the new employer.'

If the CETV is not a fair value can a more reasonable value be used for offsetting? Yes, although the CETV must be considered by the court, so that it has to be available, there is no bar on additional evidence. There are several references for this, probably the easiest source is the Lord Chancellor's Summary Paper, which was issued in July 1996 with the Regulations under s166 of the Pensions Act 1995. Paragraph 2 states that, 'the Court will be obliged to consider the CETV calculation'. But it goes on to say:

- The parties will not be barred from providing additional information as to the future expectation of the pension. The court may... take this into account ... to reflect the loss of the future benefit of the pension to the party without pension rights.
- The Regulations will not prevent the parties providing further information as to the future expectation of the pension, and will not prevent the court from taking account of that information in circumstances where it deems the CETV method of valuation provides an inappropriate or inadequate indication.

If the CETV is not a fair value can a more reasonable value be used in a pension share? No. So how can you get a fair result? By adjusting the percentage share in the order. The easiest way to explain this is with an example.

A policeman is almost 50, by which time he will have served for 30 years, having started at age 20. His salary is £30,000, which means he can retire with a pension of £20,000 per annum and on his death his widow will receive a pension of £10,000 per annum. (He has the option to cash a quarter of his own pension for a tax-free lump sum of £75,000.)

In this example the CETV is £250,000. This value is based on his

When should a value other than the CETV be used?

There are quite a number of sets of circumstances in which the CETV can be an unfair value to use. Probably the most frequent cases are when acting for the spouse of an active member of the uniformed services. CETV should not be used with some members of one of the following pension schemes:

- Police – can retire from 50 depending on service.
- Fire Brigade – can retire from 50 depending on service.
- Armed Forces – can retire from 40 depending on service and rank.
- Prison Service (where service started before November 1987) – can retire from 55 depending on service.
- Certain members of the NHS scheme – such as long serving nurses, mental health officers and midwives – can retire at 55.

The adjustment process (i)

Realistic value of the pension rights	£400,000
Each party's share	£200,000
The wife's share will need to be expressed as a percentage of the CETV which is	£250,000 / £200,000 / £250,000 = 80%

starting his pension at age 60, ie assuming he leaves the police force. This is clearly an entirely unreasonable assumption. A realistic value of his pension rights, based on his pension starting at age 50, is £400,000.

If the couple agree that the pension is to be shared 50/50 the adjustment process is as indicated in the table (The adjustment process (i) – see above).

The police scheme will then use 80% of the CETV (ie 80% of £250,000 = £200,000) to provide a pension for his wife. So that leads to a pension for her starting at age 60. She also has the option to cash a quarter of her pension for a tax-free lump sum.

The policeman is not hard done by, which is how it appears at first sight, since he seems to be giving up 80% of his pension. A pension debit of 80% of his pension, ie 80% of £20,000 = £16,000, is indeed set up at age 60.

However, when he retires at age 50 the pension debit is reduced. In the phrase used by the scheme, 'if he retires before age 60 his pension debit will be actuarially adjusted to compensate for beginning to deduct the pension debit from an earlier age'. In other words it will be reduced to £10,000.

However, if the pension sharing order were done on a naïve, albeit understandable, basis of 50% the result would be seriously unfair, which would be a gross miscarriage of the couple's intention to share the value of the pension rights equally.

One final point, after a pension share the wife's pension must start at age 60. The Government Actuary's Department has indicated that there will be no flexibility in this. There will not be the option to take an actuarially reduced pension from an earlier age as there is in many private sector schemes.

How should a pension share work if the pension scheme member is in poor health?

Care is needed because the CETV may not represent a realistic value of the pension rights.

Where the husband is in poor health the true value of his pension rights are less than for someone of his age in normal health. Pension schemes are entitled to reflect this in their CETVs but in most cases they do not. Since pension shares must be based on the CETV the 50/50 split may not be fair.

To take an example of a man in poor health who is already drawing his pension. The CETV is £250,000; it makes no allowance for the husband's poor health. A realistic value of his pension rights, based on an assessment by an experienced underwriter, is £200,000.

If the couple agree that the pension is to be shared 50/50 the adjustment process is as indicated in the table (The adjustment process (ii) – see below).

The pension scheme will then use 40% of the CETV (ie 40% of £250,000 = £100,000) to provide a pension for the wife.

How does a pension share work in combination with offsetting?

The value of pension rights is enormous in the UK. The total funded amounts are well over £1,000bn which, together with the public sector pensions, means that the average family has about £100,000 in pension rights.

Consequently, pension rights are now often the most valuable asset in a marriage. Pension schemes have now been in existence for many years and over this time the value of pension rights increases have in many cases overtaken the value of the equity in the family home. Moreover, the value of the pension rights often exceeds the total of all the other assets in the marriage. In these circumstances even if the wife, assuming that it is the husband with the pension rights, has all the other assets the division is still not fair.

One way of dealing with this is to first offset the value of part of the pension rights against other assets and then share the balance of the pension rights. In doing so to achieve fairness, tax needs to be considered:

- the offsetting calculation must take tax into account and be on prudent investor assumptions; and
- the sharing calculations do not need to.

First the total assets in the marriage must be divided.

Although pension rights do not have a market value like houses, cars, shares, and so on, they certainly have a replacement value. What this means is that if the couple were to remain married the wife would enjoy support from her husband's pension, net, of course, of his tax. If they divorce she can be given such a sum of money that replaces this benefit. Of course this sum would be outside a pension scheme, but she can if she wishes buy a pension with it.

The correct tax treatment in valuing his pension rights is to allow for three tax effects:

(1) his pension will be fully taxable;

(2) if she chooses to buy a pension she will be only partly taxable on it; and

(3) during the period between divorce and her retirement she must save the sum she has been given and the investment return on this sum will be taxable.

There is also an important investment point. She will be in the position of a 'prudent investor'. She will not wish to risk her sum – which should provide her pension – by investing in equities. A more reasonable attitude for her to take is to invest in index-linked gilts; she then is protected against inflation and has a guaranteed return. This is the underlying rationale in *Wells v Wells* [1998]. *Wells* was concerned with damages and was decided in the House of Lords. It established that the appropriate rate was the return available on index-linked gilts

The adjustment process (ii)

Realistic value of the pension rights	£200,000
Each party's share	£100,000
The wife's share will need to be expressed as a percentage of the CETV which is	£250,000 / £100,000 / £250,000 = 40%

so that there was no investment risk in assessing the amount of the damages. This is closely analogous to the situation in valuing pensions.

These factors make the CETV unsuitable. This is because the CETV is calculated by the pension scheme actuary who assumes:

- no tax – since pension schemes are virtually tax-free; and
- high investment returns – since pension schemes invest substantially in equities in the hope of achieving better long-term results.

These differences become most important in the larger cases. Consider the following example. A company executive earns £100,000 and is about to retire at age 60 from his firm's private pension scheme. He has worked for the firm throughout his career and will retire with a pension of £50,000, a widow's pension of £44,444 and a tax-free lump sum of £150,000. His wife is three years younger than he is.

The CETV is about £1.24m. Assuming that he is in normal good health for his age, an actuarial valuation of the pension rights, allowing for tax at 40% and investment criteria for a prudent investor, is about £870,000.

Suppose the equity in the house and all the other assets in the marriage amounts to £450,000. He needs £50,000 to provide a car and a deposit on a house. He is keen to keep as much of his pension as possible, in the light of *White* and *Cowan* the couple agree that equality is appropriate and therefore the division is as represented in the table above (The division (1)).

The Regulations deriving from the Welfare Reform and Pensions Act 1999 say that the pension share must be based on the CETV.

The division (1)

	Husband £	Wife £	Total £
Division of non-pension assets	50,000	400,000	450,000
Division of pension rights	610,000	260,000	870,000
Total	660,000	660,000	1,320,000
Pension share expressed as a percentage	610,000 / 870,000 = 70%	260,000 / 870,000 = 30%	= 100%

The replacement value approach is not now relevant because the value of the pension rights is not being compared with non-pension assets. Now both husband and wife:

> **'If the CETV is not a fair value – can a more reasonable value be used in a pension share? No. So how can you get a fair result? By adjusting the percentage share in the order.'**

- are in a tax-privileged pension scheme – so an allowance for tax is unnecessary;
- will be taxable on the full amount of their pensions (his tax rate may be higher than hers but in this context that is normal, unless there was an agreement to equalise their net incomes); and
- are in an equity-investment orientated pension scheme – so prudent investor criteria do not apply.

Hence the pension sharing order should be based on the CETV and on husband 70%, wife 30%.

The vital importance of this can be demonstrated by following through what the result would have been if an independent value had not been sought and the CETV used. The table (The division (1) see above) would become as the following table (The division (2) see below).

Consequently the order would be based on husband 64%, wife 36%.

The division (2)

	Husband £	Wife £	Total £
Division of non-pension assets	50,000	400,000	450,000
Division of pension rights	795,000	445,000	1,240,000
Total	845,000	845,000	1,690,000
Pension share expressed as a percentage	795,000 / 1,240,000 = 64%	445,000 / 1,240,000 = 36%	= 100%

Conclusion

The questions in this article are only some of the issues that arise with pensions on divorce; space, and probably the reader's stamina, precludes dealing with more.

Pension rights are both important and complicated. There are plenty of pitfalls for the advising solicitor and it is not reasonable to expect the solicitor to be aware of all these potential traps. Independent advice can often pay for itself many times over.

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Case reference
Wells v Wells
[1998] UKHL 27