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Pensions: Freedom to Share

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1. This paper considers issues relevant to matrimonial proceedings arising from the changes in pension legislation that came into effect on 6 April 2015 as a result of the Taxation of Pensions Act 2014. These are known colloquially as the Freedom of Pension Rules. They have been described as the most radical changes to private pensions for a generation.

Summary of the new rules

2. The new rules are designed to give individuals greater access than they enjoyed previously to funds held in private pensions.

3. The rules apply to defined contribution pension schemes. They do not apply to final salary schemes or state pensions.

4. Under the rules an individual can, from the age of 55, withdraw the entirety of his or her pension pot and convert it into a cash lump sum.

5. The first 25% will be tax free (a continuation of the previous rules which enabled a 25% tax free lump sum to be taken). The remaining 75% will be taxed at the individual's marginal rate.

6. There is no obligation to withdraw the entirety of the fund at once, and generally it will be inadvisable to do so from a tax perspective. If a high earner taxed at 45% were to draw the entirety of a £1m pension fund as cash, he would be left with £662,500 (£250,000 tax free + £750,000 taxed at 45%). It might make more sense to wait until his retirement and draw smaller amounts annually so as to take full account of tax allowances and lower tax bands.

7. Pension holders retain the option to purchase an annuity or alternatively may draw their pension income by drawdown.

8. An annuity provides a guaranteed income for life (which may be index linked) and comes to an end on the person's death whenever that occurs. It is attractive to those for who want to prioritise security of income over other considerations. However annuity rates are now at an historic low and annuities provide a relatively poor rate of return compared with alternative products.

9. A drawdown scheme involves investing the fund and withdrawing from it annually. The rate of drawdown can be varied. The major advantage of drawdown as that if a person's actual life turns out to be equal to their life expectancy (or even if it exceeds it by a small number of years) they can expect to enjoy a significantly higher income through drawdown than they could using an annuity. If they die early the fund remains intact and can be passed on as an inheritance. In many cases provided the Lifetime Allowance has not been exceeded and depending upon the age of the pension holder at death, the remaining fund can be passed on free from IHT.

10. The main disadvantage of drawdown is that a person may live significantly beyond their life expectancy in which case the fund may run out. Another risk is that the markets in which the fund is invested may perform badly and this may result in the fund being used up sooner than anticipated.

11. Whether to purchase an annuity or opt for drawdown is ultimately a matter of individual choice, a choice that should be made after consulting an IFA. It is noteworthy that most IFAs advise homeowners to opt for drawdown over an annuity as the home itself provides a form of security in the event that funds drawn down run out.

12. For the majority of home-owning clients drawdown will be the more financially sensible option, especially if they aspire to leave funds to dependants upon their death. Those of a risk-averse nature (or who hold a sentimental attachment to their home and do not wish to put it at any risk) may choose to purchase an annuity instead. In the context of matrimonial proceedings the court may need consider whether it is fair that one spouse's desire to be completely risk-averse should have adverse financial consequences for the other spouse.

Impact of the new rules on 'Sharing' case

13. Before the pension freedom rules came into effect, the courts recognised that there was a fundamental difference between liquid assets which were readily convertible into cash and pensions which were not. The difference was most acute in the case of pensions in payment which were no more than a guaranteed income stream.

14. The difference between pensions funds and cash was acknowledged by the Court of Appeal in *Cowan v Cowan* [2002] Fam 97 where Thorpe LJ said at para 69:

> 'the special characteristics of the pension funds held by the husband and the wife respectively require recognition. The husband's fund is all vested and is no more and no less than a whole life fixed rate income stream. The fact that it would costs £1.19m to purchase an identical income stream allows a capitalisation for comparative purposes. But it is not truly comparable with a cash fund of £1.19m for the obvious reason that the latter is replete with options as to deployment, investment, and spending, as well as having the capacity to survive intact the owner's demise.'

15. In *Maskell v Maskell* [2003] 1 FLR 1138 the Court of Appeal allowed an appeal in a case where the Judge below had, in a passage of his judgment, equated the value of a pension to that of other liquid assets. Thorpe LJ said at para 6:

> 'That passage seems to be fundamentally flawed, for the judge is making the seemingly somewhat elementary mistake of confusing present capital with a 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. He simply failed to compare like with like.'

16. In *Martin-Dye v Martin-Dye* [2006] 2 FLR 901 the Court of Appeal allowed an appeal against an order by which the husband had been allocated 43% of the assets, a substantial part of which comprised the CEB value of an occupational pension in payment; in contrast the wife's 57% was comprised almost entirely of liquid assets. Thorpe LJ said at paras 61–62:

> 'Inevitably different methods of valuation have to be employed for deferred pensions, which include a limited right to draw down in cash, and pensions in payment which are no more than whole life incomes streams akin to annuities. Mr Francis cites the cases of Cowan [and] Maskell which underline the special characteristics of pension funds. In the present appeal we are not dealing with deferred pensions and CETV. Our focus is upon pensions in payment and cash equivalent benefits. They are to be characterised as 'other financial resources' within the s 25(2)(a) classification. For they do not sit comfortably in the category of 'property', since they are unrealisable and non-transferable. Nor do they sit comfortably in the category of 'income' because, although purely an income stream, the income does not derive from future endeavour but from past employment or contribution which will generally have been effected during the years of marriage.
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> This case provides a useful example of this analysis. The 'property' consists of the houses and the investments. The 'income' is the receipts anticipated from the parties continuing endeavours, the wife in her livery business and the husband in his fitted kitchen business. The 'other financial resources' are their respective pensions in payment.'

17. As these cases illustrate, before the rules came into effect pension pots were widely seen as inferior assets to cash or property or other liquid funds readily convertible into cash. Absent special circumstances, it was very unusual for the outcome of a case to be that one party would be left predominantly with the liquid assets and the other mainly with pensions. Such an outcome would generally be vulnerable to an appeal.

18. The new freedom rules mean that there may no longer be such a disparity between how pensions and liquid assets are viewed in the context of matrimonial sharing, especially in cases where one or both of the parties are over the age of 55 or approaching that age:

    (a) It is much easier to assess the value of a pension in cash terms to a particular individual. The pension will generally be worth somewhere between the entirety of the untaxed value of the fund and its net value after tax if the whole fund were to be immediately drawn.

    (b) It may no longer be regarded as unfair by the courts to leave, say, the entirety of a property in the hands of a wife while compensating the husband by leaving his pension funds intact. Such an outcome may indeed be beneficial to both parties by avoiding the costs involved in pension sharing or in forcing the immediate sale of a property. That is not to say that such outcomes will be the new normal; merely that the freedom rules offer a greater ability to find unconventional solutions which fit the particular circumstances of the case.

    (c) There may even be cases where one party may prefer to retain the pension intact rather than trade a share for some of the liquid assets in order to take advantage of the IHT benefits that such funds can offer.

19. How to offset the value of a final salary or 'defined benefit' pension remains a complicated issue. In *WS v WS* [2015] EWHC 3941 (Fam) HHJ Lord Meston QC considered competing submissions as to how a husband should be compensated for the fact that the wife had the benefit of a final salary pension which provided her with a guaranteed income for life. He rejected the suggestion that the husband should be provided with a compensatory sum based upon annuity calculations and adopted a methodology based upon *Duxbury* which produced a much smaller resulting sum.

Equality of income or an equal division of the fund?

20. Under the old pension rules, it became conventional in matrimonial cases to instruct a pensions actuary to undertake a calculation as to the pension share required for the spouses to achieve equality of income in retirement at a specified age (typically either 60 or 65). The outcome of the calculation was usually that an unequal split of the fund was required in order to achieve equality of income.

21. The justification for dividing pension funds so as to provide equality of income at a future date (as opposed to simply dividing the fund equally) was that the fund represented no more than a future income stream. That being so it was potentially unfair to divided it in a manner which resulted in one party receiving in retirement a greater share of income than the other party.

22. With the new freedom rules this conventional approach is now harder to justify. A pension fund need not be converted into an annuity and offers considerably greater financial flexibility. Why, therefore, should such funds be treated differently from other assets (which – absent need – do not get shared unequally to reflect a difference in age between the parties)? If actuaries are asked to prepare an income equality report it may well be more realistic for such a report to assume that the parties will use drawdown rather than purchasing annuities.

23. In *SJ v RA* [2014] EWHC 4054 (Fam) Nicholas Francis QC (as he then was) sitting as a Deputy High Court Judge in *SJ v RA* [2014] EWHC 4054 (Fam) rejected a submission that pension funds should be divided unequally to provide equality of income saying at para 84:

> "I would regard such an approach as unfair and anachronistic in a case where assets exceed the parties' needs. The recent well-publicised changes to pension regulations will mean that pension investments are virtually to be treated as bank accounts to people over 55, as these parties are…. In cases where distribution is being made on a basis which is not guided by need it is, in my judgment, incorrect to distribute a pension fund on the basis of equality of income and there is no need for actuarial reports in the overwhelming majority of such cases. I should expect the court is to be most reluctant in the future, in big money cases, to provide permission for actuarial reports on the basis of how to effect equality of income. Moreover I suspect that annuities will, in the overwhelming majority of cases, become a thing of the past."

Need cases and capitalisation of periodical payments

24. In needs cases it is well established that, where it is appropriate to provide a former spouse with an income for life and sufficient funds exist to capitalise the income, this will almost invariably be achieved by an application of the *Duxbury* formula. *Duxbury* assumes that a capital sum invested will – over the long term – achieve certain rates of return and that the recipient of the fund will live until the precise date of his or her life expectancy.

25. 25. The *Duxbury* formula is used by the courts both in cases where the capitalisation takes place at the time of the original hearing and in those where the capitalisation sum falls to be calculated on a variation application. In the latter category of cases the courts have emphasised that there is a very limited or 'narrow' discretion to depart from the *Duxbury methodology: Pearce v Pearce* [2003] 2 FLR 1144; *Vaughan v Vaughan* [2010] 2 FLR 242.

26. Before the new freedom rules, it was obvious that a pension fund could not be treated as a capital sum capable of reducing the Duxbury sum required to be paid. Rather the courts could do no more than take account of the income which the pension would in due course produce by way of annuity. Such income did have a material impact upon the Duxbury figure produced, but to a less significant extent than if the entirety of the fund had been treated as capital for the purposes of the calculation.

27. In *Pearce v Pearce* the Court of Appeal suggested that there may be cases in which maintenance should be capitalised by pension share rather through *Duxbury*. Thorpe LJ said (obiter dicta) at para 15:

> 'Accordingly, in my judgment, in any case in which the court can exercise jurisdiction under s 31(7B)(ba) [pension sharing], it should endeavour to conclude the issue by so doing, only considering capital orders, whether alternatively or additionally, where the circumstances would not permit the court to achieve a fair outcome by substituting a pension sharing order for the periodical payments order. Of course I recognise that it is likely to be many years before the typical case invoking the court's jurisdiction under s 31(7B) has cleared the restriction imposed by s 85(3)(b). That is regrettable. In this outpost of the ancillary relief territory the task of the practitioners and the judges would be much eased by the option of providing for the former wife a personal pension carved out of the former husband's pension portfolio.'

The same point was made at the conclusion of the judgment.

28. *Pearce* itself was not a pension-sharing case and the judgment contains no explanation (other than ease for practitioners and judges) why Thorpe LJ came to this conclusion. It may be that he considered that in cases where substantial pension were available it might be unfair to furnish the applicant with a large sum of cash (calculated through *Duxbury*) when the payor of the sum would have fund his retirement through pensions (which lack the flexibility of cash). Thorpe LJ did not consider that capitalisation should be by pension annuity might be inconsistent with *Duxbury*. This part of the judgment in *Pearce* was not referred to by Wilson LJ in *Vaughan* when he cited with approval the core principle that capitalisation should be undertaken using *Duxbury*. Hughes and Patten LJJ agreed.

29. If Thorpe LJ was intending to suggest that the court should always explore the option of annuitising maintenance on a like-for-like basis with the payor's pension before resorting to the *Duxbury* formula, that suggestion is untenable following pension freedom rules. Annuity rates are now so low that the size of fund required to produce an annuity of a certain size is far higher than the equivalent *Duxbury* figure. Although the idea of dealing with capitalisation on a like-for-like may appear to be fair, appearances can be deceptive. If, for example, the husband has the benefit of a final salary scheme which provides a widow's pension after his death it would not be fair for him to fund the acquisition of a similar pension by the wife (and thus potentially fund the retirement of the wife's new partner after her death).

30. 30. In *JL v SL (No 2) (Appeal: Non-Matrimonial Property)* [2015] 2 FLR 1202 Mostyn J undertook a calculation as to the *Duxbury* fund needed to capitalise the wife's income needs going forward. He then held that the wife's pension share could be treated as part of the capital fund needed to arrive at the *Duxbury* sum. He rejected in strong terms the wife's alternative calculation based upon her drawing an annuity from her pensions. In *JL v SL (No 3) (Post-Judgment Amplification)* [2015] 2 FLR 1220 he explained:

> 'In my principal judgment I used the Duxbury algorithm to calculate the wife's needs for the three phases I identified. I started with Phase 3 (see para [58]). The figure calculated was £1,191,357. I found that part of this fund would be met by the wife's pension share of £650,000. That was a perfectly reasonable assumption to make given the greatly increased flexibility afforded to the holders of pension funds by the Taxation of Pensions Act 2014, which received royal assent on 17 December 2014. It probably would have been a reasonable assumption even had the reform not been enacted. I heard no argument to the contrary at the hearing. It would have been unreal to take some annuity figure calculated by a pension expert for the trial before District Judge Reid in October 2013 well before the pension reforms were announced in July 2014.

31. Mostyn J's judgment in *JL (No 3)* also contains a useful justification for the assumptions used in *Duxbury* (which differ from the equivalent assumptions used by IFAs when asked to advise upon capital needed to provide income in retirement):

> [13] It is important to remember that a Duxbury fund is usually calculated over a long period. In this case from the start of Phase 1 to the end of Phase 3 over 30 years are covered. Generally speaking in most human fields the best prophet of the future is the past. The key assumption is that over a longish period it can be reasonably predicted that a fund will perform in actual gross terms by 6.75% annually (ie 3% income yield plus 3.75% capital growth) but the owner of the fund will suffer inflation of 3% thus giving a real rate of return of 3.75%. The key datum is however the predicted actual gross performance of 6.75%. Is that a reasonable guess?
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> [14] Between January 1985 and January 2015 the FTSE 100 Index rose from 1,277 to 6,810. This corresponds to capital growth in that 30-year period of 5.74% annually. Over the same period the broader based FTSE 250 has grown by almost 8.8%, while a portfolio based on the US Dow Jones Industrial Index (after allowing for the variance in the exchange rate) over the same period would have grown by over 6.9%. Thus it can be seen that the rate of capital return assumed in the Duxbury algorithm of just 3.75% is somewhat cautious, recognising that the recipient of an award is unlikely to be advised to invest the whole of her fund in equities, and that other kinds of investment are likely to achieve lower capital returns. Dividends (ie income yield) would also have been paid, perhaps at 3% a year. An alternative perspective is to look at P/E ratios over a long period. From 1990 to 2014 they have averaged for the UK 12.6, which translates to annual growth of 7.9%. So on the basis of history 6.75% pa is a very reasonable guess.
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> [15] Over the same period the Retail Price Index has moved from 91.2 to 255.4. This corresponds to inflation of 3.49% annually. Again, 3% is a reasonable guess, even if there is actually no inflation right now.

This explanation was given by way of riposte to the note of caution sounded by Ryder LJ in the Court of Appeal about Duxbury in *H v H (Financial Remedies)* [2015] 2 FLR 447, when he emphasised that there was no 'industry standard' in matrimonial cases and that it was thus open to parties to contend for a different methodology on a capitalisation. Duxbury was the method selected for calculating the sum needed to compensate the husband for the wife's final salary pension in *WS* (above).

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