Hee-haw. Divorce and Pensions

Jim Connolly provides this informative guide on dealing with Pensions in a Divorce situation.

Jim Connolly is Head of Pensions and Technical Services at Goodbody Stockbrokers. He is a Pensioneer Trustee and lectures in Retirement Planning for UCD. He is a well-known commentator on pensions matters and was voted Pensions Personality of the Year for 2015/16.

If the law is an ass, then the branch of law with the biggest ass must be Schedule 23B of the Taxes Acts – the bit that deals with pensions and divorce.

Most people seeking a divorce are looking for a little closure - a permanent parting of ways, a decisive pulling of the plug, a Palthrow'esque conscious uncoupling, a goodbye and good riddance type of closure.

Unfortunately, thanks to Schedule 23B, any of your clients who have negotiated a share of their Ex's pension as part of the deal are indelibly linked to their former spouse until that former spouse retires. And to make it worse, this legislative gem means that you won't know if you have any Chargeable Excess Tax[1] to pay until your Ex retires. And to cap off the misery, the power rests with your Ex in determining if, how and when this tax bill might arise. The more affluent your client, the more pressing this issue really is.

Don't adjust your set, the following tax treatment is actually the way it is.

The Basics

The initial legal framework dealt with the distribution of pension assets in divorce quite effectively. The original legislation allowed pension benefits to be divided between the Member Spouse who owned the benefit and their Non-Member Spouse through a Pension Adjustment Order (PAO). This instrument apportions the pension according to a relevant percentage of the benefits accrued during the period of the marriage.

Once a PAO has been awarded it is the recipient of the order who controls what happens next. They can;

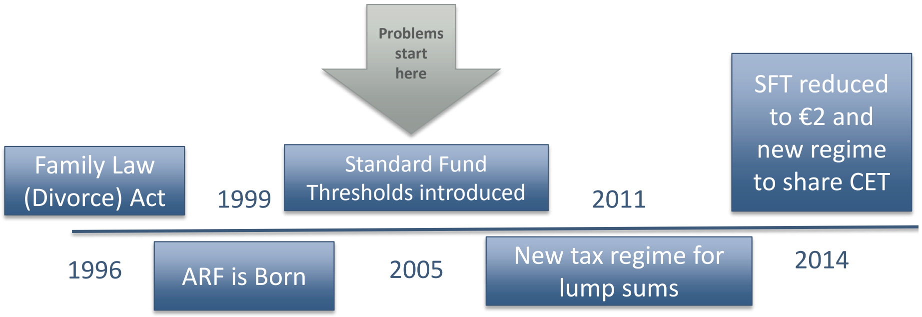
a. simply leave the benefit where it is and when their Ex retires or dies they will receive their share, OR
b. they can carve out the benefit and move it to a product in their own name.

As a pension provider and trustee, it is abundantly clear to me when a PAO client has taken advice and when they haven't. It's difficult to give broad brush advice but generally if the PAO relates to a defined contribution arrangement, the best thing to do is to carve the benefit out – take the money and run. Leaving it where it is simply leaves it within the control of an Ex where they decide how it is invested and control when the benefit is made available.

Square peg, round hole

Since 1996 the Family law positon hasn't really changed. Unfortunately, pensions legislation has – and it has changed hugely. We've new products, new thresholds, new taxes, new lump sum rules to deal with and none of these legislative measures took any material account of how they interact with family law. Real square peg, round hole territory.

What changed?



1 Chargeable Excess Tax is levied on pension funds that exceed the €2m threshold and is charged at a rate of 40%

▶ Continued on Page 18

▶ Continued from Page 17

The story starts to get complicated in 1999 with the birth of the Approved Retirement Fund (ARF). The ARF didn't really impact on the whole divorce arena other than to add a bit of confusion as to whether it fell within the definition of a pension under S2(1) of the Family Law Act. And the answer to that issue is that it doesn't and as such a Property Adjustment Order is a more appropriate instrument to capture ARF assets.

The unintended consequence of the ARF was that it created a mechanism to extract funds from a company, pocket 25% tax free and park the balance in a gross roll-up investment. Between 1999 and 2005 there was a serious amount of exploitation of the regime and some very substantial ARFs were created (the largest know to the author being €100m).

Revenue curtailed this activity in 2005 by introducing the concept of pension fund thresholds. Now if your fund delivered over €5m you would suffer chargeable excess tax (CET). Brilliant, problem solved.

Well sort of, because as one problematic door slammed shut, another flew open. Our new CET regime didn't thoroughly provide for how one should deal with divorce situations. The issue didn't get much billing (or sympathy) for the few high rollers that would have been affected by a €5m threshold but in 2010 and again in 2014 the SFT was reduced and now stands at €2m – a level that brings a far higher percentage of the population into the equation.

The way it was

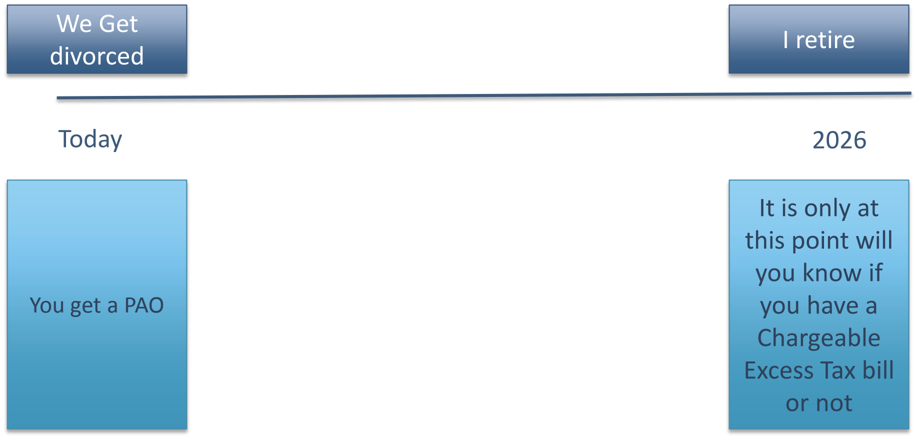
Up until 31st December 2014, all chargeable excess tax fell on the member spouse.

So, in simple terms say I have a pension fund of €2m today, we get divorced, you get half and you take the money into your own product and run. When I eventually retire, a calculation must be carried out to 'guess' what the value of my fund would have been had you not taken your half. Say this calculation results in me having a total notional pension fund of €3m. I would then incur CET of 40% of the €1m excess. Ouch.

The way it is now

In an attempt to address this inequity Finance Act 2014 introduced a regime that seems nothing short of bizarre.

Consider the same situation. Assume I'm 51.



We split up today (in 2016) and you take €1m into product in your own name. Say I am age 50 which allows you to actually retire the portion of the fund you have taken. So you sail off into the sunset with a lump sum and an ARF.

In 2026 when I retire at age 60 the administrators of my pension must carry out a calculation to establish what the value of my fund might have been had you not taken half of it 9 years earlier. So, let's say, it works out at the same €3m above.

Now a second calculation is carried out to establish how much of this you owe. And because you got €1m of my €3m notional fund, you are now the proud owner of 1/3 of the tax bill.

No, I'm not joking. A full 9 years after we spilt you get presented with a whopping tax bill of €133,333 (being 1/3 x 40% x €1m).

And all of the measures are in place for this to be deducted straight from your ARF.

Maybe its just me but this seems to be grossly unfair on the Non-Member Spouse as we are essentially saying – here's a PAO, but don't go spending it all at once because you might have a tax bill of an unknown amount payable at an unknown date in the future and its your Ex that will determine this because it's the future value of their fund that matters.

Anomalies

The interesting thing about this new regime is that the test is only carried out when I trigger my half of the benefit.

If I had given you 100% then nothing would happen as I can never trigger part of it.

This presents an anomaly. Instead of me giving you half of my fund, I could split my fund into two separate contracts first and then give you 100% of one of them. In this case, the entire issue is avoided.

The solution

The solution is to convince the Policy and Legislation division of the Department of Finance to recognise that PAOs and Standard Fund Thresholds have never worked properly and that we need a drawing board to go back to.

This should culminate in the obvious solution of recognizing that each of the parties to a divorce are entitled to their own €2m threshold and should be taxed accordingly – if I give you €1m, then you should be limited to accumulating a further €1m. As it stands today if I give you €1m of my €2m fund you can still accumulate another €2m and I have no scope to make any further contributions – nuts.

In the meantime, if you have clients that have already given away some for their pension or will be seeking a PAO they need to take advice, particularly if they are likely to breach the threshold. Obviously, they should talk to someone with a Goodbody first!