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Draft Taxation Laws Amendment Bill, 2011

The draft Taxation Laws Amendment Bill was released for comment on 2 June 2011 and gives effect to certain matters presented by the Minister of Finance in the Budget Review 2011. Members of the public could submit comments on the draft legislation to National Treasury by 5 July 2011. It is important to note that this is only a Bill at this stage and not yet finalised. The proposed changes will only become law once it is promulgated.

The changes to the Income Tax Act, 1962 ("the Act") relevant to Momentum Employee Benefits are discussed below.

1. Section 1 – paragraph (m) of the definition of "gross income" read together with the changes to sections 10(1)(*g*G) and 10(1)(*g*H): effective date 01 January 2012

Paragraph (m) of the definition of "gross income" specifies which amounts received in respect of long-term insurance policies should be included in the gross income of a taxpayer. Paragraph (m)(v) specifically excludes any proceeds from an approved policy (where the benefit is provided by the fund) from taxation in terms of paragraph (m) as these proceeds are taxed in terms of paragraph (*e*) of gross income according to the retirement tax lump sum formula.

With regards to unapproved (selfstanding) insurance policies, the proposal is to now include all amounts received in terms of a long-term insurance policy as gross income. Certain exemptions may apply dependent on whether the premiums were paid from after-tax or pre-tax money.

(i) If premiums were paid from after tax money, the policy proceeds will be tax-free; or
(ii) If premiums were paid from pre-tax money, then the policy proceeds will be taxable.

These exemptions are provided by the newly inserted paragraphs (*g*G) and (*g*H) in section 10(1) of the Act.

If the *policyholder* receives the insurance proceeds, then the proceeds will be tax exempt unless one or more premiums were deductible by the policyholder. If one or more premiums were deductible a tax exemption may still exist but only to the amount of the non-deductible premiums that were paid.

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If a *beneficiary* other than the policyholder receives the proceeds, then the proceeds will only be tax-exempt if all the premiums did not rank for deduction by the policyholder. There is an exception to this rule: policy proceeds may be fully tax exempt even if the premiums ranked for deduction provided that the pre-tax contributions are matched by a corresponding taxable inclusion as a fringe benefit for the beneficiary.

The application of the above can be demonstrated by the following examples:

Unapproved Group Life policy

An employer will receive a deduction for the premiums contributed. However the employee will be deemed to receive matching fringe benefit income in respect of the premiums and the proceeds will be tax free.

Group Income Protection policy

The employer deducts the premiums and the employee initially has matching fringe benefit income. However the employee gets a simultaneous deduction for the premiums under section 11(*a*) which neutralises the tax as a fringe benefit and the policy proceeds will be taxable when paid to the employee.

3. Section 1 – deletion of the definition of "living annuity": effective date 01 March 2012

The definition of "living annuity" is deleted. It is being replaced by the definition of a "retirement income drawdown account".

4. Section 1 – substitution in the definition of "pension fund" for subparagraph *(bb)* of paragraph (ii) of the proviso to paragraph *(c):* effective date 01 March 2012

This subparagraph provides that membership of the fund throughout the period of employment shall be a condition of employment in respect of an employee who starts employment on or after the fund comes into operation. In subparagraph *(bb)* (ii) "the employer becomes a participant in that fund;" has been added to clarify that in the case of an umbrella fund, membership of the fund shall be a condition of employment where an employee is employed by the employer on or after the date on which the employer becomes a participating employer in an umbrella fund.

5. Section 1 – changes to the definition of "pension preservation fund": effective date 01 March 2012

The Bill proposes the following changes to this definition:

- Correct the reference to the Pension Funds Act and not Pension<u>s</u> Funds Act.
- Paragraph *(a)*(ii) of the proviso: allow for former members from a provident fund or provident preservation fund to transfer to a pension preservation fund in the event of a winding up or partial winding up or in respect of past service. Unfortunately there is no corresponding change to the Second Schedule to the Income Tax Act to confirm that this will be a tax-free transfer.
- Paragraph *(a)*(iii) of the proviso: specifically refers to the transfer of an "unclaimed benefit".
- Paragraph *(b)* of the proviso: allow for the partial transfer of a retrenchment lump sum.

The effect of the last proposed change is that a member will be able to take a portion of his retrenchment benefit in a pension fund in cash and transfer the balance to a pension preservation fund.

6. Section 1 – changes to the definition of “provident preservation fund”: effective date 01 March 2012

The Bill proposes the following changes to the proviso to this definition:

- Paragraph *(a)*(iii): specifically refers to the transfer of an “unclaimed benefit”.

- Paragraph *(b):* allow for the partial transfer of a retrenchment lump sum.

The effect of the last proposed change is that a member will be able to take a portion of his retrenchment benefit in a provident fund in cash and transfer the balance to a provident preservation fund.

7. Section 1 – inserting a definition of “retirement income drawdown account”: effective date 01 March 2012

According to National Treasury’s explanatory memorandum, the retirement income drawdown account (‘RIDDA”) will replace the current living annuity product. Living annuities are currently only offered by providers who are registered in terms of the Long-term Insurance Act and retirement funds, but a RIDDA will be provided by other specified entities if this proposal becomes law. The main reason for the change is to increase the competition in the market to improve product choice and reduce fees associated with the product.

The minimum drawdown of 2.5% will be removed but the maximum of 17.5% will remain. This implies that in any particular year an investor into a RIDDA can elect to receive no income.

Further, currently when a recipient dies, the remaining savings may be withdrawn by the nominee as a lump sum or continued as an annuity. The law will be clarified to allow for a combination of the two.

The following sections in the Act have been amended to include the new definition of RIDDA:

- Section 1 – definition of “gross income” at paragraph (a)(ii) and paragraph (eA)(i) and (ii);
- Section 1 – definition of “pension fund” at paragraph (i) of the proviso to paragraph *(c)*, subparagraph *(dd)* of paragraph (ii) of the proviso to paragraph *(c)*;
- Section 1 – definition of “pension preservation fund” at paragraph *(e);*
- Section 1 – definition of “retirement annuity fund” at paragraphs *(a)* and *(b)* of the proviso;
- Section 1 – definition of “retirement date”;
- Section 7A - substitution in subsection (1) for the definition of “pension”;
- Section 10 – substitution in subsection (2) for paragraph *(b)*;
- Section 10A – substitution in the definition of “annuity contract”;
- Section 29A – substitution in subsection (4)*(a)* for subparagraph (iii);
- Paragraph 1 of the Second Schedule – substitution in paragraphs *(a)* and *(b)* of the definition of “lump sum benefit” and by the substitution for the definition of “retire”;
- Paragraph 2 of the Second Schedule – substitution in subparagraph (1)*(a)* for item (iii);
- Paragraph 3 of the Second Schedule – substitution for paragraphs (ii) and (iii);
- Paragraph 3A of the Second Schedule – substitution for paragraphs (ii) and (iii);
- Paragraph 11B of the Fourth Schedule – substitution in subparagraph (1) of paragraph *(f)* of the definition of “net remuneration”.

8. Section 1 – change to the definition of “severance benefit”: effective date 01 April 2012

The words “share capital” have been replaced by the word “shares”.

9. Section 1 – new definition of "share" inserted: effective date 01 April 2012

This has been inserted to correspond with the use of the word "shares" in the definition of "severance benefit".

10. Section 9 – substitution of section 9 to provide for "Source of income": effective date 01 March 2012

South African residents are taxed on their world-wide income with foreign sourced income qualifying for tax rebates while non-residents are only taxed on income derived from sources within SA or deemed to be within SA. The Act currently does not comprehensively define the term "source".

South African sources will now be fully defined and the concept of a "deemed source" will be eliminated. Items not included in this definition will be treated as foreign source income. Foreign residents will be subject to SA tax only in respect of SA source income.

Treatment of related annuities and pensions

This will follow the same principles as the source determination for service income, that is the source for these annuities and pension payments will be based on the source of the underlying services generating these payments.

If the service related to these annuities and pension payments is rendered within SA, the annuities and pensions will be seen as SA sources and will accordingly be taxed in SA. If services are rendered in SA and outside of SA the allocation will be based on the time spent in SA and the other country.

11. Section 11- substitution in paragraph *(w)*(ii) of item *(dd)* – Deduction of premiums payable in respect of a long-term insurance policy: effective 01 January 2012

This amendment deals mostly with the impact of a conforming or non-conforming policy on key person plans which are taken out by the employer to protect against any lost profits due to the loss of the key person. The deductibility of the premiums depends on whether the policy is conforming (has to comply with certain statutory requirements) or non-conforming. For a conforming policy, the premiums are deductible upfront and the proceeds are taxable, while the premiums for non-conforming policies are not deductible and the proceeds are normally viewed as tax-free.

It was assumed that employers preferred the upfront deduction of the premiums but practice has shown that most employers would rather receive the tax-free proceeds.

Therefore all key person plans entered into from 1 January 2012 will have to *opt* for a conforming policy if they wish to have the upfront deduction of the premiums. This must be done by expressly stating that section 11(*w)*(*ii*) must apply to the policy agreement. This statement must be made in the policy agreement. If the employer does not exercise an option, the policy will automatically be a non-conforming policy. The once off choice cannot be changed at a later stage.

For all key person policies existing prior to 01 January 2012, the employer must add an addendum to the policy which states that section 11(*w*)(*ii*) must apply. Again this is a once off choice and must be expressed by 30 June 2012. If no addendum is added to the policy, the policy will be viewed as a non-conforming policy.

12. Section 23 – substitution in paragraph *(m)*(iii) for the words preceding item *(aa)* – Deductions not allowed in the determination of taxable income: effective 01 January 2011

Section 23 sets out those deductions which are not allowed in the determination of taxable income. Section 23(*m*) does however list certain amounts in respect of which a deduction will be allowed.

In respect of contributions to a group income protection policy, the employer deducts the premiums and the employee initially has matching fringe benefit income. However the employee obtains a simultaneous deduction under section 11(*a*) for the premiums which neutralises the tax as a fringe benefit.

The addition of the words "*any contribution or payment made by the employer*" makes provision for this simultaneous deduction by the employee.

13. Paragraph 2C of the Second Schedule

There is a change to correctly refer to the Pension Funds Act and not the Pension*s* Funds Act.

14. Paragraph 4 of the Second Schedule – substitution in subparagraph (1) – date of accrual of a lump sum benefit to a member: effective date 01 March 2012

This paragraph is made subject to paragraphs 3 and 3A of the Second Schedule that deals with the death of a member or past member and the death of any other person respectively.

15. Paragraph 6 of the Second Schedule – substitution in subparagraphs (1)*(a)*(i) and (ii): effective date 01 March 2012

To make provision for the transfer from a preservation fund to a retirement annuity fund.

16. Paragraph 2 of the Seventh Schedule – by the addition of subparagraph *(k)* – Taxable Benefits: effective 01 January 2011

The addition of subparagraph *(k)* makes provision for an employee to pay fringe benefit tax in respect of insurance benefits arranged by the employer for the benefit of the employee or a beneficiary of the employee.

17. Paragraph 55 of the Eighth Schedule – capital gains tax: effective date 01 January 2012

It is proposed that all insurance policies be excluded from the application of capital gains tax including second hand policies.

18. Section 2 of the Value-Added Tax Act , 1991 – changes to the definition of "superannuation scheme": effective date 01 January 2012

Makes provision for the payment of benefits from a preservation fund.

19. Appendix 1 – Rates of normal tax and rebates

In determining the tax payable by a member upon withdrawal or retirement from a fund, the following benefit payments must be taken into account:

(i) Any lump sum withdrawal benefits received or accrued on or after 01 March 2009;
(ii) Any retirement fund lump sums received or accrued on or after 01 October 2007; and
(iii) Any severance benefits received or accrued on or after 01 March 2011.

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