

Legal update

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Non-taxable retirement fund benefits

We often get questions relating to the interpretation of paragraph 2C of the Second Schedule to the Income Tax Act dealing with benefits that are not subject to tax. This Legal Update sets out to answer these questions.

A. Paragraph 2C of the Second Schedule to the Income Tax Act

Paragraph 2C of the Second Schedule of the Income Tax Act was inserted by section 49(1) of the Revenue Laws Amendment Act No. 8 of 2007 with effect from 1 January 2006. It provides as follows.

2C. Any lump sum benefit, or part thereof, received by or accrued to a person subsequent to the person's retirement or death, or withdrawal or resignation from any pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund or the winding up of any such fund, and in consequence of or following upon an event that is prescribed by the Minister by notice in the Gazette and contemplated by the rules of any such fund or the approval of a scheme in terms of section 15B of the Pension Funds Act, 1956 (Act No. 24 of 1956), or paragraph 5.3 (1) (b) of the Schedule which amends regulation 30 of the Regulations under the Long-Term Insurance Act, 1998 (Act No. 52 of 1998), shall not constitute gross income of that person.

B. The rationale behind paragraph 2C

The reason for paragraph 2C is set out as follows in paragraph 4 – *Extraordinary lump sum payouts* on p. 5-6 of the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2007.

Three types of benefits currently payable represent extraordinary payments to retirement fund members (or former members). Until now, no special provision was made for these payments in the Second Schedule due to their one-off nature. These special payments to former members aim to partially rectify unfair practices of the past. In many instances, these rectifying payments are small because either low-income individuals bore a disproportionate share of the burden or because the amounts at issue were spread over a large number of member interests. The administrative burden and costs to obtain tax directives accordingly outweigh the monetary benefit payable to individual former members.

The first tranche of benefit involved the "Statement of Intent," whereby the Minister of Finance signed an agreement with the long-term insurance industry on 12 December 2005. In terms of this agreement, minimum values should be attributed to retirement fund members (or former members) who discontinued their contributions prematurely. This agreement was formalised in terms of the

Regulations under the Long-term Insurance Act, 1998.

In terms of the second tranche, many retirement funds have surplus accounts. The Pension Funds Second Amendment Act, 2001, prescribes that these surplus amounts must be apportioned in terms of a surplus apportionment scheme. In terms of these schemes, members (or former members) may receive their appropriate portion either in the form of cash or as a credit to their member accounts.

In terms of the third tranche, certain retirement fund administrators have negotiated better interest rates with banks by investing the funds of a number of retirement funds under the umbrella of one investment. The full benefit of these higher rates was not always fed through to retirement funds and some (or all) of the additional benefits were regarded as “profits” for the retirement fund administrator. Some of these “profits” will now be properly re-channelled to former retirement fund members.

C. Requirements for non-taxable benefits as set out in paragraph 2C

Paragraph 2C lists the following requirements for a benefit not to be taxable:

1. It must become payable **after** the member’s termination of membership of the fund.
2. It must relate to
 - a. one of the events prescribed by the Minister of Finance in a Government Gazette and provided for in the rules of the fund;
 - b. section 15B surplus; or
 - c. the “Statement of intent” refunds.

D. The notice in terms of paragraph 2C

The Notice, published in Government Gazette No. 289 on 11 March 2009, prescribed the events referred to in paragraph 2C of the Second Schedule to the Second Schedule of the Income Tax Act as follows:

- (a) *any amount received by or accrued to a person from a pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund in consequence of a payment to such fund by the administrator of such fund as a result of income received by the administrator prior to 1 January 2008 that was not disclosed to such funds;*
- (b) *any amount received by or accrued to a person from a pension fund or provident fund contemplated in paragraph (a) or (b) of the definition of “pension fund” in section 1 of the Income Tax Act, 1962 to the extent that that amount is similar to a payment in terms of a surplus apportionment scheme contemplated in section 15 B of the Pension Funds Act, 1956 (Act No. 24 of 1956);*
- (c) *any amount received by or accrued to a person from a pension preservation fund or provident preservation fund to the extent that it was paid or transferred to such a fund—*
 - (i) *as an unclaimed benefit contemplated in paragraph (c) of the definition of “unclaimed benefit” in section 1 of the Pension Fund Act, 1956 (Act No. 24 of 1956); or*
 - (ii) *as a result of or in consequence of an event contemplated in paragraph (a) of this notice.*

E. Summary of the Notice

The events prescribed in the Notice fall into the following 3 categories:

1. secret profits;
2. amounts payable from a public sector pension fund similar to a section 15B surplus amount*; and
3. a benefit from a preservation fund that was transferred to the preservation fund as –
 - a. an unclaimed surplus benefit; or
 - b. a secret profit.

* The intention behind this was probably to include public sector funds that were not registered under the Pension Funds Act and would accordingly not have been required to do surplus apportionment schemes under section 15B of that Act. There are however public sector funds that are registered under the Pension Funds Act, to which section 15B would apply.

F. Summary of non-taxable benefits

To summarise, lump sum benefits payable to a member who left a retirement fund, payable in consequence of or following the event described below, will not be taxable:

1. secret profits;
2. for non-FSB registered public sector funds: amounts similar to section 15B surplus amounts;
3. preservation fund unclaimed surplus benefits / secret profits;
4. past surplus;
5. statement of intent refunds.

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