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Legal updates

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Taxation Laws Amendment Act No. 15 of 2016 & Tax Administration Laws Amendment Act No. 16 of 2016

A. The **Taxation Laws Amendment Act No. 15 of 2016** was promulgated in Government Gazette No. 40562 on 19 January 2017. The following changes are relevant for the retirement fund industry.

1. Inclusion of benefits transferred from public sector funds to provident funds as gross income

The provident fund alignment changes that were originally planned for 1 March 2016, were postponed to 1 March 2018. As part of these changes, the definition of "pension fund" in section 1 of the Income Tax Act was changed to remove the Government Employees Pension Fund (GEPF) from paragraph (a)(i) and to create a separate paragraph (d) for it. The definition of "provident fund" was changed to create three different types of provident funds:

(a) "true" provident funds, which are funds other than pension funds, pension preservation funds, provident preservation funds, benefit funds or retirement annuity funds;

(b) municipal provident funds; and

(c) municipal entity provident funds.

The provident funds referred to in paragraphs (b) and (c) are the same types of funds referred to in paragraphs (a)(ii) and (iii) of the definition of "pension fund".

This TLAA brought about changes to the gross income definition to include certain amounts that are transferred between retirement funds as gross income – and thereby rendering it taxable.

The amendments in paragraphs (eA)(i), (ii) and (iii) of the definition of "gross income" will include benefits transferred from these funds (in the newly created categories as referred to above), where the rules of those funds forces the member to use at least two thirds of his retirement benefit to buy a pension/annuity+, to a fund whose rules allow the member to take more than one third of his retirement benefit in a lump sum++.

+ Such a fund is referred to as a "public sector fund" in the Second Schedule to the Income Tax Act. The definition of "public sector fund" has also been amended to include the new category (d) pension fund and categories (b) and (c) provident funds.

++ Such a fund is referred to as a "provident fund" in the Second Schedule to the Income Tax Act.

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The effect of these amendments is that in the event of a transfer from a public sector fund to a provident fund, the full benefit will be taxed.

Effective date: 1 March 2018, to coincide with the provident fund alignment.

2. Inclusion of emigration for exchange control purposes in respect of withdrawals from retirement funds

From 1 March 2016, a member of a retirement annuity fund is allowed to withdraw the full fund value from his retirement annuity fund before his retirement date if he ceased to be a tax resident or his South African work visa expired.

Up until now, the criteria to be met for such a withdrawal were limited to the following:

- When the member ceased to be a tax resident; or
- when the member left South Africa at the expiry of the work visa contemplated in the Immigration Act.

There was no requirement that the member must emigrate from South Africa and that the emigration must be recognised by the South African Reserve Bank (SARB) for purposes of exchange control. This created a loophole, allowing a member to withdraw from his retirement annuity without formally emigrating.

This was not National Treasury's intention, and paragraph (b)(x)(dd)(A) of the definition of "retirement annuity fund" in section 1 of the Income Tax Act was amended to include the requirement that a member must emigrate from the Republic and that emigration must be recognised by the SARB for purposes of exchange control if he wants to withdraw his benefit from a retirement annuity fund before his retirement.

Therefore, a member will only be able to withdraw from a retirement annuity, prior to retirement due to:

- Formal emigration that is recognised by the SARB, and
- Where that member's SA visa has expired.

Effective date: 1 March 2016.

3. Clarifying source rules for retirement annuity funds

If lump sums and pension payments from a pension or provident fund relate to services rendered outside of South Africa, those amounts are deemed to be from a source outside of South Africa, as reflected in sections 9(2)(i) and 9(3) of the Income Tax Act.

Retirement annuity funds are not employment-linked funds. Instead, their source is where the insurer accepted the contract. This source rule should therefore not apply to retirement annuity funds.

Section 9(2)(i) of the Income Tax Act was amended and section 9(3) repealed to make it clear that the source rule only applies to a lump sums, pensions or annuities payable by a pension find, pension preservation fund, provident fund or provident preservation fund.

Effective date: 1 March 2017.

4. Disallowing the exemption for a lump sum, pension or annuity from a retirement fund located in South Africa

From 1 March 2001, South Africa moved from a source-based system of taxation to a residence basis of taxation. This means that all the income of a South African resident is subject to normal tax in South Africa, irrespective of where the income is generated. There are however certain exemptions.

One of these was embodied in section 10(1)(gC) of the Income Tax Act, that allowed a South African tax resident, who was employed outside of South Africa, to receive the retirement benefits that they earned/accumulated while outside of South Africa, free from tax.

Section 10(1)(gC) was interpreted to apply to South African tax residents who worked outside of South Africa whilst still contributing to their South African retirement fund. This essentially resulted in this taxpayer qualifying for:

- A tax deduction on the contributions made to his South African retirement fund, whilst abroad, and
- the exemption under this section in respect of the lump sum/pension/annuity that was attributed to the service abroad, resulting in that part of his benefit being tax-free.

This double benefit was not the intention behind section 10(1)(gC) and it is therefore amended to clearly state that the exemption will not apply to benefits received by a South African tax resident from a South African retirement fund. The tax-free exemption will only apply to a benefit received from a foreign fund, and an amount transferred to a South African fund from a source outside of South Africa for that member.

Effective date: 1 March 2017.

5. Retirement fund contribution deduction against passive income

Before 1 March 2016, contribution deductions to pension funds were set off against the member's "retirement funding income" (defined as income consisting of "remuneration" as defined; generally income from employment, which did not include *passive income). For retirement annuity funds, the contribution deductions were set off against the member's "non-retirement funding income" (which included *passive income such as interest or royalties, but excluded taxable capital gains).

* Passive income is money that a person receives with little or no effort on his part. Examples of passive income are rental income, interest and dividends.

From 1 March 2016, section 11(k) of the Income Tax Act was changed, resulting in contributions to all retirement funds enjoying the same tax treatment. This allowed for a deduction of up to 27,5% of the higher of "remuneration" and "taxable income" as defined (limited to an overall annual amount of R350 000 per annum). "Remuneration", simply stated, refers to the payment made to an employee (their salary or any other amounts where PAYE is generally withheld) and for the purposes of this calculation will exclude any retirement fund lump sum, lump sum withdrawal benefit or severance benefit. "Taxable income" is a person's total gross income, from all sources, less the allowable deductions and exemptions, plus taxable capital gains.

The initial amendment of section 11(k) resulted in passive income being excluded from the amount against which the deductible contribution could be deducted; members of retirement annuity funds could not deduct their contributions against their passive income, as they could in the past. This was not the intention.

Section 11(k) was amended by adding in paragraph (v), which determines the amount against which the retirement fund contributions can be deducted. This amount will now include passive income.

Effective date: 1 March 2016.

6. Fund to apply for taxation of benefit from a provident fund as a retirement benefit where a member younger than 55 takes early retirement

Paragraph 4 of the Second Schedule to the Income Tax allows a member of a provident fund who is younger than 55 years to have his benefit taxed as a retirement benefit if he withdraws from the fund due to ill-health, or if he applies to SARS for early retirement before age 55 for other reasons, and SARS allows that; otherwise his early retirement benefit before age 55 would be taxed as a withdrawal, and not as a retirement.

This paragraph has now been amended to provide that the fund, and not the member, must apply to SARS for the early retirement benefit of a provident fund member younger than 55, for reasons other than ill-health, should be taxed as a retirement benefit instead of a withdrawal benefit. This is due to the fact that the fund, and not the individual, applies for the tax directive.

Effective date: 26 October 2016.

7. Using the correct definition of income for the formula to determine the fringe benefit for defined benefit contributions and eliminating a potential loophole

The valuation of contributions made by employers to certain retirement funds is set out in paragraph 12D of the Seventh Schedule to the Income Tax Act. Paragraph 12D(3) contains a formula to calculate the taxable fringe benefit for contributions to a pension, provident or retirement annuity fund that has a defined benefit component.

As explained in the Explanatory Memorandum in the Taxation Laws Amendment Bill, *"[t]he formula in paragraph 12D of the Seventh Schedule to the Act assumes that the value "A" represents the income that the retirement fund uses to calculate the required level of contributions given the expected liabilities of the fund. However, the wording of the provision currently refers to "remuneration" which is a different income figure. Remuneration may also differ for two individuals depending on the level of travel allowance, leading to a situation where two identical members of the same defined benefit fund would have a different fringe benefit value for the employer contribution.*

This wording also refers only to employer contributions and is silent on contributions made on behalf of the employer by the fund. These types of contributions may be interpreted to be exempt from the formula, creating a potential loophole."

The definition of "retirement funding income" in paragraph 12D(1) of the Seventh Schedule was amended to include contributions made by a pension or provident fund too. This will result in payments from an employer surplus account or other contributions made by the pension or provident fund on behalf of the employer to be subject to fringe benefit tax too. This amendment is deemed to have come into effect from 1 March 2016, and applies to contributions made from that date.

The definition of "retirement funding income" was also amended to change "*the income that* is taken into account" in the determination of the contributions made by the employer or the fund for the specific member, to "*that part of the employee's said income as* is taken into account". This amendment is effective from 1 March 2017, and applies to contributions made from that date.

B. The **Tax Administration Laws Amendment Act No. 16 of 2016** was promulgated in Government Gazette No. 40563 on 19 January 2017. The following change, relating to the application of tax directives for all section 14 transfers, is relevant for the retirement fund industry.

Before the promulgation of the Tax Administration Laws Amendment Act No. 16 of 2016, paragraph 9(3) of the Fourth Schedule to the Income Tax Act provided as follows:

(3) (a) The amount to be deducted or withheld in respect of employees' tax from any lump sum to which paragraph (d) or (e) of the definition of "gross income" in section 1 or section 7A applies, shall be ascertained by the employer+ from the Commissioner before paying out such lump sum, and the Commissioner's determination of the amount to be so deducted or withheld shall be final.

(b) Item (a) does not apply to any amount required to be included in the gross income of any person in terms of paragraph (e) of the definition of 'gross income' and paragraph 2(1)(b)(iB) of the Second Schedule as a result of a transaction contemplated in section 14(1) of the Pension Funds Act, other than an amount that is transferred for the benefit of the person to any provident fund as defined in paragraph 1 of the Second Schedule from any pension fund or pension preservation fund as defined in that paragraph.

+ *Employer* includes *an administrator of a pension fund, pension preservation fund, provident fund, provident preservation fund, retirement annuity fund or any other fund) who pays or is liable to pay to any person any amount by way of remuneration++.*

++ Remuneration includes an amount referred to in paragraph (eA)+++ of the definition of "gross income" in section 1 of the Income Tax Act.

+++ Paragraph (eA) of the definition of "gross income" refers to transfers or conversions from a public sector fund (refer to paragraph A1 of this Legal Update) to a provident fund.

The implication of paragraph 9(3) was that a fund only had to apply for a tax directive on a section 14(8) transfer and a section 14(1) transfer from a public sector fund to a provident fund.

Section 7(1)(c) of the Tax Administration Laws Amendment Act No. 16 of 2016 deletes paragraph 9(3)(b) with effect from 1 March 2017. The effect of this is that from 1 March 2017, funds will have to apply for tax directives on **all** section 14 transfers. This includes both a section 14(1) or 14(8)° transfer, and transfers from provident funds to provident funds. This might delay the transfer process.

The reasoning provided in the Explanatory Memo to the Bill was as follows:

It is proposed that an employer should apply to the Commissioner for a directive before paying out any lump sum envisaged in paragraph (d) or (e) of the definition of "gross income", i.e. the exception that was contained in subparagraph (3)(b) should be removed. SARS has the capacity to deal with these directives and they provide greater certainty to SARS, employers and taxpayers.

° A transfer between two funds can be done in terms of section 14(8) of the Pension Funds Act where the affected members were duly informed of the transfers and their objections have been resolved to the satisfaction of the trustees, and where –

- both funds are valuation exempt;
- both funds are beneficiary funds, or
- one of the funds is not registered, nor required to be registered, under the Pension Fund Act and the other one is valuation exempt.

The scheme for a section 14(8) transaction does not have to be submitted to the Financial Services Board.

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