



***Alternatives to the proposed taxation of retirement fund interests on emigration from South Africa***

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## **Abstract**

The 2021 Budget Speech, as well as the 2021 draft Taxation Laws Amendment Bill, included a proposal from National Treasury to implement an “exit tax” on retirement fund interests for resident individuals who emigrate from South Africa (i.e., become non-resident for tax purposes). The proposal, however, raised numerous concerns amongst experts in the industry, which ultimately led to its withdrawal in November 2021. While National Treasury indicated an intention to re-design the proposal, there has been no update since that time.

This study addressed two research objectives. Firstly, it investigated the policy objectives and shortcomings of the initial proposal which ultimately led to its withdrawal. Secondly, it addressed how the approach might be re-designed by considering alternatives that would achieve the objectives of the original proposal without its shortcomings. This is a relatively new area of research with no previous published work performed on the topic (to the author’s knowledge), emphasizing the relevance and significance of this study.

This study was performed using a combination of doctrinal and non-doctrinal legal interpretative research methods. Doctrinal legal research was used to obtain an understanding of the prevailing legislative framework and the initial proposal from National Treasury. Non-doctrinal legal research was used to consider alternative approaches in the re-design process.

The criteria for an alternative approach included the potentially competing needs for 1) equity within, 2) economic efficiency of, 3) administrability of, and 4) coherence of the tax system. The study explored four possible alternative approaches, each of which have some merits and some shortcomings. It concluded that one feasible alternative could be to migrate the retirement funding tax system to one in which contributions are afforded no tax incentives and retirement benefits are received free of taxation. However, this would be a radical departure from the existing approach, introduce more complexity into a system that is already dealing with the transitional provisions of several significant upheavals in the last few years, and would be complicated to manage on an ongoing basis. The other three alternatives considered would be less radical but would not be as effective in satisfying the evaluation criteria. National Treasury would need to weigh up whether the policy objectives and protection of the South African tax base are worth dealing with these challenges.

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## List of Abbreviations

<b>Abbreviations</b>	<b>Meaning</b>
DTA or DTAs	Double tax agreement/s
EEA	European Economic Area
EEE	Exempt, exempt, exempt
EET	Exempt, exempt, taxable
ETE	Exempt, taxable, exempt
ETT	Exempt, taxable, taxable
EU	European Union
GDP	Gross domestic product
IBFD	International Bureau of Fiscal Documentation
Income Tax Act or Act	South African Income Tax Act No.58 of 1962
NZS	New Zealand Superannuation
OECD MTC	Organisation for Economic Co-operation and Development Model Tax Convention
Retirement funds	Pension funds, pension preservation funds, provident funds, provident preservation funds and retirement annuity funds
SA	South Africa
SAICA	South African Institute of Chartered Accountants
SARB	South African Reserve Bank
SARS	South African Revenue Service
TAA	Tax Administration Act No.28 of 2011
TEE	Taxable, exempt, exempt
TET	Taxable, exempt, taxable
TTE	Taxable, taxable, exempt
TTT	Taxable, taxable, taxable
UK	United Kingdom
UN MDTC	United Nations Model Double Taxation Convention

# 1. Introduction

## 1.1. Background

The section 11F retirement fund contributions deduction is regarded as the largest tax expenditure for the South African fiscus within the personal income tax system,<sup>1</sup> with taxpayers eligible for the deduction of contributions not exceeding 27.5% of their remuneration or taxable income, provided those contributions do not exceed R350 000 per annum.<sup>2</sup> A taxpayer is allowed to claim these deductions for contributions made to retirement funds, as any subsequent receipt or accrual from these funds (because of retirement, death, resignation, or withdrawal) will be subject to tax in South Africa as determined in accordance with the Second Schedule to the South African Income Tax Act (“Income Tax Act” or “Act”).<sup>3</sup>

South African income tax follows a residence-based tax system, which means that residents are taxed on their worldwide income, whereas non-residents are only taxed on South African source income.<sup>4</sup> Residents<sup>5</sup> will, therefore, be subject to tax in South Africa on any subsequent receipt or accrual from retirement funds, regardless of whether those retirement funds are South African funds or not.

This study relates solely to taxpayers who emigrate from South Africa (i.e., become non-resident). Non-residents will be taxed in South Africa on any benefits received from retirement funds in respect of services rendered within South Africa.<sup>6</sup> This could, however, be overridden by the relevant articles contained in double tax agreements (“DTAs”) between South Africa and other countries. Most South African DTAs with other countries follow article 18 of the Organisation for Economic Co-operation and Development (“OECD”) Model Tax Convention (“MTC”).<sup>7</sup> This results in South Africa losing its taxing rights on any subsequent receipt or accrual from retirement funds to

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<sup>1</sup> Mashekwa Maboshe, Ingrid Woolard. “Revisiting the Impact of Direct Taxes and Transfers on Poverty and Inequality in South Africa”, WIDER Working Paper 2018/79 Helsinki: UNU-WIDER, 2018. <https://doi.org/10.35188/UNU-WIDER/2018/521-3>.

<sup>2</sup> In the Income Tax Act No.58 of 1962

<sup>3</sup> Income Tax Act No. 58 of 1962

<sup>4</sup> Ibid.

<sup>5</sup> As defined in section 1 of the Income Tax Act No. 58 of 1962

<sup>6</sup> Section 9(2)(i) of the Income Tax Act No. 58 of 1962

<sup>7</sup> Kyle Mandy, Greg Smith, “Emigration and South African retirement funds: Proposal to tax withdrawals of retirement interests”, July 2021, <https://www.pwc.co.za/en/assets/pdf/synopsis/synopsis-july-2021.pdf>

non-resident individuals;<sup>8</sup> even though the amounts were received in respect of services rendered within South Africa.

The announcement in the 2021 Budget Speech, together with the draft Taxation Laws Amendment Bill issued in July 2021, included a proposal to amend the South African Income Tax Act by including section 9HC. The proposed section provided for a deemed withdrawal of retirement fund benefits upon emigration from South Africa which could potentially give rise to income tax consequences in South Africa.<sup>9</sup> The liability for payment of income tax on this deemed withdrawal would, however, be deferred until the actual withdrawal or retirement of the taxpayer from the fund and recalculated on that date.

The rationale for the proposal was explained in the Explanatory Memorandum to the 2021 draft Taxation Laws Amendment Bill. National Treasury considered it to be unfair for the South African government to lose its taxing rights on subsequent receipts or accruals from retirement funds after having provided the taxpayer with deductions for contributions over a certain period.<sup>10</sup>

The proposal, however, raised concerns amongst experts in the industry. A key concern was the potential double taxing of the same amount, as residents who have emigrated from South Africa would be taxed in the other country (due to the exclusive taxing rights granted to the resident country in terms of the application of the double tax agreement<sup>11</sup>) and could potentially be taxed in South Africa (due to the insertion of section 9HC into the South African Income Tax Act, giving rise to a tax charge prior to emigration).<sup>12</sup> This concept of amending domestic legislation in an attempt to bypass

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<sup>8</sup> OECD Model Tax Convention on Income and on Capital, 21 November 2017; Patricia A. Brown, Articles 18 and 19(2): Pensions/Pensions and Social Security Payments – Global Tax Treaty Commentaries, Global Topics, IBFD, 30 September 2017

<sup>9</sup> Draft Taxation Laws Amendment Bill, 28 July 2021

<sup>10</sup> Draft Explanatory Memorandum on the Taxation Laws Amendment Bill, 28 July 2021

<sup>11</sup> Article 18 of the OECD Model Tax Convention on Income and on Capital (21 November 2017)

<sup>12</sup> Kyle Mandy, Greg Smith, “Emigration and South African retirement funds: Proposal to tax withdrawals of retirement interests”, July 2021, <https://www.pwc.co.za/en/assets/pdf/synopsis/synopsis-july-2021.pdf>; Draft Response Document on the 2021 Draft Tax Law Amendment Bill, 10 November 2021

existing DTAs was regarded as a “breach of good faith”<sup>13</sup> when attempted by the Netherlands government.

Following the numerous concerns from the public that the above would result in a case of treaty override,<sup>14</sup> a decision was made by National Treasury to withdraw the initial proposal. This decision was announced on 10 November 2021<sup>15</sup> and the proposal was removed from the final Taxation Laws Amendment Bill for 2021<sup>16</sup> issued on that same day. While National Treasury indicated an intention to re-design the initial proposal in the next legislative cycle,<sup>17</sup> there has been no update since that time.

## **1.2. Research problem and objectives**

The research problem in this study relates to the need to establish an exit tax on retirement fund interests on emigration from South Africa. National Treasury issued an initial proposal to amend the South African Income Tax Act to potentially give rise to income tax consequences in South Africa. However, the initial proposal raised numerous concerns amongst industry experts and was subsequently withdrawn.

The study aims to address two research objectives. Firstly, it aims to investigate the policy objectives and shortcomings of the initial proposal which ultimately led to its withdrawal. Secondly, it aims to address how the approach to taxation of retirement fund interests on emigration from South Africa should be re-designed.

The study will be guided by the following two research questions. Firstly, what were the policy objectives and shortcomings of the initial proposal which ultimately led to its withdrawal? Secondly, are there any feasible alternative approaches available that might achieve the policy objectives of the initial proposal without giving rise to its shortcomings?

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<sup>13</sup> Lameez Omarjee, “Treasury drops proposed exit tax on retirement interest, for now”, 10 November 2021, <https://www.news24.com/fin24/economy/treasury-drops-proposed-exit-tax-on-retirement-interest-for-now-20211110>

<sup>14</sup> Draft Response Document on the 2021 Draft Taxation Laws Amendment Bill, 10 November 2021

<sup>15</sup> Ibid.

<sup>16</sup> Taxation Laws Amendment Bill 22 of 2021

<sup>17</sup> Draft Response Document on the 2021 Draft Taxation Laws Amendment Bill, 10 November 2021

The study proceeds as follows:

The literature review establishes the prevailing legislative framework by considering the basis on which amounts received by or accrued to taxpayers from retirement funds are included in gross income, the deductions available to taxpayers who make contributions to South African retirement funds, the basis of determination of amounts from retirement funds to be included in gross income, the source rules that apply to non-residents who receive benefits from South African retirement funds, and an analysis of how the provisions of certain DTAs override the Income Tax Act. The next chapter seeks to understand the initial proposal from National Treasury, including the rationale for the proposal, how it was intended to work and the effect thereof, as well as the issues with the initial proposal that resulted in its withdrawal in November 2021.

The study then analyses alternative approaches to consider in the re-design process. This requires the establishment of a criteria for evaluation of a feasible alternative approach to the initial proposal issued by National Treasury. The criteria will consist of a combination of the intended outcomes of the initial proposal, mitigation of the issues identified with the initial proposal, as well as consideration of the relevant universal features of a well-designed tax system. This chapter then seeks to analyse possible retirement fund taxation regimes available and consider the South African tax legislation and other countries' retirement fund taxation systems for feasible suggestions. Each alternative discussed will include a description of how it would work if it were pursued by National Treasury, as well as the relative merits, and shortcomings of the alternative. To conclude the chapter, an overall assessment of the alternatives will be performed to compare them against the established criteria. In its conclusion, the study aims to contain a summary of the issue, a summary of the findings, recommendations on the way forward for National Treasury, recommendations for further research, and concluding remarks.

### **1.3. Research method**

The legal interpretative research method will be used in this study. This method consists of doctrinal research and non-doctrinal legal research, and a combination of these subcategories will be used in this study.

### Doctrinal legal research:

In establishing the prevailing legislative framework as well as understanding the initial proposal from National Treasury, the study will engage in doctrinal legal research. Doctrinal legal research is defined as “the systematic process of identifying, analysing, organising and synthesising statutes, judicial decisions and commentary”.<sup>18</sup> This part of the study will refer to the relevant provisions of the South African Income Tax Act,<sup>19</sup> the relevant articles in the 2017 OECD MTC, the 2021 draft Taxation Law Amendment Bill, the Explanatory Memorandum on the 2021 draft Taxation Law Amendment Bill, the final 2021 Taxation Law Amendment Bill, relevant academic papers as well as expert commentary.

### Non-doctrinal legal research:

In considering the alternative approaches to consider in the re-design process, the study will engage in non-doctrinal legal research. Non-doctrinal research is characterized as “research about the law, rather than in the law”.<sup>20</sup> Reform-orientated research is a sub-category of non-doctrinal legal research and is “designed to accomplish change in the law”.<sup>21</sup> This part of the study will refer to the 2021 draft Taxation Law Amendment Bill, the Explanatory Memorandum on the 2021 draft Taxation Law Amendment Bill, and the fundamentals or principles of taxation<sup>22</sup> to establish a criteria for evaluation of a feasible alternative approach to the initial proposal. It will then analyse the findings from the doctrinal research conducted and explore relevant academic papers, the South African tax legislation as well as other countries’ retirement fund taxation systems for feasible suggestions to consider in re-

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<sup>18</sup> Margaret McKerchar, “Philosophical Paradigms, Inquiry Strategies and Knowledge Claims: Applying the Principles of Research Design and Conduct to Taxation,” *EJournal of Tax Research* 6, no. 1 (2008): 5–22, <http://www8.austlii.edu.au/cgi-bin/viewdoc/au/journals/eJITaxR/2008/1.html>

<sup>19</sup> No.58 of 1962

<sup>20</sup> Margaret McKerchar, “Philosophical Paradigms, Inquiry Strategies and Knowledge Claims: Applying the Principles of Research Design and Conduct to Taxation,” *EJournal of Tax Research* 6, no. 1 (2008): 5–22, <http://www8.austlii.edu.au/cgi-bin/viewdoc/au/journals/eJITaxR/2008/1.html>

<sup>21</sup> *Ibid.*

<sup>22</sup> As established in the Fundamentals of Taxation: An introduction to Tax Policy, Tax Law and Tax Administration (Pasquale Pistone, Jennifer Roeleveld, Johann Hattingh, Joao Felix, Pinto Nogueira, Craig West, IBFD 2019), Books IBFD, [https://research.ibfd.org/#/doc?url=/collections/pt/html/pt\\_c02.html](https://research.ibfd.org/#/doc?url=/collections/pt/html/pt_c02.html)

designing the approach to tax retirement fund interests on emigration from South Africa. The alternatives sought should address the issues of concern with the status quo while avoiding the issues of the withdrawn proposal of National Treasury.

#### **1.4. Limitations to the study**

This study is limited to the taxation of private retirement funds on emigration of a member. No consideration will be given to the taxation of state retirement funds on emigration, as these funds operate differently and have been scoped out of this study.

As stated above, most South African DTAs with other countries follow the blueprint provided in article 18 of the OECD MTC.<sup>23</sup> This study is, therefore, limited to the OECD MTC and will not consider the guidance provided in the United Nations Model Double Taxation Convention (“UN MDTC”). This study will, furthermore, not consider any specific DTAs entered between South Africa and another country.

This study will not include a detailed comparison of South Africa’s retirement fund taxation system with other countries. This would require a comprehensive analysis of the domestic law of each country to understand the taxation system followed and has been scoped out of this study. This study will focus on South African tax aspects and will only consider relevant aspects of the retirement fund taxation system of other countries for feasible suggestions.

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<sup>23</sup> Kyle Mandy, Greg Smith, “Emigration and South African retirement funds: Proposal to tax withdrawals of retirement interests”, July 2021, <https://www.pwc.co.za/en/assets/pdf/synopsis/synopsis-july-2021.pdf>

## **2. A literature review of the current law on the taxation of retirement fund interests prior to and on emigration from South Africa**

### **2.1. How private sector retirement funds work**

There are five types of private sector retirement funds registered in South Africa; namely pension funds, pension preservation funds, provident funds, provident preservation funds and retirement annuity funds (hereafter referred to as “retirement funds”).<sup>24</sup> The Pension Funds Act<sup>25</sup> provides a definition for “pension fund” as well as guidance on the calculation of the minimum individual reserve value used to determine the member’s benefits. This Act then refers the reader to the Income Tax Act for definitions regarding the other retirement funds. The Income Tax Act also sets out some rules applicable to the various funds.

All retirement funds are defined as being established for the sole or main purpose of providing benefits (in the form of annuities or lump sum payments) to its members upon reaching their retirement date or to dependants of such members upon their death.<sup>26</sup> Pension and provident funds are employer-related funds, as membership of the fund is conditional on the member being employed by an employer participating in the fund,<sup>27</sup> whereas retirement annuity funds are independent funds, not requiring any employee-employer relationship.<sup>28</sup>

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<sup>24</sup> Section 1 of the Income Tax Act No.58 of 1962; National Treasury, “Response document supporting the revised Conduct of Financial Institutions Bill”, September 2020, [https://www.treasury.gov.za/public%20comments/2020%2010%2008%20COFI%20Response%20Document%20V4\\_FINAL%20published%20\(commentators%20updated\).pdf](https://www.treasury.gov.za/public%20comments/2020%2010%2008%20COFI%20Response%20Document%20V4_FINAL%20published%20(commentators%20updated).pdf)

<sup>25</sup> No 24 of 1956. Note that the Pension Funds Act is proposed to be renamed as the Retirement Funds Act so that it aligns with the Conduct of Financial Institutions (COFI) Bill as it will better reflect the types of funds provided for and regulated by this statute - ; National Treasury, “Response document supporting the revised Conduct of Financial Institutions Bill”, September 2020, [https://www.treasury.gov.za/public%20comments/2020%2010%2008%20COFI%20Response%20Document%20V4\\_FINAL%20published%20\(commentators%20updated\).pdf](https://www.treasury.gov.za/public%20comments/2020%2010%2008%20COFI%20Response%20Document%20V4_FINAL%20published%20(commentators%20updated).pdf)

<sup>26</sup> Definition of “pension fund organisation” in section 1 of the Pension Funds Act No. 24 of 1956 and definitions of “pension fund”, “pension preservation fund”, “provident fund”, “provident preservation fund” and “retirement annuity fund” in section 1 of the Income Tax Act No.58 of 1962

<sup>27</sup> Definition of “employer” in section 1 of the Pension Funds Act No. 24 of 1956

<sup>28</sup> Proviso (ii)(bb) of the definition of “pension fund” and proviso (ii)(bb) of the definition of “provident fund” in section 1 of the Income Tax Act No.58 of 1962

Membership of a pension preservation and/or provident preservation fund is limited to former members of a pension or provident fund where membership is terminated due to resignation, retrenchment, or dismissal from employment; or where a previous fund is wound up and the member elects to transfer their interest to the preservation fund; or where a former member of a pension or provident fund elects to transfer a lump sum benefit to a preservation fund and such election was made while they were still members of that other fund.<sup>29</sup>

Each retirement fund needs to be approved by the Commissioner of the South African Revenue Service (“SARS”).<sup>30</sup> The relevant rules of the various retirement funds are as follows:

#### **2.1.1 Contributions to the fund**

The employer of any member of a pension and/or provident fund is responsible for making employee and/or employer contributions to the fund.<sup>31</sup> Members are not allowed to make any contributions directly to a pension preservation and/or provident preservation fund as these funds only take certain amounts transferred to such funds as contemplated in paragraph 2(1)(a)(ii), (b) or (c) of the Second Schedule of the Income Tax Act.<sup>32</sup> All contributions to retirement annuity funds are the member’s responsibility.<sup>33</sup>

#### **2.1.2 Commutation of lump sum benefits**

Members of pension funds, provident funds and retirement annuity funds may not commute “more than one-third of the total value of the retirement interest”<sup>34</sup> as a single lump sum payment on retirement; with the balance being paid out as an annuity.

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<sup>29</sup> Proviso (a) to the definitions of “pension preservation fund” and “provident preservation fund” in section 1 of the Income Tax Act No.58 of 1962

<sup>30</sup> Definitions of “pension fund”, “pension preservation fund”, “provident fund”, “provident preservation fund” and “retirement annuity fund” in section 1 of the Income Tax Act No.58 of 1962

<sup>31</sup> Section 13A of the Pension Funds Act No.24 of 1956; Proviso (ii)(aa) of the definition of “pension fund” in section 1 of the Income Tax Act No.58 of 1962; Proviso (ii)(aa) of the definition of “provident fund” in section 1 of the Income Tax Act No.58 of 1962

<sup>32</sup> Proviso (b) to the definitions of “pension preservation fund” and “provident preservation fund” in section 1 of the Income Tax Act No.58 of 1962

<sup>33</sup> Proviso (b)(i) to the definition of “retirement annuity fund” in section 1 of the Income Tax Act No.58 of 1962

<sup>34</sup> Proviso (ii)(dd) of the definition of “pension fund” in section 1 of the Income Tax Act No.58 of 1962; Proviso (ii)(dd) of the definition of “provident fund” in section 1 of the Income Tax Act No.58 of 1962; Proviso (b)(ii) of the definition of “retirement annuity fund” in section 1 of the Income Tax Act No.58 of 1962

The abovementioned restriction does not apply to a taxpayer whose total interest in the fund is less than R247 500 (calculated as R165 000 x 3/2), to a deceased employee or where the member transfers the retirement interest to a pension preservation fund, provident preservation fund, or a retirement annuity fund<sup>35</sup> – meaning that the member will be entitled to a full lump sum payment.

Prior to 1 March 2021, members of provident funds were allowed to commute 100% of their total value of the retirement interest as a single lump sum payment (i.e., there was no restriction in terms of the amount to be commuted). The change in the provident fund rules was introduced as part of Government's retirement reform objectives and was aimed at encouraging South African households to increase savings toward retirement, to reduce vulnerability in retirement, to reduce reliability on the Government post retirement and to align the rules of all retirement funds.<sup>36</sup>

The abovementioned restriction does not apply to any person who was a member of a provident fund who was 55 years old or older on 1 March 2021. This means that the total value of such person's retirement interest (including returns on investment) accumulated before, on and after 1 March 2021 will be allowed to be commuted as a lump sum payment.<sup>37</sup>

In any other case (i.e., where persons are younger than 55 years old on 1 March 2021), the abovementioned restriction only applies to the value of such person's retirement interest (including returns on the investment of contributions made after that date) accumulated on or after 1 March 2021. Such person will still be allowed to commute 100% of the total value of the retirement interest accumulated prior to

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1962. A "retirement interest" is defined (in section 1 of the Act) as a member's share of the value of a retirement fund as determined in terms of the rules of the fund on the date of retirement or transfer to another retirement fund.

<sup>35</sup> Proviso (ii)(dd) of the definition of "pension fund" in section 1 of the Income Tax Act No.58 of 1962; Proviso (ii)(dd) of the definition of "provident fund" in section 1 of the Income Tax Act No.58 of 1962; Proviso (b)(ii) of the definition of "retirement annuity fund" in section 1 of the Income Tax Act No.58 of 1962.

<sup>36</sup> National Treasury, "Encouraging South African households to save more for retirement", 14 December 2021 [http://www.treasury.gov.za/comm\\_media/press/2021/2021121401%20Two-pot%20system%20retirement%20proposal%20and%20auto%20enrolment.pdf](http://www.treasury.gov.za/comm_media/press/2021/2021121401%20Two-pot%20system%20retirement%20proposal%20and%20auto%20enrolment.pdf)

<sup>37</sup> Proviso (ii)(dd)(a) of the definition of "provident fund" in section 1 of the Income Tax Act No.58 of 1962

1 March 2021 as well as any subsequent returns on that amount.<sup>38</sup> This is commonly referred to as the “vested” amount.<sup>39</sup>

Members of a retirement annuity fund, pension preservation fund or provident preservation fund are not entitled to any benefits upon retirement, death, or retrenchment prior to reaching the normal retirement age of 55 years old (i.e., this excludes any withdrawals upon resignation from employment).<sup>40</sup>

### 2.1.3 **Implementation of the two-pot retirement system**

National Treasury is currently working on its latest retirement reform, colloquially referred to as the “two-pot” retirement system. This new system is intended to preserve members’ pre-retirement savings (as members are currently able to access their pension and/or provident fund retirement interest upon resignation from employment), as well as to allow limited access to retirement savings to members who find themselves in financial distress.<sup>41</sup> It is proposed that various amendments are made to the Income Tax Act No. 58 of 1962 and the Pension Funds Act No. 24 of 1956,<sup>42</sup> all of which will affect the retirement benefit industry significantly.<sup>43</sup>

The two-pot retirement system is proposed to be implemented as of 1 September 2024<sup>44</sup> and is intended to work as follows:

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<sup>38</sup> Proviso (ii)(dd)(b) of the definition of “provident fund” in section 1 of the Income Tax Act No.58 of 1962

<sup>39</sup> National Treasury, “Encouraging South African households to save more for retirement”, 14 December 2021 [http://www.treasury.gov.za/comm\\_media/press/2021/2021121401%20Two-pot%20system%20retirement%20proposal%20and%20auto%20enrolment.pdf](http://www.treasury.gov.za/comm_media/press/2021/2021121401%20Two-pot%20system%20retirement%20proposal%20and%20auto%20enrolment.pdf)

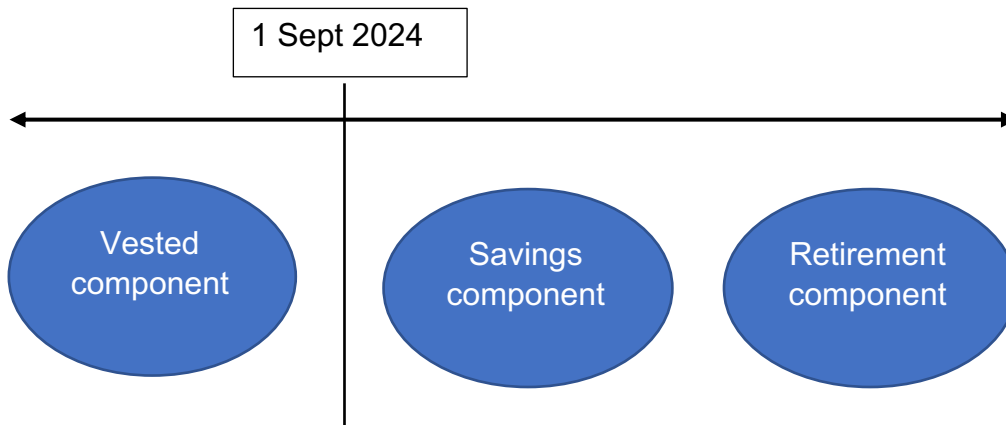
<sup>40</sup> Proviso (b)(v) to the definition of “retirement annuity fund” and paragraph (b) to the definition of “normal retirement age” in section 1 of the Income Tax Act No.58 of 1962; Proviso (d) to the definitions of “pension preservation fund” and “provident preservation fund” and paragraph (b) to the definition of “normal retirement age” in section 1 of the Income Tax Act No.58 of 1962

<sup>41</sup> Draft Memorandum on the Objects of the Draft Revenue Administration and Pension Laws Amendment Bill, 9 June 2023

<sup>42</sup> Ibid.

<sup>43</sup> Garth Theunissen, “Treasury wants ‘two-pot’ retirement system delayed until 2025”, 25 October 2023, <https://www.news24.com/fin24/economy/treasury-wants-two-pot-retirement-system-delayed-until-2025-20231025>

<sup>44</sup> Draft Explanatory Memorandum on the Revenue Laws Amendment Bill, 9 June 2023; Alexander Forbes Group Holdings Limited, “National Treasury provides an important update regarding the two-pot retirement system”, 25 October 2023, <https://www.alexforbes.com/za/en/newsroom/blogs-sa/national-treasury-update-oct.html>; Garth Theunissen, “Treasury wants ‘two-pot’ retirement system delayed until 2025”, 25 October 2023, <https://www.news24.com/fin24/economy/treasury-wants-two-pot-retirement-system-delayed-until-2025-20231025>; Draft Response Document on the 2023 Draft Revenue Laws Amendment Bill, 25 October 2023; Ahmed Areff, Na’ilah Ebrahim, “Two-pot retirement system: Treasury, MPs agree on new implementation date”, 4 December 2023,



**Figure 1: How the proposed two-pot retirement system is intended to work (author’s own construction)**

Vested component:

- Retirement funds will be required to value a member’s retirement interest as at 31 August 2024, as these amounts will form part of the “vested component” and will continue to be subject to the current retirement regime on withdrawal or retirement<sup>45</sup> (as explained in the previous sub-section).
- As of 1 September 2024, members will no longer be able to make any contributions to their “vested component”.<sup>46</sup> This will, however, not apply to members of provident funds who were 55 years or older on 1 March 2021 as they can continue making contributions to the “vested component” until they retire from or leave the fund. Alternatively, these members may opt in to participate in the two-pot retirement regime.<sup>47</sup>
- On 1 September 2024, the lower of 10% of the member’s total retirement interest as at 31 August 2024 (i.e., the vested component) or R30 000 will be

<https://www.news24.com/fin24/economy/two-pot-retirement-system-treasury-mps-agree-on-new-implementation-date-20231204>. The initial Bill was proposed to be implemented as of 1 March 2024. This was, however, changed on 25 October 2023, when National Treasury indicated a desire to push the implementation date back by one year (i.e., 1 March 2025) to give the savings and investment industry more time to implement systems needed to administer the changes. The latest implementation date, as indicated by Finance Minister Enoch Godongwana on 4 December 2023, is now 1 September 2024, and is regarded as a compromise between National Treasury and Parliament’s Standing Committee on Finance.

<sup>45</sup> Draft Explanatory Memorandum on the Revenue Laws Amendment Bill, 9 June 2023

<sup>46</sup> Ibid.

<sup>47</sup> Ibid.

transferred from this “vested component” to the “savings component”.<sup>48</sup> The new Bill refers to this as “seed capital” which will be available to members for immediate access on the implementation date of the two-pot retirement system.<sup>49</sup> The seed capital amount is being limited so as not to erode the retirement benefit but at the same time to enable pre-retirement access to benefits.<sup>50</sup>

#### Savings component:

- Retirement funds will be required to record one-third of all contributions made on or after 1 September 2024 in the “savings component”.<sup>51</sup>
- Members will be allowed to access the “savings component” without the need to resign from employment or to retire from a fund. Members are only allowed one withdrawal per annum for financial emergencies (unless they resign from employment, in which case an additional withdrawal will be allowed if the member’s gross interest in the “savings component” is less than R2 000). While there is no maximum withdrawal amount, there is a minimum withdrawal amount of R2 000 per year of assessment (if the member elects to make a withdrawal).<sup>52</sup>
- Any withdrawals from the “savings component” prior to retirement, will be added to the individual’s taxable income and will be subject to normal tax at their marginal tax rate.<sup>53</sup>

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<sup>48</sup> Ibid.; Alexander Forbes Group Holdings Limited, “National Treasury provides an important update regarding the two-pot retirement system”, 25 October 2023, <https://www.alexforbes.com/za/en/newsroom/blogs-sa/national-treasury-update-oct.html>; Draft Response Document on the 2023 Draft Revenue Laws Amendment Bill, 25 October 2023. The initial Bill referred to a maximum seed capital of R25 000. On 25 October 2023, National Treasury proposed to increase the initial maximum limit of the seed capital from R25 000 to R30 000 as an inflationary adjustment.

<sup>49</sup> Draft Explanatory Memorandum on the Revenue Laws Amendment Bill, 9 June 2023

<sup>50</sup> Ibid.

<sup>51</sup> Ibid.

<sup>52</sup> Ibid.

<sup>53</sup> Ibid.

Retirement component:

- Retirement funds will be required to record two-thirds of all contributions made on or after 1 September 2024 in the “retirement component”.<sup>54</sup>
- Members will not be allowed to access the “retirement component” until they reach normal retirement age per the rules of the fund.<sup>55</sup>
- Once the member has reached normal retirement age, the “retirement component” will be paid out in the form of an annuity.<sup>56</sup>

Members will be allowed to transfer funds from their “savings component” to their “retirement component” and from their “vested component” to their “retirement component” when they resign or retire from any fund. Any such intra-fund transfers are proposed to be tax-free (provided the transfer is a transfer of all relevant components).<sup>57</sup>

## **2.2. Deduction of contributions made to retirement funds**

Members, including employed individuals,<sup>58</sup> are allowed to claim deductions for contributions made to retirement funds in the determination of their taxable income in the year that such contributions are made, as any payments received by or accrued to members from such fund in the future will be considered for tax in South Africa.<sup>59</sup>

Prior to 1 March 2016, an individual taxpayer was only allowed to claim contributions made to pension funds and retirement annuity funds as deductions during the year of assessment in which the contributions were made;<sup>60</sup> whereas employee contributions made to provident funds were only deductible against a lump sum received upon the

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<sup>54</sup> Ibid.

<sup>55</sup> Ibid.

<sup>56</sup> Ibid.

<sup>57</sup> Ibid.

<sup>58</sup> Section 23(m) of the Income Tax Act No.58 of 1962

<sup>59</sup> By virtue of paragraph (a)/(e) of the “gross income” definition in section 1 of the Income Tax Act No.58 of 1962

<sup>60</sup> In terms of section 11(k) and 11(n) of the Income Tax Act No.58 of 1962 as it read at that time

employees' retirement (not during the year of assessment in which the contributions were made).<sup>61</sup>

This was amended (with effect from 1 March 2016) by the introduction of section 11F. This change was introduced as part of Government's wider retirement reform objectives and was implemented to encourage individuals to save more for retirement due to the higher tax deduction limits offered and to improve equity by harmonising the same deduction across all retirement funds.<sup>62</sup>

The section 11F deduction allowed each year is limited to the lesser of:

- R350 000;
- 27.5% of the higher of the taxpayer's remuneration<sup>63</sup> or taxable income (before allowing this deduction and the deduction for donations to approved public benefit organisations); and
- The taxpayer's taxable income (before allowing this deduction, the deduction for donations to approved public benefit organisations, and the inclusion of a taxable capital gain).<sup>64</sup>

Any contribution disallowed solely because of the abovementioned limits will be carried forward to the next year of assessment and will be deemed to be a contribution made in such year.<sup>65</sup>

The section 11F retirement fund contributions deduction is regarded as the largest personal income tax deduction granted to individuals against employment income.<sup>66</sup> This has been confirmed in the most recent SARS Tax Statistics, where it was established that R204.1 billion was granted as a section 11F deduction in the 2020

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<sup>61</sup> Second schedule to the Income Tax Act No. 58 of 1962 as it read at that time

<sup>62</sup> National Treasury, "Advantages of the tax and retirement reforms contained in the Taxation Law Amendment Bill 2015", 24 November 2015 <http://www.treasury.gov.za/publications/retirementreform/20151124%20Advantages%20of%20reforms.pdf>

<sup>63</sup> As defined in paragraph 1 of the Fourth Schedule to the Income Tax Act No.58 of 1962

<sup>64</sup> Section 11F (2) of the Income Tax Act No.58 of 1962

<sup>65</sup> Section 11F (3) of the Income Tax Act No.58 of 1962

<sup>66</sup> Mashekwa Maboshe, Ingrid Woolard. "Revisiting the Impact of Direct Taxes and Transfers on Poverty and Inequality in South Africa", WIDER Working Paper 2018/79 Helsinki: UNU-WIDER, 2018. <https://doi.org/10.35188/UNU-WIDER/2018/521-3>.

year of assessment (amounting to 85.5% of total personal income tax deductions granted against employment income for the year).<sup>67</sup> Further statistics have been provided for the 2017 to 2020 years of assessment in the table below, which indicate the significance of the section 11F deduction within the context of the personal tax system.

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<sup>67</sup> South African Revenue Service, Tax Statistics 2021 Main Document, page 34, <https://www.sars.gov.za/wp-content/uploads/Docs/TaxStats/2021/Tax-Statistics-2021-Main-document.pdf>

**Table 1: SARS Tax Statistics – Personal income tax deductions granted to individual taxpayers against employment income for the 2017 to 2020 years of assessment<sup>68</sup>**

**Table A2.7.1: Assessed individual taxpayers: Deductions, 2017 – 2020**

Tax year Deduction	2017 [97.1% assessed]		2018 [96.9% assessed]		2019 [96.1% assessed]		2020 [96.2% assessed]	
	Number of taxpayers	Amount allowed (R million)	Number of taxpayers	Amount allowed (R million)	Number of taxpayers	Amount allowed (R million)	Number of taxpayers	Amount allowed (R million)
4011 Donations	90 016	898	102 090	1 073	110 540	1 219	106 907	1 398
4014 Travel expenses - fixed cost - business cost claimed against allowance	376 969	22 821	368 753	23 740	350 548	23 457	306 994	21 945
4015 Travel expenses - actual business cost	21 958	1 204	22 896	1 298	23 229	1 398	21 603	1 343
4016 Other	31 729	2 912	31 251	3 003	30 083	2 945	27 112	2 844
4017 Subsistence allowance - local	9 467	113	9 258	112	6 834	87	3 922	60
4027 Depreciation	8 156	132	9 119	178	8 483	314	8 046	142
4028 Home office expense	16 916	452	18 679	601	18 805	639	19 650	590
<b>4029 Retirement fund contributions<sup>1</sup></b>	<b>4 211 863</b>	<b>202 137</b>	<b>4 053 753</b>	<b>207 958</b>	<b>3 432 342</b>	<b>193 734</b>	<b>3 494 080</b>	<b>204 091</b>
4048 Employer provided vehicle expenses	55 313	3 562	55 202	3 775	54 404	4 013	51 430	4 100
4050 Employer provided vehicle expenses (operating lease)	1 699	126	1 761	133	1 868	150	1 924	166
Other <sup>2</sup>	24 582	2 359	26 276	3 108	27 860	5 528	26 718	2 012
Medical Tax Credits Rebate <sup>3</sup>	3 009 008	20 910	2 976 849	21 934	2 601 008	19 718	2 600 944	19 782
Medical Tax Credits Rebate - additional expense <sup>3</sup>	905 589	5 378	994 039	6 164	971 221	6 692	1 041 538	7 390
<b>Total</b>		<b>236 717</b>		<b>244 979</b>		<b>233 484</b>		<b>238 693</b>
<b>Percentage of total</b>								
4011 Donations		0,4%		0,4%		0,5%		0,6%
4014 Travel expenses - fixed cost - business cost claimed against allowance		9,6%		9,7%		10,0%		9,2%
4015 Travel expenses - actual business cost		0,5%		0,5%		0,6%		0,6%
4016 Other		1,2%		1,2%		1,3%		1,2%
4017 Subsistence allowance - local		0,0%		0,0%		0,0%		0,0%
4027 Depreciation		0,1%		0,1%		0,1%		0,1%
4028 Home office expense		0,2%		0,2%		0,3%		0,2%
<b>4029 Retirement fund contributions<sup>1</sup></b>		<b>85,4%</b>		<b>84,9%</b>		<b>83,0%</b>		<b>85,5%</b>
4048 Employer provided vehicle expenses		1,5%		1,5%		1,7%		1,7%
4050 Employer provided vehicle expenses (operating lease)		0,1%		0,1%		0,1%		0,1%
Other <sup>2</sup>		1,0%		1,3%		2,4%		0,8%
Medical Tax Credits Rebate <sup>3</sup>		8,8%		9,0%		8,4%		8,3%
Medical Tax Credits Rebate - additional expense <sup>3</sup>		2,3%		2,5%		2,9%		3,1%
<b>Total</b>		<b>100,0%</b>		<b>100,0%</b>		<b>100,0%</b>		<b>100,0%</b>

1. Retirement reform was announced from 1 March 2016 in section 11F (replacement of section 11(k)) of the Income Tax Act. From the 2017 tax year retirement contributions are grouped under code 4029 and not separately under 4001, 4002, 4006 and 4007. Deductions for Income Insurance Protection Contributions can no longer be claimed from the 2016 year of assessment.

2. Includes provident fund contributions as well as tool, entertainment and foreign subsistence allowances and other deductions.

3. From the 2015 tax year no medical expenses deductions will appear on assessments as the additional medical expenses tax credit is treated as a rebate against taxes and not a deduction.

Medical tax credit (rebates and additional expenses allowed) has been added for comparative purposes. From 1 March 2014 tax credits applied to all taxpayers. Rebate amount allowed for 2014

tax year already included in medical deduction and is not included in total amount allowed.

<sup>68</sup> South African Revenue Service, Tax Statistics, Personal Income Tax – chapter 2, Table A2.7.1: Assessed individual taxpayers: Deductions, 2017 – 2020, 2021, <https://www.sars.gov.za/about/sas-tax-and-customs-system/tax-statistics/>

The section 11F retirement fund contributions deduction<sup>69</sup> is granted to individuals for all actual and deemed contributions made to a retirement fund during a particular year of assessment. As of 1 March 2016, employer contributions to all retirement funds<sup>70</sup> are regarded as a taxable fringe benefit and in turn is deemed to have been contributed by the employee for the purposes of the section 11F deduction.<sup>71</sup>

Employer contributions to retirement funds are regarded as the largest taxable fringe benefit provided within the personal income tax system. This is evident in the most recent SARS Tax Statistics where it was established that R116.2 billion was paid to pension, provident and retirement annuity funds on behalf of employees in the 2020 year of assessment (amounting to 59.2% of total taxable fringe benefits provided for the year).<sup>72</sup> Further statistics have been provided for the 2017 to 2020 years of assessment in the table below.

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<sup>69</sup> In the Income Tax Act No.58 of 1962

<sup>70</sup> National Treasury, “Advantages of the tax and retirement reforms contained in the Taxation Law Amendment Bill 2015”, 24 November 2015 <http://www.treasury.gov.za/publications/retirementreform/20151124%20Advantages%20of%20reform%20s.pdf> Prior to 1 March 2016, employer contributions made to pension and provident funds were not regarded as taxable fringe benefits.

<sup>71</sup> Section 11F (4) of the Income Tax Act No.58 of 1962

<sup>72</sup> South African Revenue Service, Tax Statistics 2021 Main Document, page 34, <https://www.sars.gov.za/wp-content/uploads/Docs/TaxStats/2021/Tax-Statistics-2021-Main-document.pdf>

**Table 2: SARS Tax Statistics – Taxable fringe benefits provided by employers to employees for the 2017 to 2020 years of assessment<sup>73</sup>**

**Table A2.6.1: Assessed individual taxpayers: Fringe benefits, 2017 – 2020**

Tax year	2017 [97.1% assessed]		2018 [96.9% assessed]		2019 [96.1% assessed]		2020 [96.2% assessed]	
	Number of taxpayers	Amount (R million)	Number of taxpayers	Amount (R million)	Number of taxpayers	Amount (R million)	Number of taxpayers	Amount (R million)
3801 Acquisition of asset at less than the actual value <sup>1</sup>	1 371 338	5 630	1 357 918	5 771	1 233 663	5 905	1 269 287	6 170
3802 Right of use of motor vehicle	83 907	6 933	80 493	7 113	75 816	7 287	72 094	7 252
3803 Right of use of asset	24	1	13	3	14	1	9	0
3804 Meals and refreshments vouchers	40	0	38	0	9	0	2	0
3805 Free or cheap residential / holiday accommodation	94 013	2 261	90 636	2 253	73 946	2 106	72 636	2 130
3806 Free or cheap services	131 131	367	138 370	387	114 248	327	125 173	363
3807 Low or interest-free loans: house	75	1	63	1	28	1	18	0
3808 Payment of employees' debt	495 936	3 931	451 835	3 930	387 823	3 781	388 194	3 928
3809 Bursaries and scholarships	6 314	95	4 858	88	9 140	117	11 445	177
3810 Medical aid paid on behalf of employee	2 091 504	56 967	2 009 122	59 365	1 707 895	55 057	1 739 290	59 515
Other <sup>1</sup>	8 967	326	11 463	2 174	0	367	10 320	394
Foreign fringe benefits <sup>2</sup>	3 436	84	3 746	91	3 734	93	3 267	86
<b>Pension and provident fund<sup>3</sup></b>	<b>3 692 762</b>	<b>113 594</b>	<b>3 561 493</b>	<b>118 941</b>	<b>2 969 017</b>	<b>109 418</b>	<b>3 031 793</b>	<b>116 210</b>
<b>Total</b>		<b>190 191</b>		<b>200 117</b>		<b>184 461</b>		<b>196 225</b>
<b>Percentage of total</b>								
3801 Acquisition of asset at less than the actual value <sup>1</sup>		3,0%		2,9%		3,2%		3,1%
3802 Right of use of motor vehicle		3,6%		3,6%		4,0%		3,7%
3803 Right of use of asset		0,0%		0,0%		0,0%		0,0%
3804 Meals and refreshments vouchers		0,0%		0,0%		0,0%		0,0%
3805 Free or cheap residential / holiday accommodation		1,2%		1,1%		1,1%		1,1%
3806 Free or cheap services		0,2%		0,2%		0,2%		0,2%
3807 Low or interest-free loans: house		0,0%		0,0%		0,0%		0,0%
3808 Payment of employees' debt		2,1%		2,0%		2,0%		2,0%
3809 Bursaries and scholarships		0,0%		0,0%		0,1%		0,1%
3810 Medical aid paid on behalf of employee		30,0%		29,7%		29,8%		30,3%
Other <sup>1</sup>		0,2%		1,1%		0,2%		0,2%
Foreign fringe benefits <sup>2</sup>		0,0%		0,0%		0,1%		0,0%
<b>Pension and provident fund<sup>3</sup></b>		<b>59,7%</b>		<b>59,4%</b>		<b>59,3%</b>		<b>59,2%</b>
<b>Total</b>		<b>40,3%</b>		<b>40,6%</b>		<b>40,7%</b>		<b>100,0%</b>

1. Includes insurance policies ceded to individual and any other benefit or asset received.

2. Foreign fringe benefits (codes 3851 to 3863).

3. Pension, retirement annuity and provident fund contributions (codes 3817 to 3819, 3825 to 3828) resulting from retirement reform announced from 1 March 2016 in section 11F (replacement of section 11(k)) of the Income Tax Act.

<sup>73</sup> South African Revenue Service, Tax Statistics, Personal Income Tax – chapter 2, Table A2.6.1: Assessed individual taxpayers: Fringe benefits, 2017 – 2020, 2021, <https://www.sars.gov.za/about/sas-tax-and-customs-system/tax-statistics/>

### **2.3. Taxation of amounts received by or accrued to a taxpayer on retirement or withdrawal from funds**

In terms of the rules of the various retirement funds outlined previously, amounts received by or accrued to a taxpayer from retirement funds will either take the form of an annuity or a lump sum benefit.

#### **2.3.1 Annuity payments**

Any “annuity” received by or accrued to a taxpayer must be included in gross income.

<sup>74</sup> The term “annuity” is not defined in the legislation. In *KBI en ‘n Ander v Hogan 55 SATC 329* an annuity was authoritatively defined for the purposes of the Income Tax Act as a periodic payment, where the recipient has the right to receive more than one payment, and where each payment received does not reduce any principal sum.<sup>75</sup> A periodic payment received from a pension fund upon retirement satisfies all three essential requirements of this definition. Annuities form part of a taxpayer’s taxable income and are subject to normal tax in terms of the progressive tax rates which apply to individual taxpayers.<sup>76</sup>

#### **2.3.2 Lump sum benefits**

Any “retirement fund lump sum benefit or retirement fund lump sum withdrawal benefit” received by or accrued to a taxpayer must be included in gross income.<sup>77</sup> A “retirement fund lump sum benefit” is defined<sup>78</sup> as an amount determined in terms of paragraph 2(1)(a) or (c) of the Second Schedule to the Act, whereas a “retirement fund lump sum withdrawal benefit” is defined<sup>79</sup> as an amount determined in terms of paragraph 2(1)(b) of the Second Schedule to the Act. The provisions of paragraph 2 are subject to

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<sup>74</sup> By virtue of special inclusion paragraph (a) to the gross income definition in section 1 of the Income Tax Act No.58 of 1962

<sup>75</sup> *KBI en ‘n Ander v Hogan 55 SATC 329*

<sup>76</sup> South African Revenue Service, Rates of Tax for Individuals, <https://www.sars.gov.za/tax-rates/income-tax/rates-of-tax-for-individuals/>

<sup>77</sup> By virtue of special inclusion paragraph (e) to the gross income definition in section 1 of the Income Tax Act No.58 of 1962. This special inclusion excludes receipts or accruals from Public Sector retirement funds, as these are dealt with in terms of paragraph (eA) of the gross income definition. This exclusion, therefore, aligns with the scope of this study as outlined in Chapter 1.

<sup>78</sup> in section 1 of the Income Tax Act No.58 of 1962

<sup>79</sup> *Ibid.*

section 9(2)(i)<sup>80</sup> which means that the source rule overrides the special inclusion rule. Source will be dealt with later in this chapter.

A “lump sum benefit” is defined<sup>81</sup> as including an amount (other than an annuity) determined in respect of commutation (or conversion) of an annuity (or part thereof) which is due from a retirement fund because of current or previous membership, as well as any fixed amount (other than an annuity) payable in consequence of current or previous membership. Events such as retirement, death, or termination or loss of employment (hereafter referred to as “retrenchment”) potentially give rise to lump sums that fall within the category “retirement lump sum benefits”, whereas lump sums arising in any other context (such as awards in terms of a divorce order, transfers between funds, resignation from a fund, or the winding up of the fund) fall within the category “retirement lump sum withdrawal benefits”.<sup>82</sup> Retirement lump sum benefits as well as retirement lump sum withdrawal benefits are made at the election of the taxpayer. This distinction is important, as the way the paragraph (e) gross income inclusion amount is determined, and the applicable rate of taxation is affected by this classification.

#### 2.3.2.1 **Retirement fund lump sum benefits**

##### Retirement, death, or retrenchment

Paragraph 2(1)(a)<sup>83</sup> prescribes the basis of determination of the amount to be included into paragraph (e) of the gross income definition in the event of a lump sum benefit received upon retirement, death, or retrenchment. The gross income inclusion will be the net amount, calculated as the lump sum benefit received by or accrued to a taxpayer less any paragraph 5 or 6 deductions.

Paragraph 5 deals with deductions in respect of benefits upon retirement or death; whereas paragraph 6 deals with deductions in respect of benefits due to transfers to other funds before the normal retirement age<sup>84</sup> as a result of retrenchment. In terms of both paragraphs, a taxpayer is allowed to deduct the sum of any contributions made

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<sup>80</sup> Preamble to paragraph 2(1) of the Second Schedule to the Income Tax Act No.58 of 1962

<sup>81</sup> Paragraph 1 of the Second Schedule to the Income Tax Act No.58 of 1962

<sup>82</sup> Second Schedule to the Income Tax Act No. 58 of 1962

<sup>83</sup> of the Second Schedule to the Income Tax Act No.58 of 1962

<sup>84</sup> As defined in section 1 of the Income Tax Act No.58 of 1962

to retirement funds that did not qualify as a deduction in terms of section 11F (including contributions made to a provident fund prior to the introduction of section 11F), to the extent that these were not allowed as a deduction in terms of the Second Schedule in a year of assessment subsequent to their initial disqualification or as an exemption in terms of section 10C, as well as any amounts transferred from one fund to another fund for the benefit of the member on retrenchment.<sup>85</sup>

The aggregate deductions allowed may not exceed the lump sum benefit received by or accrued to a taxpayer in any year of assessment. Any disallowed deductions will be carried forward to the next year of assessment or applied against the annuity (in terms of section 10C).<sup>86</sup>

#### Transfers on or after normal retirement age but before retirement date

Transfers from a pension and/or provident fund to a preservation fund and/or retirement annuity fund could occur where a member chooses to continue working after the normal retirement age<sup>87</sup> and postpones retirement to a later date to retain their benefits and increase their available retirement funds. This later date is referred to as the “retirement date”, which is defined as the date on which the member has elected to retire (which must be on or after the normal retirement age) and becomes entitled to a benefit (either an annuity or a lump sum) in terms of the rules of the fund.<sup>88</sup>

Previously, the transfers between retirement funds were restricted, as it was believed to be administratively burdensome. These restrictions were, however, removed (with effect from 1 March 2019) after the retirement fund industry indicated that the system changes required for the transfers between retirement funds would not be too onerous.<sup>89</sup>

Paragraph 2(1)(c)<sup>90</sup> prescribes the basis of determination of the amount to be included by virtue of paragraph (e) of the gross income definition in the event of a lump sum

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<sup>85</sup> Paragraph 5(1) and paragraph 6(1) of the Second Schedule to the Income Tax Act No.58 of 1962

<sup>86</sup> Paragraph 5(2) and paragraph 6(2) of the Second Schedule to the Income Tax Act No.58 of 1962

<sup>87</sup> As defined in section 1 of the Income Tax Act No.58 of 1962

<sup>88</sup> Section 1 of the Income Tax Act No.58 of 1962

<sup>89</sup> Explanatory Memorandum on the Taxation Laws Amendment Bill, 2018 (issued by National Treasury on 17 January 2019)

<sup>90</sup> of the Second Schedule to the Income Tax Act No.58 of 1962

benefit received upon transfer (from one fund to another) on or after normal retirement age<sup>91</sup> but before retirement date. The gross income inclusion will be the net amount, calculated as the lump sum benefit received by or accrued to a taxpayer less any paragraph 6A deductions, being the sum of any transfers made between retirement funds.<sup>92</sup>

#### Retirement fund lump sum benefit tax table

The normal tax rates applied to retirement fund lump sum benefits are more advantageous than if the lump sum were taxed with the rest of taxable income (i.e., in terms of the progressive tax tables for individual taxpayers). The first R550 000 of cumulative retirement fund lump sum benefits is tax-free, and the amounts that exceed this threshold are taxed at lower rates than the equivalent amount of regular taxable income (calculated in terms of the progressive tax tables for individual taxpayers).<sup>93</sup> From 1 March 2014, the tax-free portion of the lump sum benefits increased from R315 000 to R500 000 to align with Government's wider retirement reform objectives. The reform objectives include encouraging more people to save for retirement and to preserve their retirement savings. In addition, the large increase in the tax-free portion for retirement lump sum benefits aimed to avoid instances where lower income earning individuals may be required to pay tax on their lump sum benefits despite not benefitting from a deduction due to their taxable income falling below the tax-free threshold.<sup>94</sup> From 1 March 2023, the tax-free portion of the lump sum benefits increased from R500 000 to R550 000 to account for the impact of inflation over several years.<sup>95</sup>

The retirement fund lump sum benefits tax table works on a cumulative basis. This means that a taxpayer first needs to calculate their normal tax on the aggregate of the

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<sup>91</sup> As defined in section 1 of the Income Tax Act No.58 of 1962

<sup>92</sup> Paragraph 6A of the Second Schedule to the Income Tax Act No.58 of 1962

<sup>93</sup> South African Revenue Service, Rates of Tax for Individuals, <https://www.sars.gov.za/tax-rates/income-tax/rates-of-tax-for-individuals/>

<sup>94</sup> National Treasury, "2014 Budget Review", 26 February 2014, <http://www.treasury.gov.za/documents/national%20budget/2014/review/FullReview.pdf>

<sup>95</sup> \_South African Revenue Service, Retirement Lump Sum Benefits, <https://www.sars.gov.za/tax-rates/income-tax/retirement-lump-sum-benefits/>; Carrie Norden, "Unpacking the changes to the retirement fund lump sum tax tables", Allan Gray, 11 April 2023, <https://www.allangray.co.za/latest-insights/personal-investing/unpacking-the-changes-to-the-retirement-fund-lump-sum-tax-tables/>

current year and any prior year lump sum benefits received. This amount is reduced by the recalculated tax on the prior year lump sum benefits received to arrive at the normal tax due on the current lump sum benefit.

### **2.3.2.2 Retirement fund lump sum withdrawal benefits**

#### **Any other event**

Paragraph 2(1)(b)(ii)<sup>96</sup> prescribes the basis of determination of the amount to be included into paragraph (e) of the gross income definition in the event of a lump sum benefit received in any other event (i.e., a withdrawal). The normal tax effects are similar to those discussed above. The relevant deductions are outlined in paragraph 6<sup>97</sup> (as discussed above). In addition, a taxpayer is allowed to claim a deduction for any transfers made to any other retirement fund (for example, to that of a new employer).<sup>98</sup> Such amounts will be considered for tax when they are received in the form of either a lump sum or an annuity from the fund to which they are transferred.

#### **Retirement fund lump sum withdrawal benefit tax table**

The normal tax rates applied to retirement fund lump sum withdrawal benefits are less favorable than those applied to retirement fund lump sum benefits. Since 1 March 2014, only the first R25 000 was tax-free.<sup>99</sup> From 1 March 2023, the tax-free portion increased from R25 000 to R27 500 to account for inflation.<sup>100</sup> The retirement fund lump sum withdrawal benefits tax table also works on a cumulative basis.

Government imposes a substantial tax on withdrawals made prior to retirement as a disincentive to depleting savings before retirement.<sup>101</sup> This may seem controversial as many members of retirement funds find themselves in need of funds in emergencies (due to a lack of short-term savings) which may lead to them having to resign from

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<sup>96</sup> of the Second Schedule to the Income Tax Act No.58 of 1962

<sup>97</sup> Ibid.

<sup>98</sup> Paragraph 6(1)(a) of the Second Schedule to the Income Tax Act No.58 of 1962

<sup>99</sup> National Treasury, “2014 Budget Review”, 26 February 2014, <http://www.treasury.gov.za/documents/national%20budget/2014/review/FullReview.pdf>

<sup>100</sup> South African Revenue Service, Retirement Lump Sum Benefits, <https://www.sars.gov.za/tax-rates/income-tax/retirement-lump-sum-benefits/>; Carrie Norden, “Unpacking the changes to the retirement fund lump sum tax tables”, Allan Gray, 11 April 2023, <https://www.allangray.co.za/latest-insights/personal-investing/unpacking-the-changes-to-the-retirement-fund-lump-sum-tax-tables/>

<sup>101</sup> National Treasury, “Encouraging South African households to save more for retirement”, 14 December 2021 [http://www.treasury.gov.za/comm\\_media/press/2021/2021121401%20Two-pot%20system%20retirement%20proposal%20and%20auto%20enrolment.pdf](http://www.treasury.gov.za/comm_media/press/2021/2021121401%20Two-pot%20system%20retirement%20proposal%20and%20auto%20enrolment.pdf)

their employment to access retirement savings.<sup>102</sup> National Treasury is currently working on reforms to allow members limited access to their retirement savings without placing their employment at risk (as discussed in section 2.1.3 above), while still preserving savings for retirement (to align with government's long-term objectives).<sup>103</sup>

## **2.4. Taxation of amounts received by or accrued to a taxpayer subsequent to emigration from South Africa**

### **2.4.1 Resident vs non-resident**

A natural person is defined as being a "resident" for South African tax purposes if such natural person is:

- "Ordinarily resident"<sup>104</sup> in South Africa; or
- If not ordinarily resident during any time of a year of assessment, by virtue of satisfying all requirements of the physical presence test;<sup>105</sup> and
- Not deemed to be a resident of another country by the application of a double tax agreement ("DTA") between the government of the Republic of South Africa and that other country.<sup>106</sup>

The term "ordinarily resident" is not defined in the legislation, so one needs to look to the decisions in *Cohen v CIR 13 SATC 362* and *CIR v Kuttel 1992 (3) SA 242 (A)* for guidance.

In *Cohen v CIR*,<sup>107</sup> it was held that a taxpayer is "ordinarily resident in the country to which he would naturally and as a matter of course return from his wanderings, it might be called his usual or principal residence and his real home". This was confirmed in

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<sup>102</sup> Ibid.

<sup>103</sup> National Treasury, "Advantages of the tax and retirement reforms contained in the Taxation Law Amendment Bill 2015", 24 November 2015 [http://www.treasury.gov.za/publications/retirementreform/20151124%20Advantages%20of%20reform\\_s.pdf](http://www.treasury.gov.za/publications/retirementreform/20151124%20Advantages%20of%20reform_s.pdf); National Treasury, "Encouraging South African households to save more for retirement", 14 December 2021 [http://www.treasury.gov.za/comm\\_media/press/2021/2021121401%20Two-pot%20system%20retirement%20proposal%20and%20auto%20enrolment.pdf](http://www.treasury.gov.za/comm_media/press/2021/2021121401%20Two-pot%20system%20retirement%20proposal%20and%20auto%20enrolment.pdf)

<sup>104</sup> Paragraph (a)(i) of the definition of "resident" in section 1 of the Income Tax Act No.58 of 1962

<sup>105</sup> Paragraph (a)(ii) of the definition of "resident" in section 1 of the Income Tax Act No.58 of 1962

<sup>106</sup> Proviso to the definition of "resident" in section 1 of the Income Tax Act No.58 of 1962

<sup>107</sup> 13 SATC 362

*CIR v Kuttel*,<sup>108</sup> where it was held that a taxpayer is “ordinarily resident where he has his usual or principal residence, i.e., what may be described as his real home”.

The assessment of “ordinarily resident” is, therefore, one of fact; is not dependent on the number of days the natural person was physically present in South Africa, and is not restricted to the particular year under review (the mode of life before, during and after the relevant year can be considered).<sup>109</sup>

A natural person who does not satisfy the requirements of “ordinarily resident” may still be regarded as a resident for South African tax purposes if such person satisfies all requirements of the physical presence test. To satisfy all requirements of the physical presence test, the natural person must be present in South Africa for:

- “More than 91 days in the current year of assessment; and
- More than 91 days in the previous five years of assessment; and
- More than 915 days in aggregate in the previous five years of assessment”.<sup>110</sup>

Where a natural person is found to be a resident in terms of the laws of South Africa and another country, the relevant article contained in the DTA between the two countries needs to be considered. The application of a DTA could override the South African domestic tests indicated above and could deem a natural person to be exclusively a resident of another country.<sup>111</sup> Any natural person who fails to satisfy the definition of “resident”<sup>112</sup> will be classified as a “non-resident”.

#### 2.4.2 **Source rules**

Members of retirement funds who cease to be resident as defined for South African tax purposes will only be subject to tax on South African source income.

Any annuity or lump sum benefit from a retirement fund received by or accrued to a non-resident member will be from a South African source if the services in respect of

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<sup>108</sup> 1992 (3) SA 242 (A)

<sup>109</sup> Cohen v CIR 13 SATC 362

<sup>110</sup> Paragraph (a)(ii) (aa) and (bb) of the definition of “resident” in section 1 of the Income Tax Act No.58 of 1962

<sup>111</sup> Proviso to the definition of “resident” in section 1 of the Income Tax Act No.58 of 1962

<sup>112</sup> in section 1 of the Income Tax Act No.58 of 1962

which that amount is so received by or accrued to were rendered in South Africa.<sup>113</sup> If the services were rendered partly in South Africa and partly outside South Africa while contributing to the retirement fund, the receipt or accrual should be apportioned, and only the portion relating to the services rendered in South Africa will be regarded as being from a South African source.<sup>114</sup> The amount to be included in gross income<sup>115</sup> will be calculated as the lump sum benefit or annuity received by or accrued to the member multiplied by the period of services provided in South Africa divided by the total period of services provided.<sup>116</sup> The legislation does not provide guidance on how the period should be determined. The most reasonable basis to use would be linked to how often contributions to the retirement fund were made (i.e., if contributions were made monthly, the apportionment should be done monthly; whereas if contributions were made weekly, the apportionment should be done on a weekly basis).<sup>117</sup>

Based on the provisions of the South African Income Tax Act only (i.e., ignoring the application of any DTA), South Africa has taxing rights over any retirement benefits paid to non-residents in respect of services rendered wholly or partly in South Africa.

### 2.4.3 **Double tax agreements**

#### **Residence**

The OECD MTC contains the following rules which will be considered in making the assessment of where a natural person is resident (commonly referred to as the “tie-breaker rules”):

- “A natural person shall be deemed to be a resident solely in the country in which the natural person has a permanent home;
- If a permanent home is available in both countries, a natural person shall be deemed to be a resident solely in the country in which the natural person’s personal and economic relations are closer (centre of vital interests);

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<sup>113</sup> Section 9(2)(i) of the Income Tax Act No.58 of 1962

<sup>114</sup> Proviso to section 9(2)(i) of the Income Tax Act No.58 of 1962

<sup>115</sup> via paragraph (a) or (e) of the gross income definition in section 1 of the Income Tax Act No.58 of 1962

<sup>116</sup> Proviso to section 9(2)(i) of the Income Tax Act No.58 of 1962

<sup>117</sup> Chapter 2.6.9 of Notes on South African Income Tax (Phillip Haupt, Elke Haupt), Hedron Tax Consulting and Publishing CC, Republic of South Africa, 2022

- If sole residence cannot be determined based on the above, a natural person shall be deemed to be a resident solely in the country where the natural person has a habitual abode;
- If a habitual abode is available in both countries or in neither of them, a natural person shall be deemed to be a resident solely in the country in which the natural person is a national;
- If a natural person is a national in both countries or in neither of them, the competent authorities of South Africa and the other country shall settle the question by mutual agreement.”<sup>118</sup>

A recent United Kingdom (“UK”) ruling in the matter of *Jonathan Oppenheimer v HMRC*,<sup>119</sup> demonstrates how comprehensive and complex an assessment of a natural person’s residency status can be. In this case, it was noted that HMRC (the respondent) argued that the taxpayer was treaty resident in the United Kingdom; whereas Jonathan Oppenheimer (the appellant) argued that he was treaty resident in South Africa. The taxpayer appealed to the court seeking a proper application of article 4(2) of the DTA between South Africa and the United Kingdom. In making its decision, the court needed to make a detailed assessment of all relevant facts and circumstances, which included the following aspects – family, work, permanent homes, time spent in each country, assets and wealth, significant events and friendships, hobbies, political, philanthropic, cultural, and business involvement, as well as health service providers. Applying the relevant tie-breaker rules contained in article 4(2)<sup>120</sup>, it was held that the taxpayer was treaty resident in South Africa as his personal and economic relations were closer to South Africa. In addition, it was held that even if the personal and economic relations were not closer to South Africa, the taxpayer would still be regarded as treaty resident in South Africa due to his nationality (the habitual abode factor could not be relied upon as he had that in both countries).<sup>121</sup>

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<sup>118</sup> Article 4(2) of the Double Tax Agreement between South Africa and United Kingdom, page 339 of the Income Tax Act No. 58 of 1962

<sup>119</sup> [2022] UKFT 00112 (TC)

<sup>120</sup> of the Double Tax Agreement between South Africa and United Kingdom, page 339 of the Income Tax Act No. 58 of 1962

<sup>121</sup> Jonathan Oppenheimer v HMRC [2022] UKFT 00112 (TC)

## Article 18 of the OECD MTC

Section 108<sup>122</sup> seeks to provide relief where the same income may be subject to tax in more than one country and allows the rules of the double tax agreement to override the South African Income Tax Act.

Article 18 of the OECD MTC deals with pensions payable by private sector retirement funds. This article provides a single rule stating that pensions payable to a resident of another country in respect of past employment shall be taxable only in that other country.<sup>123</sup> This means that the resident country has exclusive taxing rights<sup>124</sup> and this article, read together with section 108 of the Income Tax Act,<sup>125</sup> has the effect of overriding the source rules provided in South African Income Tax Act.

### **2.4.4 Emigration**

The term “emigration” is defined as the act of “leaving one’s own country to settle permanently in another”.<sup>126</sup> The concept of “financial emigration” as recognised by the South African Reserve Bank (“SARB”) for exchange control purposes has been phased out with effect from 1 March 2021<sup>127</sup> and has been replaced with a three-year tax residency test.<sup>128</sup> The change from financial emigration to three-year residency test

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<sup>122</sup> of the Income Tax Act No. 58 of 1962

<sup>123</sup> Article 18 of the OECD Model Tax Convention on Income and on Capital (21 November 2017)

<sup>124</sup> OECD Commentary on Article 18 of the OECD Model Tax Convention on Income and on Capital, 21 November 2017, <https://www.oecd.org/ctp/treaties/model-tax-convention-on-income-and-on-capital-condensed-version-20745419.htm>; Patricia A. Brown, Articles 18 and 19(2): Pensions/Pensions and Social Security Payments – Global Tax Treaty Commentaries, Global Topics, IBFD, 30 September 2017

<sup>125</sup> No. 58 of 1962

<sup>126</sup> South African Concise Oxford Dictionary, ISBN 978 0 19 571804 1, Oxford University Press Southern Africa (Pty) Ltd, Cape Town, Republic of South Africa, 1999, page 378. The term “emigration” is not defined in legislation, and there are no authoritative South African judgements dealing with this term. One, therefore, needs to look at the ordinary dictionary meaning for guidance.

<sup>127</sup> South African Reserve Bank, “Currency and Exchanges Manual for Authorised Dealers”, 23 February 2022, page 84, <https://www.resbank.co.za/content/dam/sarb/what-we-do/financial-surveillance/financial-surveillance-documents/2020/Currency%20and%20Exchanges%20Manual%20for%20Authorised%20Dealers.pdf>

<sup>128</sup> Lize de la Harpe, “Withdrawing retirement funds on emigration: The impact of the Taxation Laws Amendment Act”, 3 March 2021, <https://www.bizcommunity.com/Article/196/512/213581.html>

was outlined in the 2020 Budget Review and was implemented by government to modernize the foreign exchange control system.<sup>129</sup>

Under the old “financial emigration” process as recognised by the SARB, an individual was required to submit an MP336(b) form to an authorised South African commercial bank (also known as an authorised dealer). The MP336(b) form was part of the application process to emigrate financially and was essentially a declaration of any remaining South African assets and liabilities.<sup>130</sup> In addition, the individual was required to apply for an emigration Tax Clearance Certificate from the South African Revenue Service (“SARS”). This application included a statement of assets and liabilities for the previous three tax years, a capital gains tax calculation on the deemed disposal of assets on the day before ceasing to be a resident, as well as details of all retirement funds, insurance policies, trusts, business interests, loans, donations, inheritances, property, and income.<sup>131</sup> The authorised dealer was responsible for verifying all supporting documentation submitted prior to the application being approved by SARB. The emigration process was very stringent and there were restrictions placed on the non-resident’s bank accounts upon emigration.<sup>132</sup> The restrictions on such bank accounts were only removed once the SARB financial emigration process was finalised.<sup>133</sup>

The verification process from an authorised dealer as well as approval from the SARB falls away under the new emigration process (effective from 1 March 2021). The new emigration process is now administered by SARS and focusses exclusively on the tax residency status of the individual. Once the individual taxpayer has proven their non-residency status to SARS and is tax compliant, SARS will issue an Emigration Tax

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<sup>129</sup> Ibid.

<sup>130</sup> FinGlobal, “MP 336(b) Form: What it is & why you need it”, 31 August 2020, <https://www.finglobal.com/2020/08/31/mp-336b-form/>

<sup>131</sup> Craig Torr, “The process of financial emigration”, 9 November 2020, <https://www.moneyweb.co.za/financial-advisor-views/the-process-of-financial-emigration/>

<sup>132</sup> Ibid.; BusinessTech, “South Africa’s financial emigration system has changed, 1 March 2021”, <https://businesstech.co.za/news/finance/471824/south-africas-financial-emigration-system-has-changed-here-are-the-new-rules/>

<sup>133</sup> Eric Jordaan, “Financial emigration: what is it and when is it appropriate?”, 12 October 2020, <https://www.moneyweb.co.za/financial-advisor-views/financial-emigration-what-is-it-and-when-is-it-appropriate/>

Clearance Certificate. The non-residency status of an individual taxpayer is determined based on the two tax residency tests and needs to be proven at the time of leaving South Africa. In addition, SARS approval is required before any funds may be expatriated by an authorised dealer.<sup>134</sup>

The change from financial emigration to three-year residency test has a direct impact on the application of the South African Income Tax rules, as the tax legislation previously allowed for the payment of lump sum benefits when a member emigrated from South Africa as recognised by the SARB for exchange control purposes.<sup>135</sup> The legislation has, however, been amended with effect from 1 March 2021 to align with the new process.

The definitions for “retirement annuity fund”, “pension preservation fund” and “provident preservation fund”<sup>136</sup> contain the following updates, effective from 1 March 2021:

- Any resident member who emigrated from South Africa and whose emigration was recognised and approved by the SARB for exchange control purposes on or before 28 February 2021 will be entitled to a lump sum benefit payment upon emigration date.<sup>137</sup>
- Any resident member who emigrates from South Africa on or after 1 March 2021 (i.e., becomes a non-resident) will only be entitled to a lump sum benefit payment once such member has been a non-resident for an uninterrupted period of three years or longer.<sup>138</sup>

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<sup>134</sup> BusinessTech, “South Africa’s financial emigration system has changed, 1 March 2021”, <https://businesstech.co.za/news/finance/471824/south-africas-financial-emigration-system-has-changed-here-are-the-new-rules/>

<sup>135</sup> Lize de la Harpe, “Withdrawing retirement funds on emigration: The impact of the Taxation Laws Amendment Act”, 3 March 2021, <https://www.bizcommunity.com/Article/196/512/213581.html>

<sup>136</sup> in section 1 of the Income Tax Act No.58 of 1962

<sup>137</sup> Proviso (x)(dd)(A)(AA) to the definition of “retirement annuity fund”, proviso (c)(ii) (aa)(A) of the definition of “pension preservation fund” and proviso (c)(ii) (aa)(a) of the definition of “provident preservation fund” in section 1 of the Income Tax Act No.58 of 1962

<sup>138</sup> Proviso (x)(dd)(A)(BB) to the definition of “retirement annuity fund”, proviso (c)(ii) (aa)(B) of the definition of “pension preservation fund” and proviso (c)(ii) (aa)(b) of the definition of “provident preservation fund” in section 1 of the Income Tax Act No.58 of 1962

This means that an individual who emigrates from South Africa on or after 1 March 2021 will need to wait a minimum of three tax years before being entitled to any lump sum benefit from a retirement fund. This decision ignores the financial needs of the individual taxpayer at the time he or she leaves South Africa permanently. Individuals who emigrated and obtained approval from SARB prior to 1 March 2021 are unaffected by the above changes.

#### 2.4.5 **Illustrative example of the issue**

Included below is a brief example to illustrate the issue with the current tax treatment of retirement interests when emigrating from South Africa and changing tax residency status.

South African tax resident Mr A was employed in South Africa and contributed to a pension fund and retirement annuity fund since 1 March 1992. He received significant tax deductions over this period. On retirement, any benefits received by Mr A from the fund should be subject to tax in South Africa as part of his worldwide income.

On 1 March 2021, Mr A emigrated from South Africa and ceased to be resident in South Africa for income tax purposes from that date. Under the new exchange control rules, he is required to wait at least three tax years (i.e., on or after 1 March 2024) before he can receive retirement benefits from both South African retirement funds.

In terms of South African domestic legislation, such amounts should be subject to tax in South Africa based on the section 9(2)(i) source rules as the services were rendered in South Africa.

The application of a DTA, consistent with the provisions of Article 18 of the OECD MTC<sup>139</sup> will, however, result in the resident country having exclusive taxing rights in respect of the retirement benefits from the South African retirement funds (i.e., it overrides South African source rules, and results in South Africa losing its taxing rights over these amounts).

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<sup>139</sup> Note that Article 18 of the OECD MTC exclusively deals with pensions received by or accrued to a taxpayer from a private retirement fund. Payments from state retirement funds are dealt with in a separate article.

It would seem inequitable<sup>140</sup> for the South African government to lose its taxing rights on subsequent receipts or accruals from South African retirement funds.<sup>141</sup> The South African government granted large deductions to taxpayers for contributions to retirement funds in anticipation of the taxation of future receipts or accruals from such retirement funds; the other country bore no cost of providing any deductions but receives the exclusive right to tax receipts or accruals from such retirement funds (due to the application of a DTA). It was this perceived inequity that led to the National Treasury proposal to levy tax on retirement savings on emigration.

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<sup>140</sup> Julia Kagan, Investopedia, “Tax Fairness: What it means, examples, arguments for and against”, 29 October 2021, [https://www.investopedia.com/terms/t/tax\\_fairness.asp](https://www.investopedia.com/terms/t/tax_fairness.asp)

<sup>141</sup> Draft Explanatory Memorandum on the Taxation Laws Amendment Bill, 28 July 2021

### **3. Understanding the initial proposal issued by National Treasury**

#### **3.1 The initial proposal issued by National Treasury in 2021**

The 2021 Budget Review included a proposal to tax retirement interests deemed to have accrued to an individual taxpayer upon ceasing to be tax resident in South Africa.<sup>142</sup> Government proposed the insertion of section 9HC into the Income Tax Act No. 58 of 1962.<sup>143</sup> The proposed section 9HC would result in a deemed withdrawal of an individual taxpayer's interest in a retirement fund on the day before ceasing to be resident in South Africa. The effect of deeming the amount to accrue to the individual prior to ceasing to be resident results in South Africa having taxing rights over the amount, as a DTA cannot apply until such time that the individual is resident of the other country (i.e., the taxing rights are not forfeited under any DTA at that date). This deemed accrual could, therefore, potentially result in a normal tax liability due to SARS.<sup>144</sup>

As established in the previous chapter, when an individual taxpayer intends to leave South Africa permanently and ceases to be a resident prior to retirement, that taxpayer's retirement interest may be exclusively subject to tax in the resident country because of the application of a double tax agreement ("DTA"). This has the effect of overriding the section 9(2)(i)<sup>145</sup> source rule provided in the Income Tax Act, which results in South Africa losing its taxing rights<sup>146</sup> on receipts or accruals from South African retirement funds.

It is, therefore, not difficult to understand the discomfort of the South African government, especially considering the current trend in emigration of South African residents, many of whom have substantial retirement savings that have been built up

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<sup>142</sup> National Treasury, "2021 Budget Review", Annexure C, 24 February 2021 <http://www.treasury.gov.za/documents/national%20budget/2021/review/Annexure%20C.pdf>

<sup>143</sup> Draft Taxation Laws Amendment Bill, 28 July 2021

<sup>144</sup> Ibid.

<sup>145</sup> of the Income Tax Act No. 58 of 1962

<sup>146</sup> Draft Explanatory Memorandum on the Taxation Laws Amendment Bill, 28 July 2021

in South Africa over many years.<sup>147</sup> Based on data from various sources, it was noted that approximately 23 000 South African tax residents emigrate to other countries each year in search of greener pastures.<sup>148</sup> There are many DTAs entered into between South Africa and other countries where the sole taxing right on the South African retirement interest is granted to the other country. The list of countries includes but is not limited to the United Kingdom, Australia, New Zealand, the People's Republic of China, Hong Kong SAR, Denmark, Germany, Italy, Portugal, and Spain.<sup>149</sup> This implies that the loss to the South African government in this scenario could be significant. Hence, the initial proposal issued by National Treasury.<sup>150</sup>

The initial proposal issued by National Treasury was intended to achieve the following two outcomes:

- Ensure neutrality of the tax treatment for all types of retirement fund benefits (regardless of a taxpayer's residency status).<sup>151</sup> This was desired because the South African government provided taxpayers with large deductions for previous contributions made to retirement funds; and
- Ensure that there is a sound mechanism in place to verify that the retirement withdrawal tax is calculated on the correct value.<sup>152</sup> This was desired due to the timing difference between the date the taxpayer ceases to be a resident and the date the withdrawal occurs and tax is due (i.e., an uninterrupted period of three years or longer).<sup>153</sup> This means that the applicable tax rates and the deemed accrual would be based on the individual's value of the retirement interest immediately before ceasing to be a resident in South Africa; regardless

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<sup>147</sup> Kyle Mandy, Greg Smith, "Emigration and South African retirement funds: Proposal to tax withdrawals of retirement interests", July 2021, <https://www.pwc.co.za/en/assets/pdf/synopsis/synopsis-july-2021.pdf>

<sup>148</sup> Joon Chong, Wesley Grimm, "Tightening the noose on emigrants' retirement assets", Accountancy South Africa, April 2021, <http://magazine.accountancysa.org.za/asa-april-2021?m=52861&i=702647&p=104&ver=html5>

<sup>149</sup> Ibid.

<sup>150</sup> Ibid.

<sup>151</sup> Draft Explanatory Memorandum on the Taxation Laws Amendment Bill, 28 July 2021

<sup>152</sup> Ibid.

<sup>153</sup> Proviso (x)(dd)(A)(BB) to the definition of "retirement annuity fund", proviso (c)(ii) (aa)(B) of the definition of "pension preservation fund" and proviso (c)(ii) (aa)(b) of the definition of "provident preservation fund" in section 1 of the Income Tax Act No.58 of 1962

of the individual's intentions at the time.<sup>154</sup> For example, if at the time of ceasing to be a resident, the individual is not over retirement age, but will be after the three year waiting period, the tax liability in South Africa should be calculated using the retirement fund lump sum withdrawal table, and should be based on the deemed accrual as determined prior to ceasing to be a resident, together with associated interest (i.e., any growth in the retirement fund between the time that the individual ceased to be a resident in South Africa and the time the tax is due should not form part of the deemed accrual).

It was proposed that the new section 9HC would apply with effect from 1 March 2022 and that it would work as follows:<sup>155</sup>

- There would be a deemed withdrawal of the individual's interest in the retirement fund on the day before he or she ceases to be tax resident in South Africa.
- The deemed withdrawal would result in an amount deemed to accrue to the individual taxpayer in terms of paragraph 2(1)(b)(ii) of the Second Schedule.<sup>156</sup>
- This deemed accrual would be subject to tax in South Africa, calculated based on the current retirement fund lump sum withdrawal benefits table on the day before ceasing to be resident in South Africa, regardless of the taxpayer's intentions at that time (i.e., this is the first tax calculation).
- While the possible normal tax liability would be determined on the date before ceasing to be a South African tax resident, the deemed tax would only be due and payable on the date and to the extent that an amount is receivable from a retirement fund.
- The abovementioned deemed tax would, however, be increased by interest (determined at the rate provided in section 189 of the Tax Administration Act) on the remaining tax balance outstanding, until such time that the tax is paid in full.

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<sup>154</sup> Draft Explanatory Memorandum on the Taxation Laws Amendment Bill, 28 July 2021

<sup>155</sup> Ibid.

<sup>156</sup> to the Income Tax Act No.58 of 1962; Draft Taxation Laws Amendment Bill, 28 July 2021

- The actual accrual would be subject to tax in South Africa, calculated according to when the taxpayer wishes to withdraw his or her interest in the retirement fund (i.e., this is the second tax calculation).
  - If the taxpayer wishes to withdraw his or her interest prior to retirement or death, the actual tax would be calculated based on the current retirement fund lump sum withdrawal benefits table. Based on the current proposal, it is unclear whether this also applies to taxpayers who have already reached retirement age (as defined)<sup>157</sup> at the date of ceasing to be tax resident.
  - If the taxpayer retains his or her interest in the South African retirement fund and only withdraws his or her interest on death or retirement, the actual tax would be calculated based on the current retirement fund lump sum benefits tables or the progressive normal tax tables (if an annuity was received by or accrued to).
- The deemed tax (i.e., the first tax calculation) plus interest becomes payable at the date the actual withdrawal or retirement accrual occurs.
- A tax credit would be provided for the deemed tax as calculated when the individual ceased to be a South African tax resident (i.e., the first tax calculation). Based on the uncertainty in the current proposal (as discussed in 3.2.1.4 below), it is assumed that the tax credit for the deemed tax would be set off against any South African tax liability at the time an amount is receivable from a retirement fund (i.e., the first tax calculation would either reduce or eliminate the second tax calculation).<sup>158</sup> In the event that the amount is not subject to tax in South Africa (i.e., there is no second tax calculation), only the payment of the first deemed tax amount plus interest will be due to SARS (i.e., there will be no set off).

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<sup>157</sup> Section 1 of the Income Tax Act No.58 of 1962

<sup>158</sup> Joon Chong, Wesley Grimm, "Tightening the noose on emigrants' retirement assets", Accountancy South Africa, April 2021, <http://magazine.accountancysa.org.za/asa-april-2021?m=52861&i=702647&p=104&ver=html5>

The taxpayer would be responsible for ensuring that a valuation of the retirement interest is performed on the date before ceasing to be a resident and to notify SARS of the change in their residency status.<sup>159</sup>

## **3.2 Key issues with the initial proposal**

The initial proposal to insert section 9HC into the South African Income Tax Law raised numerous concerns amongst experts in the industry. The following key issues were raised.

### **3.2.1 Summary of key issues with the initial proposal**

#### **3.2.1.1 Overriding some existing DTAs between South Africa and other countries**

The Constitution provides that an international agreement (i.e., DTA) entered into between South Africa and another country binds the Republic (once it has been approved by resolution in both the National Assembly and the National Council of Provinces),<sup>160</sup> and becomes law in the Republic (when it is enacted into law by national legislation).<sup>161</sup> Section 108(2),<sup>162</sup> furthermore, provides that the provisions of a DTA shall have effect as if enacted in this Act once it has been approved by Parliament and published in the Gazette.

The initial proposal to insert section 9HC into the Act would contravene South Africa's obligations under international law, as it would be inconsistent with some of South Africa's DTAs with other countries.<sup>163</sup> This is seen as controversial,<sup>164</sup> and overriding

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<sup>159</sup> Draft Explanatory Memorandum on the Taxation Laws Amendment Bill, 28 July 2021

<sup>160</sup> Section 231(2) of the Constitution of the Republic of South Africa, 1996

<sup>161</sup> Section 231(4) of the Constitution of the Republic of South Africa, 1996; Done Howell, BDO, "Cessation of tax residency: tax triggers for retirement fund interests", 13 September 2021, <https://www.bdo.co.za/en-za/insights/2021/tax/cessation-of-tax-residency-tax-triggers-for-retirement-fund-interests>

<sup>162</sup> of the Income Tax Act No.58 of 1962

<sup>163</sup> CDH Incorporated, "Exit charge on retirement fund interests when ceasing residency", 16 September 2021, <https://www.cliffedekkerhofmeyr.com/news/publications/2021/Tax/tax-alert-16-september-Exit-charge-on-retirement-fund-interests-when-ceasing-residency.html>

<sup>164</sup> Draft Response Document on the 2021 Draft Taxation Laws Amendment Bill, 10 November 2021

negotiated terms of existing DTAs could remove the certainty afforded to taxpayers.<sup>165</sup> It could be argued that removing such certainty is in contravention of the Promotion of Administrative Justice Act, No.3 of 2000, to which National Treasury and SARS are bound.<sup>166</sup>

In addition, it was noted that the initial proposal does not align with the OECD MTC's policy and administrative considerations. The commentary on the OECD MTC supports the principle that a taxpayer should only have an administrative burden to comply with tax obligations in his or her resident country (i.e., not in multiple countries).<sup>167</sup> The effect of the initial proposal would result in tax administrative responsibilities in both South Africa and the taxpayer's new resident country, since the tax due in South Africa would only become payable subsequent to the taxpayer ceasing to be tax resident in South Africa.

In *CSARS v Tradehold Ltd*,<sup>168</sup> the Supreme Court of Appeal held that where there is a conflict between a DTA and the Act, the DTA modifies South African domestic law and will apply in preference to such law. Based on National Treasury's initial proposal, it is unclear how these conflicting provisions would be reconciled.

### 3.2.1.2 **Potential double taxation of the same amount**

Bypassing existing DTAs between South Africa and other countries could potentially result in double taxation of the same amount for the individual taxpayer upon emigration from South Africa.<sup>169</sup> The insertion of the new section 9HC into the South African Income Tax Act would result in a deemed withdrawal of the taxpayer's retirement interests upon ceasing to be a resident in South Africa (i.e., upon

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<sup>165</sup> Kyle Mandy, Greg Smith, "Emigration and South African retirement funds: Proposal to tax withdrawals of retirement interests", July 2021, <https://www.pwc.co.za/en/assets/pdf/synopsis/synopsis-july-2021.pdf>

<sup>166</sup> Done Howell, BDO, "Cessation of tax residency: tax triggers for retirement fund interests", 13 September 2021, <https://www.bdo.co.za/en-za/insights/2021/tax/cessation-of-tax-residency-tax-triggers-for-retirement-fund-interests>

<sup>167</sup> Kyle Mandy, Greg Smith, "Emigration and South African retirement funds: Proposal to tax withdrawals of retirement interests", July 2021, <https://www.pwc.co.za/en/assets/pdf/synopsis/synopsis-july-2021.pdf>

<sup>168</sup> (132/11) [2012] ZASCA 61

<sup>169</sup> Kyle Mandy, Greg Smith, "Emigration and South African retirement funds: Proposal to tax withdrawals of retirement interests", July 2021, <https://www.pwc.co.za/en/assets/pdf/synopsis/synopsis-july-2021.pdf>

emigration); the subsequent application of the DTA on withdrawal or retirement from the fund grants the other (resident) country sole taxing rights on subsequent receipts from the South African retirement fund.<sup>170</sup> The initial proposal, therefore, appears to be misaligned with the spirit and overall purpose of tax treaties, namely the avoidance of double taxation.<sup>171</sup>

### 3.2.1.3 **Tax Administration Act (“TAA”) override**

The initial proposal indicates that payment of the tax on the deemed accrual, together with interest charged thereon, will be deferred to the date and to the extent that an amount is received from a retirement fund.<sup>172</sup> The interest charged would be determined at the rate provided in section 189 of the TAA<sup>173</sup> and would be charged on the tax balance deferred, until such time that the tax is paid in full.<sup>174</sup> Section 187(3) of the TAA,<sup>175</sup> however, provides that interest on late payments may only be charged on debt that is due and payable under a tax Act. It is, therefore, questionable whether it is reasonable or even constitutional to charge interest on a tax debt which is not yet due.<sup>176</sup>

### 3.2.1.4 **Uncertainty in the initial proposal**

Various aspects in the initial proposal are unclear. These include the following:

- The proposal is unclear as to how the payment of the tax on the deemed accrual plus interest will need to be made. It seems to suggest that the payment will be

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<sup>170</sup> Done Howell, BDO, “Cessation of tax residency: tax triggers for retirement fund interests”, 13 September 2021, <https://www.bdo.co.za/en-za/insights/2021/tax/cessation-of-tax-residency-tax-triggers-for-retirement-fund-interests>

<sup>171</sup> Ibid.

<sup>172</sup> Draft Explanatory Memorandum on the Taxation Laws Amendment Bill, 28 July 2021; Joon Chong, Wesley Grimm, “Tightening the noose on emigrants’ retirement assets”, Accountancy South Africa, April 2021, <http://magazine.accountancysa.org.za/asa-april-2021?m=52861&i=702647&p=104&ver=html5>

<sup>173</sup> No. 28 of 2011

<sup>174</sup> Draft Explanatory Memorandum on the Taxation Laws Amendment Bill, 28 July 2021

<sup>175</sup> No. 28 of 2011

<sup>176</sup> Done Howell, BDO, “Cessation of tax residency: tax triggers for retirement fund interests”, 13 September 2021, <https://www.bdo.co.za/en-za/insights/2021/tax/cessation-of-tax-residency-tax-triggers-for-retirement-fund-interests>

withheld against actual payments received by the emigrant taxpayer in the future from the retirement fund.<sup>177</sup>

- It is unclear how the tax credit granted for the deemed tax calculated upon ceasing to be a South African tax resident would be applied. Since the emigrant taxpayer will now be tax resident in another country and the sole taxing rights granted to such other country, there might not be any South African tax to credit against.<sup>178</sup>
- The current proposal (i.e., the tax on the deemed accrual, plus interest charged) will erode the asset base of the retirement savings of the taxpayer in the fund. Given the recent amendments to legislation, emigrants may only access their retirement fund savings after an uninterrupted period of at least three years after ceasing to be a South African resident. This means that interest will be charged for at least three years or even longer (if the taxpayer waits until retirement or death). This results in a significant portion of the retirement fund savings being used to pay the interest on the tax, instead of being used for retirement as planned. It may even lead to a nil retirement fund balance or lead to the taxpayer having to pay a shortfall (due to the associated interest on the deemed tax or a significant decline in the value of the retirement funds after emigration). This scenario is, thus, misaligned with government's policy to encourage retirement savings in South Africa generally.<sup>179</sup>
- There seems to be a mismatch between the amount on which the deemed tax is charged and the actual cash flow. The proposed deemed tax debt deferral is levied on the full retirement fund value. However, the resultant cash flows on exit from the retirement fund equates to only one-third of the value (assuming the taxpayer waits until retirement).<sup>180</sup>

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<sup>177</sup> Joon Chong, Wesley Grimm, "Tightening the noose on emigrants' retirement assets", Accountancy South Africa, April 2021, <http://magazine.accountancysa.org.za/asa-april-2021?m=52861&i=702647&p=104&ver=html5>

<sup>178</sup> Ibid.

<sup>179</sup> Ibid.

<sup>180</sup> Done Howell, BDO, "Cessation of tax residency: tax triggers for retirement fund interests", 13 September 2021, <https://www.bdo.co.za/en-za/insights/2021/tax/cessation-of-tax-residency-tax-triggers-for-retirement-fund-interests>

- The proposal does not cater for instances of failed emigration or where an individual who ceased to be tax resident in South Africa becomes resident in South Africa again (either due to the application of the South African domestic law residence tests or in terms of the provisions of a DTA).<sup>181</sup>

### 3.2.1.5 **Discretionary withdrawals from South African retirement funds**

A final concern was that the proposed insertion of section 9HC would lead to discretionary withdrawals of retirement interests prior to emigration from South Africa.<sup>182</sup> This proposal may result in taxpayers who emigrate from South Africa choosing to take their South African retirement fund savings in full (where possible), as the tax uncertainties of leaving these funds to grow in South Africa until retirement are too great. In this instance, the South African fiscus will receive some tax immediately. The full withdrawal will, however, be an overall loss for the economy, as the South African retirement funds pool will be reduced and the tax base on any growth of the funds had they not been withdrawn will be forfeited.<sup>183</sup>

### 3.2.2 **The effect of the abovementioned issues with the initial proposal**

In 2020, the Netherlands government was challenged on a legislative proposal to impose a Dividend Withholding exit tax levy on companies or head offices wishing to relocate from the Netherlands to certain other jurisdictions.<sup>184</sup> One of the main objections to the proposed bill was that it conflicted with double tax treaties concluded by the Netherlands.<sup>185</sup> This was regarded as a “breach of good faith”.<sup>186</sup> In 2021, the proposal was amended for the fourth time by narrowing the scope of the proposed exit

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<sup>181</sup> Ibid.

<sup>182</sup> Draft Response Document on the 2021 Draft Taxation Laws Amendment Bill, 10 November 2021

<sup>183</sup> Joon Chong, Wesley Grimm, “Tightening the noose on emigrants’ retirement assets”, Accountancy South Africa, April 2021, <http://magazine.accountancysa.org.za/asa-april-2021?m=52861&i=702647&p=104&ver=html5>

<sup>184</sup> PWC, “Dividend exit tax for companies proposed”, 2 November 2020, <https://www.pwc.nl/en/insights-and-publications/tax-news/enterprises/dividend-exit-tax-for-companies-proposed.html>

<sup>185</sup> Charlotte Tolman, Michael Molenaars, “Netherlands considers an exit levy proposal in response to corporate relocations”, January 2022, [https://www.stibbe.com/sites/default/files/2022-07/2022tni1\\_11\\_Tolman\\_Molenaars\\_13043.pdf](https://www.stibbe.com/sites/default/files/2022-07/2022tni1_11_Tolman_Molenaars_13043.pdf)

<sup>186</sup> Lameez Omarjee, “Treasury drops proposed exit tax on retirement interest, for now”, 10 November 2021, <https://www.news24.com/fin24/economy/treasury-drops-proposed-exit-tax-on-retirement-interest-for-now-20211110>

tax.<sup>187</sup> In terms of the amendments, the proposed exit tax would only be levied on investors who are residents of non-European Union (“EU”) or non-European Economic Area (“EEA”) countries with which the Netherlands has not concluded a tax treaty.<sup>188</sup> Despite the above amendment, on 15 July 2022, the Netherlands government made the decision not to adopt the bill.<sup>189</sup>

Based on the abovementioned issues with the proposal and the recent experience of the Netherlands’ failed amendment, the initial proposal for the insertion of section 9HC was withdrawn by National Treasury on 10 November 2021,<sup>190</sup> and the proposal was removed from the final Taxation Laws Amendment Bill for 2021.<sup>191</sup> Upon removal of the initial proposal, National Treasury indicated that its next plan was to revise the multiple DTAs with other countries to ensure that South Africa retains taxing rights on payments from South African retirement funds. The South African government intends on starting these negotiations soon.<sup>192</sup> Furthermore, while National Treasury has indicated an intention to provide an alternative proposal in the next legislative cycle,<sup>193</sup> no updates were provided in either the 2022 or 2023 Budget Review.<sup>194</sup> It is therefore unclear whether National Treasury is actively pursuing an alternative solution.

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<sup>187</sup> PWC, “Cabinet advises against proposed dividend exit tax”, 19 July 2022, <https://www.pwc.nl/en/insights-and-publications/tax-news/enterprises/dividend-exit-tax-on-relocation-of-head-offices.html>

<sup>188</sup> Ibid. ; PWC, “Dividend exit tax for companies proposed”, 2 November 2020, <https://www.pwc.nl/en/insights-and-publications/tax-news/enterprises/dividend-exit-tax-for-companies-proposed.html>

<sup>189</sup> PWC, “Cabinet advises against proposed dividend exit tax”, 19 July 2022, <https://www.pwc.nl/en/insights-and-publications/tax-news/enterprises/dividend-exit-tax-on-relocation-of-head-offices.html>

<sup>190</sup> Draft Response Document on the 2021 Draft Taxation Laws Amendment Bill, 10 November 2021

<sup>191</sup> Taxation Laws Amendment Bill 22 of 2021

<sup>192</sup> National Treasury, “2022 Budget Review”, 23 February 2022, <http://www.treasury.gov.za/documents/national%20budget/2022/review/FullBR.pdf>

<sup>193</sup> Draft Response Document on the 2021 Draft Taxation Laws Amendment Bill, 10 November 2021

<sup>194</sup> National Treasury, “2022 Budget Review”, Annexure C, 23 February 2022, <https://www.treasury.gov.za/documents/national%20budget/2022/review/Annexure%20C.pdf>; National Treasury, “2023 Budget Review”, Annexure C, 22 February 2023, <https://www.treasury.gov.za/documents/national%20budget/2023/review/Annexure%20C.pdf>

## **4. Alternative approaches to the initial proposal issued by National Treasury**

### **4.1 Criteria for evaluation of a feasible alternative approach**

As established previously, National Treasury grants taxpayers significant income tax deductions for contributions made to retirement funds, in part because any subsequent receipts or accruals upon retirement or withdrawal ought to be taxed in South Africa. However, it was noted that South Africa could forfeit such taxing rights where taxpayers emigrate from South Africa and cease to be resident prior to retirement due to the application of some DTAs between South Africa and other countries. The initial proposal issued by National Treasury in 2021 aimed to address this by amending the South African tax legislation to include a deemed withdrawal of an individual taxpayer's retirement interest immediately prior to emigration, which could potentially result in a normal tax liability to SARS, but which would become payable only upon withdrawal or retirement from the fund.<sup>195</sup>

The initial proposal was, however, very complicated, included various aspects which were unclear, and might possibly contravene South African laws and regulations (including the South African Constitution, the South African Income Tax Act, the South African Tax Administration Act, and the Promotion of Administrative Justice Act). Furthermore, it was concerning that the initial proposal could lead to overriding some existing DTAs with other countries, which could lead to an amount being taxed twice in the hands of the taxpayer. Finally, there was a concern that the initial proposal might lead to taxpayers withdrawing their South African retirement savings in full prior to leaving South Africa.

This chapter aims to establish whether alternative approaches exist that might achieve the policy objectives of the initial proposal without giving rise to the abovementioned issues. The following criteria will be used as the basis of evaluation for a feasible alternative approach. The criteria consist of a combination of the objectives of the initial proposal, the issues identified with the initial proposal, and some universal features of a well-designed tax system (also referred to as the “building blocks” of good tax

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<sup>195</sup> Draft Taxation Laws Amendment Bill, 28 July 2021

policy).<sup>196</sup> The criteria for the alternative approach include the potentially competing needs for 1) equity within the tax system, 2) economic efficiency of the tax system, 3) administrability of the tax system, and 4) coherence of the tax system.<sup>197</sup>

#### 4.1.1 **Equity**

Equity is defined as “fairness in the taxation system”. This feature traditionally considers the “ability to pay” principle, where a taxpayer’s burden should reflect his or her economic capacity to bear such burden. The “ability to pay” principle should be considered with reference to horizontal equity. Horizontal equity focuses on the principle of individual equity, where taxpayers who are similarly situated should be taxed similarly (i.e., taxpayers who earn the same amount of income and/or capital should pay the same amount of tax).<sup>198</sup> This criterion aligns with the first intended outcome of the initial proposal issued by National Treasury, namely the need to ensure neutrality of the tax treatment for all types of retirement fund benefits (regardless of a taxpayer’s residency status).<sup>199</sup>

#### 4.1.2 **Economic efficiency**

Economic efficiency is very broadly defined and encompasses several key concepts. This study focuses on “stability of the tax system”, as well as “simplicity of the tax system”. Stability in a tax system generates certainty for taxpayers and prevents unnecessary increases in compliance costs, whereas simplicity focuses on the need to remove complexity which could incite tax avoidance behaviour on the taxpayer’s part.<sup>200</sup> This criterion aligns with the second intended outcome of the initial proposal issued by National Treasury, namely the need to ensure that there is a sound mechanism in place to verify that the retirement withdrawal tax is calculated on the

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<sup>196</sup> As established in the Fundamentals of Taxation: An introduction to Tax Policy, Tax Law and Tax Administration (Pasqaule Pistone, Jennifer Roeleveld, Johann Hattingh, Joao Felix, Pinto Nogueira, Craig West, IBFD 2019), Books IBFD, [https://research.ibfd.org/#/doc?url=/collections/pt/html/pt\\_c02.html](https://research.ibfd.org/#/doc?url=/collections/pt/html/pt_c02.html)

<sup>197</sup> Fundamentals of Taxation: An introduction to Tax Policy, Tax Law and Tax Administration (Pasqaule Pistone, Jennifer Roeleveld, Johann Hattingh, Joao Felix, Pinto Nogueira, Craig West, IBFD 2019), Books IBFD, [https://research.ibfd.org/#/doc?url=/collections/pt/html/pt\\_c02.html](https://research.ibfd.org/#/doc?url=/collections/pt/html/pt_c02.html)

<sup>198</sup> Ibid.

<sup>199</sup> Draft Explanatory Memorandum on the Taxation Laws Amendment Bill, 28 July 2021

<sup>200</sup> Fundamentals of Taxation: An introduction to Tax Policy, Tax Law and Tax Administration (Pasqaule Pistone, Jennifer Roeleveld, Johann Hattingh, Joao Felix, Pinto Nogueira, Craig West, IBFD 2019), Books IBFD, [https://research.ibfd.org/#/doc?url=/collections/pt/html/pt\\_c02.html](https://research.ibfd.org/#/doc?url=/collections/pt/html/pt_c02.html)

correct value<sup>201</sup> (i.e., stability and simplicity), and some of the issues with the initial proposal as previously discussed (including the complexity thereof).

#### 4.1.3 **Administrability**

Administrability of a tax system considers the cost (to the government) of collection of a tax and ensures that it is not excessive when compared to the actual tax collected through appropriate enforcement (i.e., the cost to collect a tax should not outweigh the tax collected, also referred to as the tax yield). A tax system that is administratively convenient creates a sense of equity for the taxpayer and facilitates taxpayer compliance.<sup>202</sup> This criterion aligns with some of the issues with the initial proposal as previously discussed.

#### 4.1.4 **Coherence**

The coherence of a tax system is an overarching feature which considers the interaction within and between taxes as well as the base on which tax is levied. Any tax system should aim to avoid instances of economic double taxation (i.e., where the same income is taxed twice), avoid the possibility of any treaty override, and should ensure that the overall tax burden is not skewed towards one particular group of taxpayers. It should, furthermore, aim to broaden the tax base (i.e., the taxable persons covered by the tax) so that it is perceived as being fair.<sup>203</sup> This criterion aligns with most of the issues with the initial proposal as previously discussed.

The initial proposal may be seen as not being a well-designed tax system as it prioritized equity and economic efficiency but lacked administrability and coherence of the tax system. Therefore, a feasible alternative approach to taxation of retirement fund interests on emigration from South Africa should aim to satisfy all or most of the abovementioned criteria.

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<sup>201</sup> Draft Explanatory Memorandum on the Taxation Laws Amendment Bill, 28 July 2021

<sup>202</sup> Fundamentals of Taxation: An introduction to Tax Policy, Tax Law and Tax Administration (Pasquale Pistone, Jennifer Roeleveld, Johann Hattingh, Joao Felix, Pinto Nogueira, Craig West, IBFD 2019), Books IBFD, [https://research.ibfd.org/#/doc?url=/collections/pt/html/pt\\_c02.html](https://research.ibfd.org/#/doc?url=/collections/pt/html/pt_c02.html)

<sup>203</sup> Ibid.

## 4.2 Analysis of possible retirement fund taxation regimes

A taxpayer's retirement savings can typically be separated into the following three stages:

- Actual and deemed contributions made by members to any retirement fund;
- Investment income and capital gains that accrue to the retirement fund; and
- Any benefits received by members of the retirement fund upon withdrawals or retirement.<sup>204</sup>

It is possible to levy tax on any or all of the abovementioned three stages, depending on the taxation regime applied by National Treasury. There are eight possible taxation regimes available to National Treasury, as outlined in the table below. The tax-exempt<sup>205</sup> or taxable status of any of these stages are denoted by "E" and "T" respectively. The exemption of contributions to a retirement fund is provided by the income tax deduction given to members who contribute, and the income accruing to the fund through investment of contributions is exempt because the retirement fund is exempt from tax in terms of section 10(1)(d).<sup>206</sup>

**Table 3: Possible taxation regimes available to National Treasury (author's own construction)**

	<b>Contributions</b>	<b>Accumulated growth</b>	<b>Withdrawals</b>
<b>EET</b>	Exempt	Exempt	Taxable
<b>TEE</b>	Taxable	Exempt	Exempt
<b>TTE</b>	Taxable	Taxable	Exempt
<b>ETT</b>	Exempt	Taxable	Taxable
<b>TTT</b>	Taxable	Taxable	Taxable
<b>EEE</b>	Exempt	Exempt	Exempt

<sup>204</sup> Edward Whitehouse, "The tax treatment of funded pensions", 2001 <https://www.oecd.org/finance/private-pensions/2391559.pdf>

<sup>205</sup> Note that "exempt" or "tax-exempt" in this context does not refer to "exempt income" as defined in section 1 of the Income Tax Act No. 58 of 1962. In this context, "exempt" or "tax-exempt" simply means that the stage is not taxed (due to tax relief provided by National Treasury).

<sup>206</sup> of the Income Tax Act No.58 of 1962

<b>EET</b>	Exempt	Taxable	Exempt
<b>TET</b>	Taxable	Exempt	Taxable

This study considers the first three taxation regimes (i.e., EET, TEE, or TTE) in further detail. It will not consider the ETT taxation regime as this would not significantly change anything that the EET taxation regime does not achieve. It will not consider extreme taxation regimes which aim to tax all or none of the possible three stages (i.e., TTT or EEE). Similarly, it will not consider a taxation regime which aims to solely tax or exempt accumulation growth (i.e., ETE or TET) as isolating such growth can be difficult.<sup>207</sup>

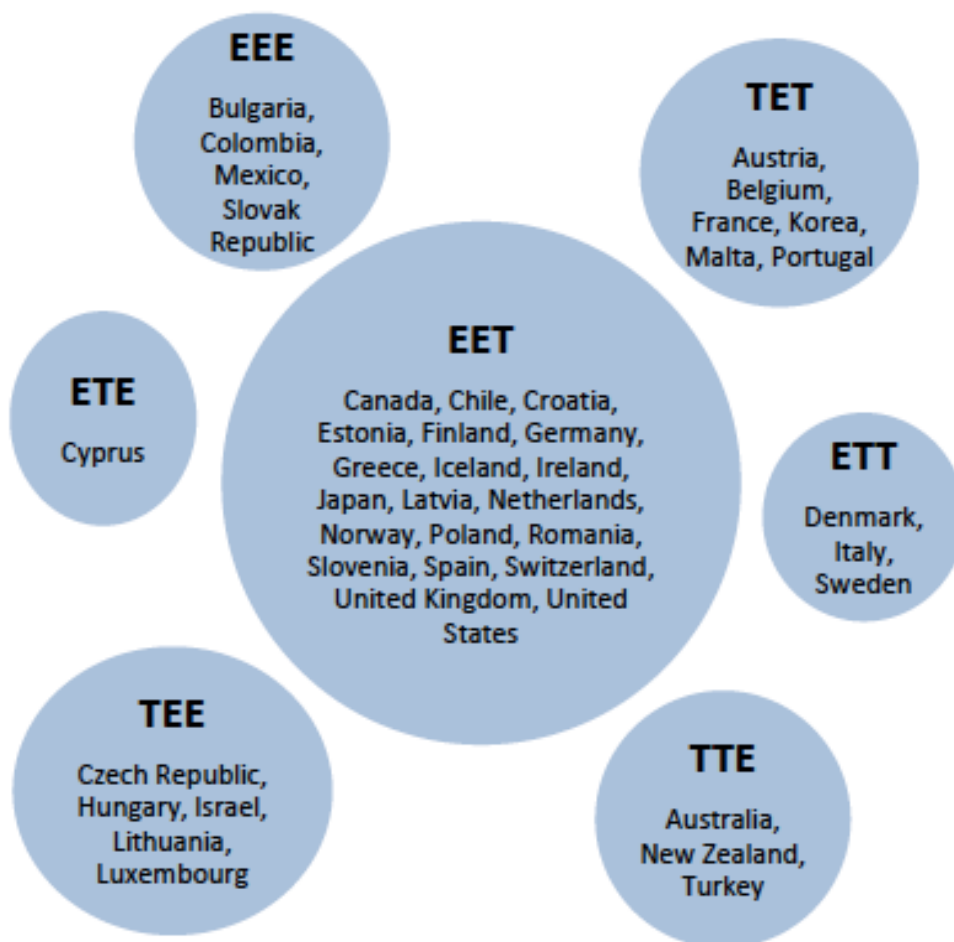
South Africa currently applies the EET taxation regime to retirement savings, where income received upon withdrawals or retirement are only taxed once. This means that contributions are made from pre-tax income to retirement funds, while income accruing to the fund through investment of contributions is exempt from tax in terms of section 10(1)(d),<sup>208</sup> and those contributions together with investment income that forms the basis of retirement benefits is subject to tax on retirement or withdrawal. As indicated in Figure 2 below, approximately half of OECD countries (including countries with the largest private pension markets, such as Canada, Switzerland, the United Kingdom, and the United States) apply a variant of the EET taxation regime to retirement savings.<sup>209</sup> The EET regime is regarded as the most popular taxation regime for private pension plans.<sup>210</sup>

<sup>207</sup> Edward Whitehouse, “The tax treatment of funded pensions”, 2001 <https://www.oecd.org/finance/private-pensions/2391559.pdf>

<sup>208</sup> of the Income Tax Act No.58 of 1962

<sup>209</sup> OECD, Project on Financial Incentives and Retirement Savings, Policy brief no. 1, “The tax treatment of retirement savings in private pension plans”, December 2018, <https://www.oecd.org/daf/fin/private-pensions/Tax-treatment-of-retirement-savings-Policy-Brief-1.pdf>

<sup>210</sup> OECD, Pensions Outlook, “Chapter 2: does the tax treatment of retirement savings provide an advantage when people save for retirement”, 2016, [https://www.oecd-ilibrary.org/sites/pens\\_outlook-2016-5-en/index.html?itemId=/content/component/pens\\_outlook-2016-5-en](https://www.oecd-ilibrary.org/sites/pens_outlook-2016-5-en/index.html?itemId=/content/component/pens_outlook-2016-5-en)



*Note: Main pension plan in each country.*

**Figure 2: Tax treatment of retirement savings in private pension plans, 2018<sup>211</sup>**

The following table indicates the net pension resulting from a contribution of R100 made five years before retirement under each of the first four taxation regimes.<sup>212</sup> It assumes a proportional tax of 25% and a rate of return on investment of 10% per annum over five years. The effects of inflation are ignored for simplicity.

<sup>211</sup> OECD, Project on Financial Incentives and Retirement Savings, Policy brief no. 1, “The tax treatment of retirement savings in private pension plans”, December 2018, <https://www.oecd.org/daf/fin/private-pensions/Tax-treatment-of-retirement-savings-Policy-Brief-1.pdf>

<sup>212</sup> Edward Whitehouse, “The tax treatment of funded pensions”, 2001 <https://www.oecd.org/finance/private-pensions/2391559.pdf>

**Table 4: Net pension arising from alternative pension taxation regimes (adapted)** <sup>213</sup>

	Calculations	Expenditure tax		Comprehensive income tax	
		EET	TEE	TTE	ETT
		Pre-tax rate of return 10% = post-tax rate of return = 10%		Pre-tax rate of return 10% > post-tax rate of return 7.5%	
Contribution	a	100	100	100	100
Tax on contribution	$b = a \times 25\%$	-	25	25	-
Fund at contribution	$c = a - b$	100	75	75	100
Net investment return	$d = e - c$	61.05	45.79	32.67	43.56
Fund at retirement	$e = c(1+i)^5$  <i>i = post-tax rate of return</i>	161.05	120.79	107.67	143.56
Tax on pension	$f = e \times 25\%$	40.26	-	-	35.89
<b>Net pension</b>	$g = e - f$	<b>120.79</b>	<b>120.79</b>	<b>107.67</b>	<b>107.67</b>

In theory, the EET and TEE regimes result in the same net pension. The pre-tax return on pre-tax contributions under the EET taxation regime (determined as  $61.05/100 = 0.6105$ ) is the same as the post-tax return on post-tax income under the TEE taxation regime ( $45.79/75 = 0.6105$ ). This means that it does not matter whether the tax is paid up-front (under the TEE taxation regime) or at the end (under the EET taxation regime). These regimes, commonly referred to as “expenditure tax” systems, only tax consumption (or expenditure) and apply the same tax rate (whether now or in the future). It could, thus, be argued that expenditure tax systems are equitable in the tax

<sup>213</sup> Ibid.

treatment of different taxpayers regardless of the point in time at which tax is levied. The main difference between the EET and TEE regimes is the timing of tax revenue for the government; revenues are postponed until retirement or withdrawal under the EET regime; whereas revenues are received immediately under the TEE regime.<sup>214</sup>

Based on the above table, it is evident that both the EET and TEE regimes provide the same overall tax outcome to taxpayers in the case where their income is subject to the same marginal tax rate throughout their working and retirement life. This may, however, not be true in reality, as the marginal tax rate that applies to a retired individual is usually lower than the rate applied during that person's working life (as the income received upon retirement is usually lower than the income received whilst working).<sup>215</sup> Taxpayers, therefore, benefit more from up-front tax relief when they are currently taxed at the higher marginal tax rate and can defer the taxation of their retirement income to a lower tax rate in the future.<sup>216</sup> It is, however, worth noting that tax rates can be changed by the fiscus to achieve a desired outcome either in the present moment or in the future.

Similarly, the TTE and ETT regimes result in the same net pension. However, the post-tax rate of return under these two regimes are both lower than the first two regimes because the investment is taxed twice under the ETT regime, and the investment is taxed under the TTE regime even though it is made from after-tax income. These regimes are commonly referred to as "comprehensive income tax" systems as they tax all accruals to income, whether from earnings or investments, regardless of whether they are saved or consumed. These regimes treat retirement savings in the same way as any other form of consumption, when it is well understood that retirement savings are not the same as any other good or service. Applying any of these regimes is, thus, often seen as a disincentive to saving because consumption now is worth more than consumption in the future.<sup>217</sup>

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<sup>214</sup> Ibid.

<sup>215</sup> OECD, "Financial Incentives and Retirement Savings", Highlights, Policy brief no.3, 2018, <https://www.oecd.org/daf/fin/private-pensions/Financial-Incentives-and-Retirement-Savings-2018-highlights.pdf>

<sup>216</sup> Edward Whitehouse, "The tax treatment of funded pensions", 2001 <https://www.oecd.org/finance/private-pensions/2391559.pdf>

<sup>217</sup> Ibid.

The inclusion of the four taxation regimes in the above example in Table 2 was necessary to emphasize the main difference between “expenditure tax” systems and “comprehensive income tax” systems, which are explored further in the analysis below. However, as mentioned previously, this study will not consider the ETT taxation regime in further detail.

### **4.3 Alternative 1: Accept the current status quo**

If this alternative were pursued by National Treasury, the current EET taxation regime is retained and the proposed exit tax on retirement fund interests upon emigration from South Africa is withdrawn permanently.<sup>218</sup> National Treasury would embark on its plan to revise the multiple DTAs with other countries,<sup>219</sup> and would forfeit this tax revenue unless and until it is able to renegotiate such DTAs. Alternatively, National Treasury would not embark on its plan to revise the multiple DTAs with other countries,<sup>220</sup> and would rather forfeit this tax revenue indefinitely. This alternative approach applies equally to all taxpayers who leave South Africa with no retirement savings until they retire or die; taxpayers who leave with all South African retirement savings upon emigration; and taxpayers who are unsure if they are leaving South Africa permanently.

#### **4.3.1 Merits of accepting the current status quo**

National Treasury has indicated a desire to retain the current EET taxation regime as part of its latest significant retirement reforms (i.e., the implementation of the proposed “two-pot” retirement system discussed in chapter two). This regime ensures that income is only taxed once, that the logic applied in the 2016 retirement reforms to

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<sup>218</sup> The view to withdraw the current proposal is supported by professional bodies such as The South African Institute of Chartered Accountants (SAICA) and The South African Institute of Taxation (SAIT). The South African Institute of Chartered Accountants, “SAICA comments on the Draft Taxation Laws Amendment Bill and Tax Administration Laws Amendment Bill of 2021 and the second batch of the 2021 Draft Tax Bills”, 27 August 2021, [https://saicawebprstorage.blob.core.windows.net/uploads/resources/INTEGRITAS-770361-v1-2021\\_08\\_27\\_SAICA\\_comments\\_to\\_the\\_Draft\\_TLAB\\_and\\_TALAB\\_2021\\_FINAL.pdf](https://saicawebprstorage.blob.core.windows.net/uploads/resources/INTEGRITAS-770361-v1-2021_08_27_SAICA_comments_to_the_Draft_TLAB_and_TALAB_2021_FINAL.pdf); South African Institute of Taxation, “Comments on the 2021 Draft TLAB”, 27 August 2021, [https://cdn.ymaws.com/www.thesait.org.za/resource/resmgr/2021\\_technical/sars\\_submissions/pit\\_et\\_wg\\_submission\\_draft.pdf](https://cdn.ymaws.com/www.thesait.org.za/resource/resmgr/2021_technical/sars_submissions/pit_et_wg_submission_draft.pdf)

<sup>219</sup> National Treasury, “2022 Budget Review”, 23 February 2022, <http://www.treasury.gov.za/documents/national%20budget/2022/review/FullBR.pdf>

<sup>220</sup> Ibid.

harmonize the tax treatment across all retirement funds is retained, and that the complexity which comes with valuing growth on contributions is minimized or avoided.<sup>221</sup> This regime also supports the desire to ensure that individuals maintain their standard of living in retirement and encourages individuals through tax incentives to save for their own retirement so that the cost of social security benefits will be reduced.<sup>222</sup> This alternative, therefore, maintains stability and simplicity for the taxpayer.

In addition, it was noted in chapter three that various OECD policy and administrative considerations support the principle of allocating sole taxing rights to the country of residence.<sup>223</sup> The resident country is regarded as being in a better position to provide for adequate taxation of retirement fund interest payments as it is easier for such country to assess the taxpayer's overall ability to pay tax, depending on worldwide income and relevant personal circumstances.<sup>224</sup> This view is administrable as it also supports the principle that a taxpayer should only have an administrative burden to comply with tax obligations in his or her resident country.<sup>225</sup>

There seems to be evidence which suggests that an up-front tax incentive (in the form of the section 11F income tax deduction for contributions made to retirement funds) provides certainty for taxpayers as it is an immediately felt benefit, which incentivizes taxpayers to save for retirement.<sup>226</sup> The up-front incentive results in a moderate increase in disposable income and the size of the initial investment due to the tax relief afforded to the taxpayer.<sup>227</sup> This is, however, not a universal view, as the results of an analysis performed by the OECD noted that regimes where only one stage is subject

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<sup>221</sup> Draft Explanatory Memorandum on the Revenue Laws Amendment Bill, 9 June 2023

<sup>222</sup> Edward Whitehouse, "The tax treatment of funded pensions", 2001 <https://www.oecd.org/finance/private-pensions/2391559.pdf>

<sup>223</sup> OECD Commentary on Article 18 of the OECD Model Tax Convention on Income and on Capital, 2010, <https://www.oecd.org/berlin/publikationen/43324465.pdf>

<sup>224</sup> Ibid.

<sup>225</sup> Ibid.

<sup>226</sup> Gizelle D. Willows, Thomas Burgers, Darron West, 2018, "A comparison of retirement saving using discretionary investment and Regulation 28", South African Journal of Economic and Management Sciences 21(1), a1995. <https://doi.org/10.4102/sajems.v21i1.1995>, [http://www.scielo.org.za/scielo.php?script=sci\\_arttext&pid=S2222-34362018000100059](http://www.scielo.org.za/scielo.php?script=sci_arttext&pid=S2222-34362018000100059)

<sup>227</sup> Ibid.

to personal income tax (i.e., contributions, returns on investment or withdrawals) provide the same overall tax advantage for an average individual contributing to a private pension plan (provided that the tax rates used are the same throughout, regardless of the stage at which that tax is levied).<sup>228</sup> The OECD study of taxation and savings survey indicated that “there is no clear evidence that the level of taxation, along with other factors affecting the rate of return, does generally affect the level of saving”.<sup>229</sup> Alan Blinder further commented that “there is zero evidence that tax incentives that enhance the rate of return on savings actually boost the national saving rate. None. No evidence. Economists now accept that as a consensus view”.<sup>230</sup> Given the conflicting views, it might be worth not assigning too much weight to the theory that an upfront tax incentive provides more certainty for taxpayers than a later tax incentive would.

If this alternative is pursued by National Treasury, it will eliminate all key issues in the initial proposal as outlined in chapter three previously, resulting in simplicity for the taxpayer. Accepting the current status quo and not implementing any further significant retirement reforms would, thus, be well received by taxpayers and grant them much need stability.

If this alternative is pursued by National Treasury, it will protect taxpayers who have emigrated from South Africa from double taxation on their retirement savings. The new resident country might not allow a tax credit overseas for taxes paid in South Africa as they have exclusive taxing rights in terms of the DTA. By agreeing to accept the current status quo (and forfeiting the tax revenue), National Treasury will prevent the taxpayer’s retirement savings from being significantly eroded. This alternative is, therefore, coherent.

It appears that National Treasury is aware that the initial proposal constitutes a treaty override.<sup>231</sup> The enactment of section 9HC into the South African domestic tax law is

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<sup>228</sup> OECD, Pensions Outlook, “Chapter 2: does the tax treatment of retirement savings provide an advantage when people save for retirement”, 2016, [https://www.oecd-ilibrary.org/sites/pens\\_outlook-2016-5-en/index.html?itemId=/content/component/pens\\_outlook-2016-5-en](https://www.oecd-ilibrary.org/sites/pens_outlook-2016-5-en/index.html?itemId=/content/component/pens_outlook-2016-5-en)

<sup>229</sup> Edward Whitehouse, “The tax treatment of funded pensions”, 2001 <https://www.oecd.org/finance/private-pensions/2391559.pdf>

<sup>230</sup> Ibid.

<sup>231</sup> Draft Explanatory Memorandum on the Taxation Laws Amendment Bill, 28 July 2021

significant as it will constitute South Africa's first treaty override.<sup>232</sup> The decision to accept the current status quo and to respect existing DTAs with other countries is coherent as National Treasury could be seen as acting in good faith, as could the decision to attempt to renegotiate existing DTAs in favour of South Africa.

If National Treasury chooses to accept the current status quo, it will comply with many of its DTAs with other countries which is good for its international standing. Honoring the relevant DTAs entered into many years ago is coherent and aligns with the aim of National Treasury to promote economic development and good governance.<sup>233</sup> This alternative, furthermore, removes any administrative issues for National Treasury regarding the costs of tax collection (as it concedes to continuing to forfeit fiscal revenue).

#### 4.3.2 **Shortcomings of accepting the current status quo**

If National Treasury retains the current EET taxation regime and withdraws the initial proposal permanently, it concedes to continuing to forfeit fiscal revenue. As outlined in chapter three, the current South African tax emigration statistics (presumably including taxpayers who benefitted from the services rendered by the government (including access to roads, schools, medical services, etc.) and who received favorable tax deductions whilst contributing to South African retirement funds prior to emigration), as well as the forfeiture of taxing rights under many of the DTAs with other countries to which South Africa is a party, confirms the significant loss to the South African government which may be perceived as incoherent.<sup>234</sup>

This alternative is, furthermore, incoherent insofar as it will result in a reduction in the future tax base of South Africa (which is linked to the forfeiture of tax revenue discussed above). The decision to allow some taxpayers to emigrate from South Africa without having to pay tax on subsequent receipts or accruals from South African

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<sup>232</sup> Tax Consulting South Africa, "Submissions in relation to the 2021 Draft Taxation Laws Amendment Bill", 2021, [https://static.pmg.org.za/210831TCSA\\_Submission.pdf](https://static.pmg.org.za/210831TCSA_Submission.pdf)

<sup>233</sup> National Treasury, "Budget Summary", Vote 7, <https://www.treasury.gov.za/documents/national%20budget/2009/ene/7%20nat%20treas.pdf>

<sup>234</sup> Kyle Mandy, Greg Smith, "Emigration and South African retirement funds: Proposal to tax withdrawals of retirement interests", July 2021, <https://www.pwc.co.za/en/assets/pdf/synopsis/synopsis-july-2021.pdf>; Joon Chong, Wesley Grimm, "Tightening the noose on emigrants' retirement assets", Accountancy South Africa, April 2021, <http://magazine.accountancysa.org.za/asa-april-2021?m=52861&i=702647&p=104&ver=html5>

retirement funds may also be perceived as being inequitable towards resident taxpayers who choose to remain in South Africa and who will be taxed on such subsequent amounts. It may also be perceived as incoherent as it skews the tax burden towards one particular group of taxpayers (i.e., residents) and allows non-residents to avoid such tax liability.

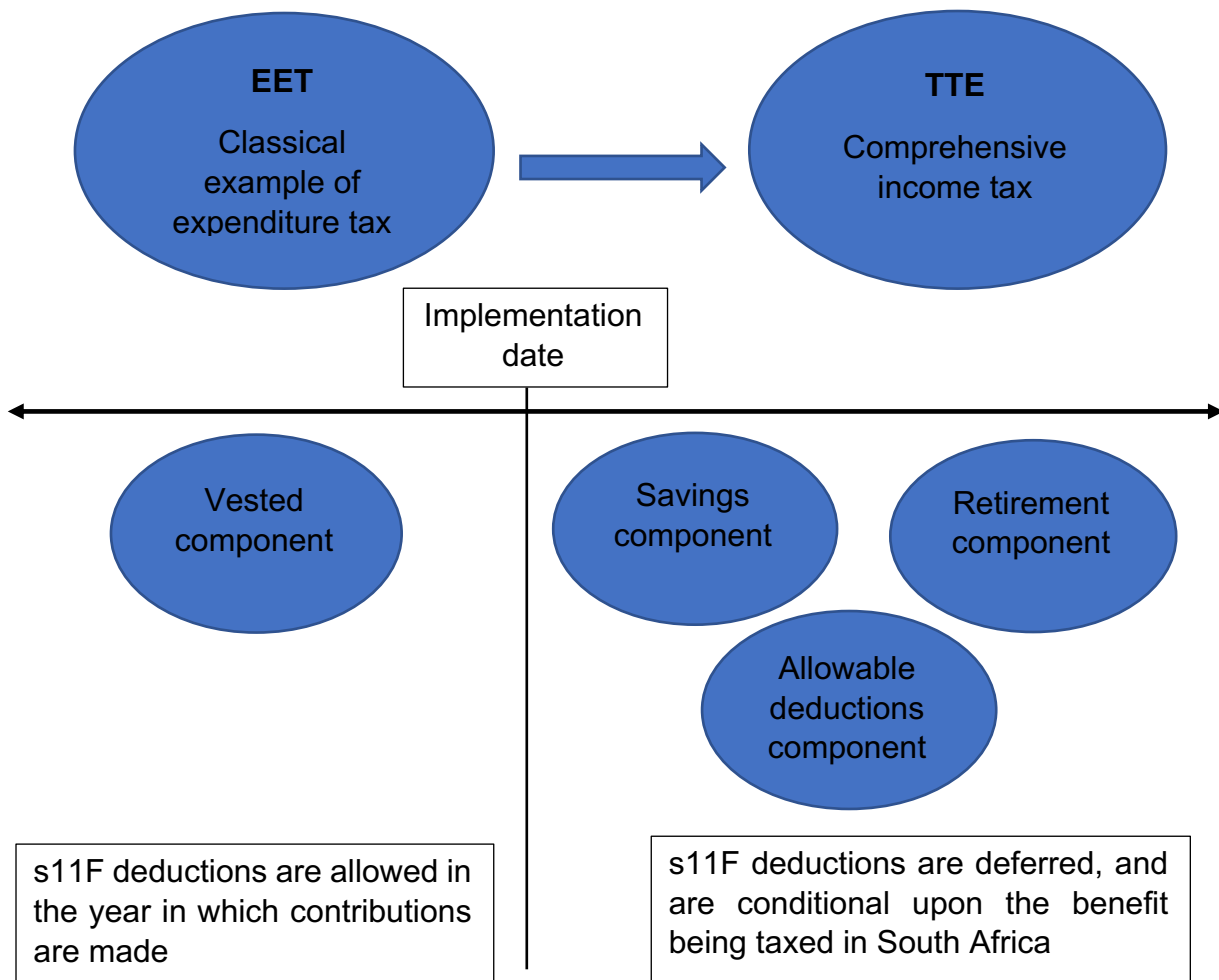
The decision by National Treasury to embark on its plan to revise the multiple DTAs with other countries<sup>235</sup> might not be the best way to utilize South Africa's current resources. The negotiation/renegotiation process is a lengthy, complex one and comes with various challenges. Some of the challenges include obtaining the necessary authorization from the other countries involved; the costs involved (and whether the benefits derived from this process will outweigh such costs); the significant number of skilled staff required to plan, hold, and conclude such discussions; the process involved to draft documents which then need to be signed by the government of both countries, etc.<sup>236</sup>

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<sup>235</sup> National Treasury, "2022 Budget Review", 23 February 2022, <http://www.treasury.gov.za/documents/national%20budget/2022/review/FullBR.pdf>

<sup>236</sup> The Platform for Collaboration on Tax, "Toolkit on Tax Treaty Negotiations", May 2021, [https://www.tax-platform.org/sites/pct/files/publications/The%20Toolkit%20on%20Tax%20Treaty%20Negotiations%20Toolkit\\_Updated%20052021.pdf](https://www.tax-platform.org/sites/pct/files/publications/The%20Toolkit%20on%20Tax%20Treaty%20Negotiations%20Toolkit_Updated%20052021.pdf); United Nations, Department of Economic and Social Affairs, "Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries", 2019, <https://www.un.org/esa/ffd/wp-content/uploads/2019/06/manual-bilateral-tax-treaties-update-2019.pdf#page=38>

#### 4.4 Alternative 2: Deferred, conditional income tax deductions



**Figure 3: Modified TTE taxation regime, where income tax deductions are deferred and conditional (author’s own construction)**

If this alternative were pursued, National Treasury would apply a modified version of the TTE taxation regime by making section 11F income tax deductions deferred and conditional. The International Bureau of Fiscal Documentation (“IBFD”) defines “deferral” as “the postponement of current taxation on income economically accruing to the taxpayer”.<sup>237</sup> Whereas the term “conditional” is defined as “depending on

<sup>237</sup> IBFD, International Tax Glossary, deferral of tax definition, <https://research.ibfd.org/#/glossary> This definition explains the concept of deferral and is useful, even though it refers to income and not deductions.

fulfilling certain requirements”.<sup>238</sup> A classic example would be the principle that a capital gain is not taxable until an event of realization occurs.<sup>239</sup>

Under this alternative, National Treasury would postpone the income tax deduction relating to contributions made or deemed to be made by members to retirement funds (as of the effective date), until such time as the benefits from such funds (be it a lump sum or annuity) are taxed in South Africa. If South Africa loses the right to tax any future income from a South African retirement fund (due to emigration which results in the application of a DTA granting sole taxing rights to the country of residence), the amount in the “allowable deductions component” falls away (i.e., the taxpayer will then lose the right to claim these income tax deductions).

This approach is classified as the TTE taxation regime as the deferral of income tax deductions relating to contributions made or deemed to be made by members would effectively mean that such contributions are made from after-tax income. Similarly, reducing the lump sum or annuity benefit received by or accrued to taxpayers by allowable deductions later, means that the returns generated over time (i.e., which is the difference between the two) may be subject to tax in South Africa. The tax on the returns will only happen on withdrawal or retirement, and not every time an amount of interest or dividends accrues (as is the case with other investment products). The returns will, furthermore, likely be subject to tax at a lower rate due to the favorable tax regime applicable at retirement.

This modification would require the following adjustments to the current and/or proposed legislation:

- The wording in section 11F (1) of the Income Tax Act would need to be updated to remove any reference to “in any year of assessment during which the contributions were made”. These would be replaced with the following wording “the deduction, or part thereof, will be allowed in the year of assessment during which any benefit from such retirement fund is taxed in South Africa”.

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<sup>238</sup> Hendrick Pinheiro, Estevao Horvath, “Conditional and Unconditional Tax Incentives from a Legal Certainty Perspective”, Beijing Law Review, 2023, 14, 1640-1651. <https://doi.org/10.4236/blr.2023.144089>

<sup>239</sup> IBFD, International Tax Glossary, deferral of tax definition, <https://research.ibfd.org/#/glossary>

- An additional subsection, section 11F (6) to the Income Tax Act could be included to deal with the conditions. The wording in this subsection would need to clearly indicate that any deduction, or part thereof, available in the “allowable deductions component” may only be deductible to the extent that the lump sum is considered for tax in South Africa. If South Africa loses its taxing rights, the full amount in this component will fall away.
- There would be no need to adjust the relevant paragraphs in the Second Schedule,<sup>240</sup> as the deductions that were disallowed previously are already being set off against any benefits received by or accrued to a taxpayer. This alternative approach is, thus, not a fundamental change to the way the taxable amount is calculated.
- Alternatively, section 11F could be removed and the deductions could be granted in terms of the Second Schedule or section 10C.<sup>241</sup> The allowable deductions can first be set off against any lump sum in terms of the Second Schedule, and any remaining amounts can be considered in terms of the section 10C exemption calculation. This order is currently used in the determination of the section 10C exemption.<sup>242</sup>
- This would require an adjustment to the current “two-pot” retirement system. Under this alternative, a “third-pot” would be added to the system, called the “allowable deductions component”. This component would consist of all deferred income tax deductions for contributions to retirement funds made on/after the implementation date.
- The duty to keep record of the amount in the “allowable deductions component” could be placed on National Treasury or on retirement fund administrators. The SARS e-filing system would need to be updated so that it calculates the allowable deduction for each tax year but disallows the deduction in the year in which contributions are made (i.e., place it into the “third-pot” to be utilized by the taxpayer at a later stage, if the relevant conditions are satisfied).

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<sup>240</sup> to the Income Tax Act No.58 of 1962

<sup>241</sup> Ibid.

<sup>242</sup> As explained in Chapter 5.2.5 of Silke: South African Income Tax (Madeleine Stiglingh (editor), Alta Koekemoer, Linda Van Heerden, Jolani Wilcocks, Pieter Van der Zwan), LexisNexis (Pty) Ltd, South Africa, 2022

#### 4.4.1 Merits of deferred, conditional income tax deductions

The concept of deferred and conditional deductions is already being used in the South African taxation legislation. Section 23F (1)<sup>243</sup> deals with the deferral of a section 11(a) income tax deduction available for expenditure incurred in acquiring trading stock. It provides that no section 11(a) deduction is allowed where expenditure was incurred for the acquisition of trading stock that was neither sold during such year of assessment nor held by the taxpayer at the end of the year of assessment. The income tax deduction is deferred or postponed to the first succeeding year of assessment during which the trading stock is sold by the taxpayer, or the amount forms part of the closing stock adjustment in terms of section 22(1), or there is evidence which suggests that the stock will neither at any date be sold nor held by the taxpayer (due to the loss or destruction of the trading stock, the termination of the agreement, or any other reason).<sup>244</sup>

Similarly, section 23F (2)<sup>245</sup> deals with the recoupment of an amount if the trading stock was disposed of, and a section 11(a) income tax deduction was claimed, but the full consideration has not accrued to the taxpayer during such year. The effect of the recoupment is that it essentially limits the section 11(a) income tax deduction to the amount that accrues to the taxpayer and that was included in gross income (basically matching income and expenditure) and defers the balance until such time further consideration accrues to the taxpayer.

In the *CSARS v Marula Platinum Mines* case,<sup>246</sup> it was held that section 23F (2) is an anti-avoidance provision and the purpose and function of the section is to delay the section 11(a) income tax deduction of the acquisition costs of trading stock until the income from the disposal of such stock has been included in the taxpayer's gross income. This section was also looked at in the *Income Tax Case No. 1847*,<sup>247</sup> where the acquisition costs allowed in terms of section 11(a) had to be recouped until such time as the selling price from the sale of the stock accrued to the taxpayer.

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<sup>243</sup> of the Income Tax Act No.58 of 1962

<sup>244</sup> Section 23F (1) of the Income Tax Act No.58 of 1962

<sup>245</sup> of the Income Tax Act No.58 of 1962

<sup>246</sup> *CSARS v Marula Platinum Mines* (218/2015) [2015] ZASCA 121 – paragraph 14

<sup>247</sup> *Income Tax Case No. 1847* 73 SATC 126

This concept also features in the section 11(a)<sup>248</sup> general deductions formula, where the basic premise of deductibility is that the expenditure must have been “incurred in the production of income”. While these words are not explicitly used in section 11F<sup>249</sup> dealing with the deduction for contributions to retirement funds, it is an implicit expectation that such contributions will lead to income in the future that will be taxed in South Africa.

Based on the above, it is evident that the concept of matching income and expenditure already exists within the South African taxation legislation. This supports the alternative to postpone the section 11F income tax deductions until such time as an amount is included into the taxpayer’s gross income and taxed in South Africa. This alternative, therefore, provides certainty and stability for taxpayers.

Any such change in the income tax deductions would need to apply to all taxpayers who remain in South Africa as well as to taxpayers who leave South Africa prior to retirement or death. This could be seen as equitable towards taxpayers.

As explained previously, National Treasury struggled to accept the fact that the application of some DTAs resulted in South Africa losing its taxing rights upon emigration from South Africa, after it granted significant income tax deductions to such taxpayers. This concern is removed if this alternative is accepted, as the income tax deductions are not granted in the year in which contributions are made to retirement funds, and the granting of such deductions is conditional on South Africa retaining its right to tax subsequent income from such funds. As indicated above, the amount included in the “allowable deductions component” would fall away where South Africa loses its taxing rights. This may be perceived as coherent.

If this alternative is pursued by National Treasury, the taxpayer may seek tax relief in the other country of residence for any undeducted contributions in South Africa when the resultant income is subject to tax in that other country. There is merit in believing that the other resident country is better positioned to deal with deductions disallowed in South Africa than with income already taxed in South Africa. The OECD MTC provides that article 18, dealing with pensions payable by private sector retirement

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<sup>248</sup> of the Income Tax Act No.58 of 1962

<sup>249</sup> Ibid.

funds, applies regardless of the tax treatment of the scheme under which the relevant payments are made; thus, a payment made under a pension plan that is not eligible for tax relief could still constitute a “pension or other similar remuneration”.<sup>250</sup> While article 18 of the OECD MTC does not explicitly mention the tax treatment of disallowed contributions, it is likely that they may allow the deduction in the other resident country (similar to paragraph 5 or 6 of the Second Schedule).<sup>251</sup> The South Africa (“SA”)-United Kingdom (“UK”) DTA addresses the deductibility of contributions made to a retirement fund in another country and allows these contributions to be deducted in the resident country as it is treated as being made in that country and subject to the same conditions and limitations as contributions made in such resident country.<sup>252</sup> Allowing the undeducted contributions to be deducted in the other resident country avoids economic double taxation which may be perceived as coherent. However, as mentioned in chapter one, the consideration of foreign jurisdictions’ tax law and the detail of specific DTAs is beyond the scope of this dissertation.

Implementing the modified TTE taxation regime under this alternative rather than attempting to levy tax on a deemed withdrawal on emigration from South Africa is coherent as it does not result in treaty override (i.e., article 18 of the OECD MTC is honored as the other resident country is granted exclusive taxing rights on such amounts). The fact that a taxpayer may lose the right to claim certain deductions in instances where South Africa loses the right to tax any future income from a South African retirement fund (due to the application of a DTA) is a separate issue. The possibility of the taxpayer being taxed on the gross subsequent income amount in the other country of residence if such country does not allow a deduction for undeducted contributions in South Africa is also a separate issue and does not result in treaty override of article 18 of the OECD MTC.

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<sup>250</sup> OECD Commentary on Article 18 of the OECD Model Tax Convention on Income and on Capital, 21 November 2017, <https://www.oecd.org/ctp/treaties/model-tax-convention-on-income-and-on-capital-condensed-version-20745419.htm>

<sup>251</sup> to the Income Tax Act No.58 of 1962

<sup>252</sup> Article 17(3)(a) of the Double Tax Agreement between South Africa and United Kingdom, page 343 of the Income Tax Act No.58 of 1962

The implementation of stricter taxation regimes has been done in other countries before. As indicated in Figure 2 (in section 4.2 above),<sup>253</sup> there are countries applying the TTE taxation regime, such as Australia, New Zealand, and Turkey, which tax contributions made to retirement funds and allow subsequent withdrawals from funds to be tax-free. Australia allows subsequent retirement benefits to be tax-free as they have already been subject to tax in the fund (where the benefits comprised a taxed element).<sup>254</sup> The transition to the TTE taxation regime could, thus, be less administratively burdensome if the processes followed by other countries that have done it before are studied.

Prior to the tax reform which took place in the late 1980s, New Zealand followed the EET taxation regime and offered tax incentives to save for retirement through tax exemptions on contributions made to retirement funds. Between 1988 and 1990, New Zealand changed its taxation regime from EET to TTE by removing all tax incentives for retirement savings and flattening the tax scale. The change in the taxation regime was done to ensure tax neutrality between different savings vehicles (i.e., there was no distinction between the tax treatment of retirement savings and any other types of savings).<sup>255</sup> The intent was to “level the playing field” by removing, or minimizing, the economic cost of distortions that arose from treating various income streams differently.<sup>256</sup> After this change, New Zealand’s tax system became one of the most broadly based, neutral and efficient in the OECD.<sup>257</sup> The process followed in New Zealand could be studied to reduce the administrative issues which may arise during the transition period in South Africa.

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<sup>253</sup> OECD, Project on Financial Incentives and Retirement Savings, Policy brief no. 1, “The tax treatment of retirement savings in private pension plans”, December 2018, <https://www.oecd.org/daf/fin/private-pensions/Tax-treatment-of-retirement-savings-Policy-Brief-1.pdf>

<sup>254</sup> Peter Harper, Taxation of foreign pensions, <https://asenaadvisors.com/knowledge-centre/whitepapers/taxation-of-foreign-pensions/>

<sup>255</sup> Ministry of Social Development, “Periodic Report Group 2003, Background Paper, A Description of New Zealand’s Current Retirement Income Framework”, July 2003, <https://www.treasury.govt.nz/sites/default/files/2007-11/prg-msd-dnzcrif.pdf>

<sup>256</sup> Susan St. John, “New Zealand’s Experiment in Tax Neutrality for Retirement Saving”, The Geneva Papers, 2007, <https://link.springer.com/article/10.1057/palgrave.gpp.2510142>

<sup>257</sup> Thomas Dalsgaard, “The Tax system in New Zealand: An Appraisal and Options for Change”, OECD Economics Department working paper No. 281, 31 January 2001, <https://www.oecd-ilibrary.org/docserver/382808014300.pdf?expires=1699344775&id=id&accname=guest&checksum=F7447805993004811DBD09B756BDFC1C>

#### 4.4.2 **Shortcomings of deferred, conditional income tax deductions**

The postponement of the most significant section 11F income tax deduction, and possible loss thereof where the conditions are not satisfied later, may lead to an increased normal tax liability for taxpayers during the years of assessment in which contributions are made to retirement funds. This confirms the aggressive nature of a “comprehensive income tax” regime such as TTE which could be seen as controversial, given the current state of the economy and that taxpayers are already struggling financially. The fact that these taxpayers may get the relief later if they stay in South Africa might soften the negative impact of this alternative.

As mentioned under alternative one, there seems to be evidence which suggests that an up-front tax incentive (in the form of the section 11F income tax deduction for contributions made to retirement funds) is an immediately felt benefit, which incentivizes taxpayers to save for retirement.<sup>258</sup> This alternative may reduce the certainty afforded to taxpayers and may result in unintended consequences as taxpayers might want to save less in retirement funds where deductions are deferred and conditional. By deferring the deduction to a time where taxpayers may be in a lower tax bracket, it provides less benefit to taxpayers than receiving the section 11F deduction at the time of making contributions.

This alternative could, furthermore, lead to reduced retirement savings as taxpayers are able to invest less due to the upfront taxing of the amounts contributed to retirement funds, reducing the level of certainty afforded to taxpayers. It should, however, be noted that while it was alleged that New Zealand’s shift from EET to TTE led to a dramatic reduction in pension savings, there is no clear evidence that there is a direct correlation between tax treatment and the size of pension funds. Austria and Portugal have relatively small funds regardless of the most generous tax incentives provided to taxpayers. In contrast, Finland and Japan apply the stringent comprehensive tax income system but have large pension funds.<sup>259</sup> Given the diverse

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<sup>258</sup> Gizelle D. Willows, Thomas Burgers, Darron West, 2018, “A comparison of retirement saving using discretionary investment and Regulation 28”, South African Journal of Economic and Management Sciences 21(1), a1995. <https://doi.org/10.4102/sajems.v21i1.1995>, [http://www.scielo.org.za/scielo.php?script=sci\\_arttext&pid=S2222-34362018000100059](http://www.scielo.org.za/scielo.php?script=sci_arttext&pid=S2222-34362018000100059)

<sup>259</sup> Edward Whitehouse, “The tax treatment of funded pensions”, 2001 <https://www.oecd.org/finance/private-pensions/2391559.pdf>

results recorded in other countries, it might be worth not assigning too much weight to the theory that it will negatively impact retirement savings.

The promise of a deduction later, if certain requirements are satisfied, requires taxpayers to trust that a future government will not change the tax policy. It is, however, not guaranteed that a future government will adhere to commitments made by prior governments. They may view pension fund withdrawals as an easy revenue target and go against the decision to allow the promised deferred deduction of contributions. This would likely undermine the attractiveness of retirement savings to future potential investors and reduce the level of certainty for taxpayers.<sup>260</sup> This has been experienced in New Zealand before where compulsory contribution limits were established by the 1975 Labour government, which were subsequently removed with the change of government in the following year.<sup>261</sup> The fact that returns may be taxed under this alternative could also lead to taxpayers choosing to invest in an alternative savings vehicle which allows returns to be tax-free. This may, however, be classified as an unintended consequence (i.e., not a tax issue), which is beyond the scope of this dissertation.

If this alternative is pursued, it may result in different tax treatment for resident versus non-resident taxpayers. This alternative may result in resident taxpayers being taxed on their returns, whereas non-resident taxpayers who emigrate from South Africa not being taxed on such returns. It could be argued that these non-resident taxpayers will be taxed in their new resident country, which may balance out the inequity.

Given that this alternative regains taxing rights over contributions only, the risk of fiscal revenue loss remains in instances where South Africa loses its taxing rights due to the application of some DTAs. Under this alternative, National Treasury may still forfeit the right to tax the additional returns on the contributions made by taxpayers, which may be perceived as incoherent.

A modified TTE taxation regime would be a dramatic policy change, could be costly to implement and may cause increased political issues. As indicated above, the SARS

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<sup>260</sup> Ibid.

<sup>261</sup> Ministry of Social Development, "Periodic Report Group 2003, Background Paper, A Description of New Zealand's Current Retirement Income Framework", July 2003, <https://www.treasury.govt.nz/sites/default/files/2007-11/prg-msd-dnzcrif.pdf>

e-Filing system would need to be updated so that the section 11F deductions are still calculated but not included in the taxpayer's current year of assessment. Furthermore, the transition from EET to a modified TTE taxation regime could take a long time and the ongoing administrative problem of managing the transition would not be simple as it would require management of past contributions that have already been deducted versus future contributions that will be a deferred deduction (even though the change in contributions could be tracked by National Treasury or retirement funds from the implementation date). The fact that this change only applies prospectively could mean that there is some inequity, as taxpayers who would have made contributions under the old system could be in a better position than someone who is starting to make contributions under the new system.

If this alternative is pursued by National Treasury, there is a chance that the taxpayer may not be allowed tax relief in the other country of residence for any undeducted contributions in South Africa. As mentioned previously, article 18 of the OECD MTC does not explicitly mention the tax treatment of disallowed contributions. This may be perceived as incoherent as the non-resident taxpayer might be taxed on the gross subsequent income amount, without the benefit of the deduction for the contributions in either country. However, as mentioned in chapter one, the consideration of foreign jurisdictions' tax law and the detail of specific DTAs is beyond the scope of this dissertation.

A further possible complication arises where a taxpayer chooses to emigrate from South Africa a few years after being retired. There is uncertainty regarding whether these taxpayers should still be allowed to claim deductions, and if so, the amount of deductions that should be allowed and how this should be determined. National Treasury may need to assess whether it would allow all allowable deductions to be claimed upfront upon retirement, or if the deductions will be allowed to be claimed proportionally against each month's pension. The latter may be fairer, but more complicated to administer.

As indicated above, New Zealand changed its taxation regime from EET to TTE in the late 1980s and was able to sustain this for nearly 20 years. At that time, it was noted that New Zealand was the only OECD country to treat retirement savings the same as any other form of savings. The idea of tax neutrality in the treatment of savings was,

however, difficult to realize in practice. The consultative committee set up to hear the public's submissions regarding the proposed change to the TTE taxation regime listed the following key concerns: the proposed TTE taxation regime would be more fiscally costly than the equivalently neutral EET regime (despite the short-term gains due to bringing the tax liability forward to contributions); there would be a risk of an increased number of retirement funds being wound up which would mean increased dependency on state pensions in the future; and the fear that some future government could impose a tax on pensions later on even though the upfront incentive was removed might disincentivize contributions. The changed taxation regime was, nonetheless, implemented, worked tolerably well, and was applied for nearly two decades.<sup>262</sup>

It was questionable whether New Zealanders can save enough, individually or as a nation, under the current TTE regime. In addition, membership in retirement funds decreased between 1990 and 2005. In 2005 in New Zealand, total pension funds were only 11.3 percent of gross domestic product ("GDP").<sup>263</sup> While the TTE taxation regime remained in place, New Zealand had no choice but to reintroduce some tax incentives (such as a new retirement savings plan, KiwiSaver, offered by private-sector providers and partially subsidized by government, as well as tax incentives for employer contributions)<sup>264</sup> for retirement savings toward the end of 2007.<sup>265</sup> The KiwiSaver retirement plan was introduced to encourage New Zealanders to save more for retirement to maintain their pre-retirement standard of living and to supplement the public pension benefit plan, called the New Zealand Superannuation ("NZS").<sup>266</sup> Based on the New Zealand experience, it is, therefore, questionable whether this alternative would work in South Africa for the foreseeable future (unless National Treasury provides some subsidies as the upfront tax rates is higher than the retirement tax rates).

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<sup>262</sup> Susan St. John, "New Zealand's Experiment in Tax Neutrality for Retirement Saving", The Geneva Papers, 2007, <https://link.springer.com/article/10.1057/palgrave.gpp.2510142>

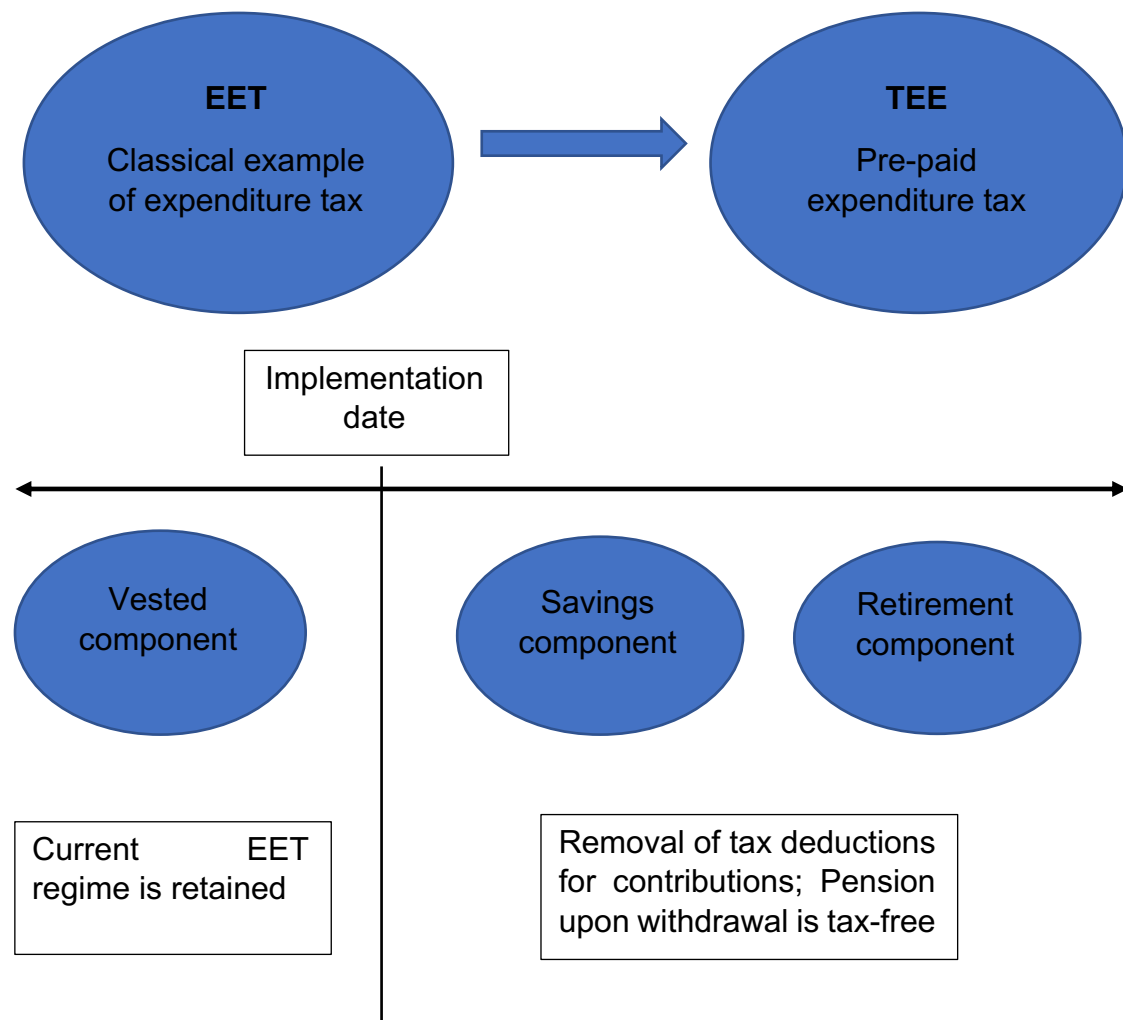
<sup>263</sup> Ibid.

<sup>264</sup> Barbara E. Kritzer, "KiwiSaver: New Zealand's New Subsidized Retirement Savings Plan", 2007, <https://www.ssa.gov/policy/docs/ssb/v67n4/v67n4p113.pdf>

<sup>265</sup> Susan St. John, "New Zealand's Experiment in Tax Neutrality for Retirement Saving", The Geneva Papers, 2007, <https://link.springer.com/article/10.1057/palgrave.gpp.2510142>

<sup>266</sup> Barbara E. Kritzer, "KiwiSaver: New Zealand's New Subsidized Retirement Savings Plan", 2007, <https://www.ssa.gov/policy/docs/ssb/v67n4/v67n4p113.pdf>

#### 4.5 Alternative 3: Change the taxation regime from EET to TEE



**Figure 4: Changing the taxation regime from EET to TEE (author’s own construction)**

If this alternative were pursued by National Treasury, the taxation regime applied to retirement savings would change from the classical example of expenditure tax,<sup>267</sup> EET, to the pre-paid expenditure tax,<sup>268</sup> TEE. Under this alternative, National Treasury would remove the current section 11F income tax deduction allowed against actual and deemed member contributions (as of the implementation date) and allow future retirement saving benefits (on or after implementation date), to be taken tax-free. This would mean that individual taxpayers would make contributions to retirement funds

<sup>267</sup> Edward Whitehouse, “The tax treatment of funded pensions”, 2001 <https://www.oecd.org/finance/private-pensions/2391559.pdf>

<sup>268</sup> Ibid.

out of their after-tax income and would no longer receive an upfront tax incentive to make those contributions.

#### 4.5.1 **Merits of changing the taxation regime from EET to TEE**

Under this alternative, the returns generated on the investment remain tax-free and will not be subject to tax in South Africa. This appears to be more favorable to the taxpayer when compared to alternative two. As illustrated in the table in section 4.2 above, the net pension for the taxpayer under both the EET and TEE taxation regimes is the same. The pre-tax return on pre-tax contributions under the EET taxation regime (determined as  $61.05/100 = 0.6105$ ) is the same as the post-tax return on post-tax income under the TEE taxation regime ( $45.79/75 = 0.6105$ ). It was proven in the abovementioned table that it does not matter whether the tax is paid to National Treasury upfront (under the TEE taxation regime) or at the end (under the EET taxation regime). This alternative is, therefore, equitable for taxpayers and coherent for National Treasury as neither party wins nor loses under this option. Furthermore, the conflicting views regarding tax incentives (discussed under alternative one) justifies the alternative to defer the tax incentive from the stage of contributions to the stage of withdrawals by removing the current tax deduction and allowing retirement saving benefits to be tax-free.

The argument (included under alternative one) that the tax treatment obtained under the EET taxation regime ensures that individuals maintain their standard of living in retirement is questionable, as it is not guaranteed that individuals would make “sufficient” provision for retirement.<sup>269</sup> This uncertainty is one of the reasons why National Treasury wishes to implement the “two-pot” retirement system to ensure that at least two-thirds of future contributions are preserved.<sup>270</sup> This supports the shift in taxation regime from EET to TEE and may be perceived as providing certainty to taxpayers. It could be argued that other means, such as a minimum level of

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<sup>269</sup> Ibid.

<sup>270</sup> Draft Memorandum on the Objects of the Draft Revenue Administration and Pension Laws Amendment Bill, 9 June 2023

compulsory contributions to retirement funds, could be explored as an alternative to granting tax relief when making contributions to such funds.<sup>271</sup>

There is, furthermore, no guarantee that the current EET taxation regime encourages individuals to save for their own retirement and in so doing reduces the cost of social security benefits (as argued for under alternative one).<sup>272</sup> It is well understood that our current economic circumstances do not allow everyone to save for retirement, especially for unemployed individuals and individuals with low-income earnings. These individuals, therefore, rely on and will remain reliant on National Treasury to support their standard of living. This, furthermore, supports the shift in taxation regime from EET to TEE and may be perceived as providing certainty to taxpayers.

The current upfront tax incentive comes at a cost in fiscal revenue which ultimately negatively impacts public sector spending.<sup>273</sup> Removing this incentive protects the South African tax base as it allows government to collect tax immediately, which in turn increases the fiscal revenue available to provide services to the public. It will, furthermore, raise more fiscal revenue from higher-rate taxpayers during their working life compared to lower tax rates charged during their retirement life.<sup>274</sup>

The change in prospective contributions and the benefits attributable to them would apply equally to all taxpayers who remain in South Africa as well as to taxpayers who leave South Africa prior to retirement. This could be seen as equitable for the taxpayer.

While this alternative may seem very harsh on taxpayers, it is worth noting that National Treasury intends to remove the medical aid tax credits currently granted to taxpayers in terms of sections 6A and 6B of the Income Tax Act.<sup>275</sup> These credits will be redirected from wealthier individuals into the National Health insurance (i.e., the public medical system). It is alleged that neither the current private medical tax credit system nor the public medical system works efficiently and effectively, and that this

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<sup>271</sup> Edward Whitehouse, "The tax treatment of funded pensions", 2001 <https://www.oecd.org/finance/private-pensions/2391559.pdf>

<sup>272</sup> Ibid.

<sup>273</sup> Ibid.

<sup>274</sup> Ibid.

<sup>275</sup> No.58 of 1962

shift would result in additional funding available to the public medical sector.<sup>276</sup> The removal of the upfront tax incentive would similarly allow National Treasury to redirect the extra tax collected upfront to the public social security benefits system and may be regarded as good administrability.

It is Whitehouse's view that a generous tax treatment may be costly in terms of revenue forgone and may encourage tax avoidance.<sup>277</sup> The collection of fiscal revenue upfront limits the risk of intentional tax avoidance and evasion and is simple as it reduces the administrative burden often placed on retirement funds. It ensures that revenue can be collected from foreign workers and people who emigrate on or before retirement, demonstrating a well administered tax system.<sup>278</sup> This means that National Treasury will not lose out at the end when taxpayers choose to emigrate before retirement as those retirement savings would have been allowed tax-free anyway.

As explained previously, the current regime and application of some DTAs may result in South Africa losing its taxing rights on retirement savings upon emigration from South Africa. This risk is removed if National Treasury changes the taxation regime from EET to TEE. Implementing the TEE taxation regime and allowing the future retirement savings to be tax-free in South Africa is coherent as it does not result in treaty override (i.e., article 18 of the OECD MTC is honored as the other resident country is granted exclusive taxing rights on such amounts). The possibility of the taxpayers being taxed on the gross subsequent income amount in the other country of residence if such country does not allow a deduction for undeducted contributions in South Africa is a separate issue and does not result in treaty override of article 18 of the OECD MTC.

South Africa would not be the first country to implement a TEE taxation regime. As indicated in Figure 2 (in section 4.2 above),<sup>279</sup> there are countries applying the TEE

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<sup>276</sup> eNCA, "Farewell to medical aid tax credits", 1 November 2023, <https://www.enca.com/business/farewell-medical-aid-tax-credits>

<sup>277</sup> Edward Whitehouse, "The tax treatment of funded pensions", 2001 <https://www.oecd.org/finance/private-pensions/2391559.pdf>

<sup>278</sup> Ibid.

<sup>279</sup> OECD, Project on Financial Incentives and Retirement Savings, Policy brief no. 1, "The tax treatment of retirement savings in private pension plans", December 2018, <https://www.oecd.org/daf/fin/private-pensions/Tax-treatment-of-retirement-savings-Policy-Brief-1.pdf>

taxation regime, such as Luxembourg, Czech Republic, and Hungary, that tax the income from which contributions are made to retirement funds (i.e., no deduction is allowed for such contributions) and allow subsequent income from funds to be tax-free. This evidence supports the shift in taxation regime from EET to TEE and may be perceived as providing a sense of stability and certainty for taxpayers. Furthermore, as mentioned under alternative two (in section 4.4.2 above), there is no clear evidence to suggest that a shift in any taxation regimes consistently negatively impacted retirement savings.

#### **4.5.2 Shortcomings of changing the taxation regime from EET to TEE**

This alternative may result in significant administrability challenges as the shift from EET to TEE taxation regime is a dramatic policy change. The transition between the two taxation regimes could take a long time, be costly to implement and the ongoing administrative problems of managing the transition could be complicated. It would require National Treasury or retirement funds to deal with the legacy contributions that were deductible as well as the new contributions that are not allowed as deductions (as of the implementation date). Furthermore, as the regime change will only be effective prospectively, the risk of fiscal revenue loss remains in instances where South Africa loses its taxing rights over benefits arising from contributions already allowed as a deduction (due to the application of some DTAs).

As mentioned previously, there seems to be evidence which suggests that an upfront tax incentive (in the form of the section 11F income tax deduction for contributions made to retirement funds) is an immediately felt benefit, which incentivizes taxpayers to save for retirement.<sup>280</sup> The alternative to remove this upfront tax incentive may result in unintended consequences as taxpayers may no longer wish to invest in retirement funds voluntarily, which could lead to reduced fund sizes. Possible mitigating options include making contributions to retirement funds compulsory or granting a lower percentage of contributions made as a tax deduction (for example, 10% of the contributed amount) without planned recovery through future taxation of retirement benefits.

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<sup>280</sup> Gizelle D. Willows, Thomas Burgers, Darron West, 2018, "A comparison of retirement saving using discretionary investment and Regulation 28", South African Journal of Economic and Management Sciences 21(1), a1995. <https://doi.org/10.4102/sajems.v21i1.1995>, [http://www.scielo.org.za/scielo.php?script=sci\\_arttext&pid=S2222-34362018000100059](http://www.scielo.org.za/scielo.php?script=sci_arttext&pid=S2222-34362018000100059)

A change in taxation regime could be costly to implement and may cause increased issues for the retirement benefit industry and economy. This alternative could result in reduced retirement savings to be managed by retirement funds, as contributions to such funds are made from after-tax income. This might result in shrinkage of the overall retirement investment pool, creating a problem for the economy, as retirement funds are significant investors. This was one of the concerns raised when New Zealand moved away from an upfront deduction system, as discussed under alternative two. This risk might be partially offset by the upfront collection and utilisation of increased fiscal revenue by National Treasury.

If this alternative is pursued by National Treasury, the taxpayer may still be taxed in the other country of residence on subsequent withdrawals or retirement benefits, even though they made contributions to retirement funds from after-tax income in South Africa (due to the removal of the income tax deduction for contributions made to such funds). As indicated under alternative two, the OECD MTC provides that article 18, dealing with pensions payable by private sector retirement funds, applies regardless of the tax treatment of the scheme under which the relevant payments are made; thus, a payment made under a pension plan that is not eligible for tax relief could still constitute a “pension or other similar remuneration”.<sup>281</sup> As article 18 of the OECD MTC makes no explicit mention of the tax treatment of undeducted contributions, there is a chance that the taxpayer may not be allowed tax relief in the other country of residence for such amounts. This may be viewed as incoherent. The non-resident may, nonetheless, seek tax relief for the undeducted contributions in the other country of residence. However, as mentioned in chapter one, the consideration of foreign jurisdictions’ tax law and the detail of specific DTAs is beyond the scope of this dissertation.

It is, furthermore, not guaranteed that a future government will adhere to commitments made by prior governments. They may view pension fund withdrawals and retirement benefits as an easy revenue target and reverse the decision to allow these to be received tax-free, despite the removal of the tax deduction. The fear of such an eventuality would undermine the attractiveness of retirement savings to future

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<sup>281</sup> OECD Commentary on Article 18 of the OECD Model Tax Convention on Income and on Capital, 21 November 2017, <https://www.oecd.org/ctp/treaties/model-tax-convention-on-income-and-on-capital-condensed-version-20745419.htm>

potential investors and remove uncertainty for taxpayers.<sup>282</sup> This has been experienced in New Zealand before, as discussed under alternative two.

#### **4.6 Alternative 4: Establishment of a simplified exit tax on retirement fund interests**

National Treasury initially proposed to classify the retirement fund interest as a revenue asset in terms of the new section 9HC.<sup>283</sup> The revenue asset was intended to result in the deemed proceeds amount being included in gross income (in terms of special inclusion paragraph (e))<sup>284</sup> which would be subject to tax in South Africa based on the retirement fund lump sum withdrawal benefits table.<sup>285</sup>

The concept of an “exit tax” which occurs upon ceasing to be resident currently exists in the South African tax legislation. Section 9H<sup>286</sup> provides for a deemed disposal of a natural person’s assets immediately prior to ceasing to be a resident. The deemed disposal (which is similar to an exit tax) could trigger ordinary income or be subject to capital gains tax.<sup>287</sup> To be subject to capital gains tax, the Eighth Schedule<sup>288</sup> requires the disposal of an asset which had a base cost for an amount of proceeds (also referred to as the four basic building blocks in determining a capital gain or loss).<sup>289</sup>

The definition of an asset is not concerned with the capital or revenue nature of property.<sup>290</sup> The inclusion of the retirement fund interest as a revenue asset in terms of section 9H may result in the deemed proceeds amount being included in gross income and being subject to normal tax at the marginal tax rates (consistent with the

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<sup>282</sup> Edward Whitehouse, “The tax treatment of funded pensions”, 2001 <https://www.oecd.org/finance/private-pensions/2391559.pdf>

<sup>283</sup> Draft Explanatory Memorandum on the Taxation Laws Amendment Bill, 28 July 2021

<sup>284</sup> section 1 of the Income Tax Act No.58 of 1962

<sup>285</sup> Draft Explanatory Memorandum on the Taxation Laws Amendment Bill, 28 July 2021

<sup>286</sup> of the Income Tax Act No.58 of 1962

<sup>287</sup> South African Revenue Service, “Comprehensive Guide to Capital Gains Tax”, Issue 9, 5 November 2020, <https://www.sars.gov.za/wp-content/uploads/Ops/Guides/LAPD-CGT-G01-Comprehensive-Guide-to-Capital-Gains-Tax.pdf>

<sup>288</sup> to the Income Tax Act No.58 of 1962

<sup>289</sup> South African Revenue Service, “Comprehensive Guide to Capital Gains Tax”, Issue 9, 5 November 2020, <https://www.sars.gov.za/wp-content/uploads/Ops/Guides/LAPD-CGT-G01-Comprehensive-Guide-to-Capital-Gains-Tax.pdf>

<sup>290</sup> Ibid.

way amounts withdrawn from the savings component will be taxed under the proposed two-pot retirement system). Given that this classification may lead to the same concerns previously raised with the initial proposal, it might be more useful to consider the inclusion of retirement fund interests as a capital asset in the current section 9H.<sup>291</sup>

An asset is broadly defined as “including property of whatever nature, whether moveable or immoveable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum; and a right or interest of whatever nature to or in such property”.<sup>292</sup> As discussed in chapter two, retirement funds are governed by the rules contained in the Pension Funds Act,<sup>293</sup> resulting in a taxpayer’s retirement fund interest being treated differently to other assets (such as immoveable property owned). Section 37C<sup>294</sup> provides that the discretionary right to distribute the taxpayer’s retirement savings invested and accumulated in such funds belongs to the trustees of the fund (i.e., it will not be regarded as the taxpayer’s asset or property in the taxpayer’s estate upon death). Unless the current South African tax legislation is amended to provide for a “deemed asset”, it seems as though the first building block for capital gains tax is missing.

Disposal is also broadly defined in the Eighth Schedule and consists of actual and deemed disposals.<sup>295</sup> It would, however, be difficult to classify a taxpayer’s retirement fund interest as a disposal based on the nature of the investment (as one does not dispose of a retirement fund interest), even though section 9H provides for deemed disposals.

Proceeds is defined as being “equal to any amount received by or accrued to the taxpayer in respect of the disposal of an asset”.<sup>296</sup> This amount must, however, be reduced by “any amount that must be or was included in the gross income of that person or that must be or was taken into account when determining the taxable income

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<sup>291</sup> of the Income Tax Act No.58 of 1962

<sup>292</sup> Paragraph 1 of the Eighth Schedule to the Income Tax Act No.58 of 1962

<sup>293</sup> No. 24 of 1956

<sup>294</sup> of the Pension Funds Act No. 24 of 1956

<sup>295</sup> Paragraphs 11 and 12 of the Eighth Schedule to the Income Tax Act No.58 of 1962

<sup>296</sup> Paragraph 35(1) of the Eighth Schedule to the Income Tax Act No.58 of 1962

of that person”.<sup>297</sup> The words “must be” look to the future,<sup>298</sup> and as discussed in chapter two, it is clear that any amount received by or accrued from a retirement fund will be included in the taxpayer’s gross income (although it may be argued that this future inclusion will not arise in the case of the taxpayer who ceases to be tax resident in South Africa). The base cost of an asset is defined as being “the sum of expenditure actually incurred in the acquisition or creation of the asset”, plus other allowable expenditure.<sup>299</sup> This amount must, similarly, be reduced by “any amount which is or was allowed as a deduction in determining the taxable income of that person”.<sup>300</sup> As discussed in chapter two, the amounts contributed to any retirement fund is allowed as a deduction in terms of the current section 11F<sup>301</sup> (and previously in terms of section 11(k) or (n)). Thus, while there may be a disposal on cessation of residence, it should not give rise to a capital gain or loss.<sup>302</sup>

Based on the above, it appears that including retirement fund interests as a capital asset will also not be meaningful and that it should not form part of section 9H.<sup>303</sup> This was confirmed in the 2021 draft Taxation Laws Amendment Bill, where it was proposed that “any amount representing the value of the interest in any pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund” must explicitly be excluded from the deemed exit tax in terms of section 9H.<sup>304</sup> This amendment to clarify section 9H was supported by the South African Institute of Chartered Accountants (SAICA) in its comments on the initial proposal submitted to National Treasury.<sup>305</sup>

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<sup>297</sup> Paragraph 35(3) of the Eighth Schedule to the Income Tax Act No.58 of 1962

<sup>298</sup> South African Revenue Service, “Comprehensive Guide to Capital Gains Tax”, Issue 9, 5 November 2020, <https://www.sars.gov.za/wp-content/uploads/Ops/Guides/LAPD-CGT-G01-Comprehensive-Guide-to-Capital-Gains-Tax.pdf>

<sup>299</sup> Paragraph 20(1) of the Eighth Schedule to the Income Tax Act No.58 of 1962

<sup>300</sup> Paragraph 20(3) of the Eighth Schedule to the Income Tax Act No.58 of 1962

<sup>301</sup> of the Income Tax Act No.58 of 1962

<sup>302</sup> South African Revenue Service, “Comprehensive Guide to Capital Gains Tax”, Issue 9, 5 November 2020, <https://www.sars.gov.za/wp-content/uploads/Ops/Guides/LAPD-CGT-G01-Comprehensive-Guide-to-Capital-Gains-Tax.pdf>

<sup>303</sup> of the Income Tax Act No.58 of 1962

<sup>304</sup> Draft Taxation Laws Amendment Bill, 28 July 2021

<sup>305</sup> The South African Institute of Chartered Accountants, “SAICA comments on the Draft Taxation Laws Amendment Bill and Tax Administration Laws Amendment Bill of 2021 and the second batch of the

It may, therefore, be more appropriate to consider the introduction of a simplified exit tax on retirement savings in South Africa. If this alternative were pursued by National Treasury, it would require amendments to the initial proposal issued so that it does not result in the same concerns raised previously. Such an approach would retain the concept of a deemed withdrawal of the individual's interest in the retirement fund on the day before he or she ceases to be tax resident in South Africa. However, it would also require consideration of the proposed two-pot retirement system.

The retirement fund interest which would be deemed to have been withdrawn, and subject to tax in South Africa, would need to consist of 100% of the vested component (i.e., on or before 1 September 2024) and the one-third of contributions included in the savings component (from 1 September 2024) as determined on the day before ceasing to be tax resident, since this is the maximum amount that a taxpayer could actually withdraw. The two-thirds of contributions (made on or after 1 September 2024) included in the retirement component would be excluded from the total deemed amount to avoid subjecting to tax an amount that the taxpayer could not actually have withdrawn at the date of emigration. The tax on the deemed amount would have to be calculated without any regard to the taxpayer's intention to withdraw or retain his or her retirement fund interest. The tax could be calculated either with reference to a flat rate or a progressive tax rate.

If this alternative were pursued by National Treasury, a flat rate could be used to determine the tax liability in South Africa. In determining the flat rate which would work in South Africa, National Treasury would need to consider the state of the economy, whether the rate represents a reasonable compromise in comparison to the taxes that would have otherwise arisen in the future if the taxpayer has not ceased to be resident and other relevant factors. Alternatively, the retirement fund interest balance could be split between the amount included in the vested component and the savings component and could be taxed progressively to align with the proposed two-pot retirement system. The amount included in the vested component could be subject to tax in terms of the retirement fund lump sum withdrawal table, whereas the amount

included in the savings component could be subject to tax in terms of the normal tax tables (at the marginal tax rates).

The exit tax charged under this alternative would be due and payable by the taxpayer prior to emigrating from South Africa (i.e., the tax liability will not be deferred to a later date). The retirement fund could subtract the exit tax charged from the taxpayer's current retirement fund balance to avoid any potential cash flow problems for the taxpayer. Furthermore, the obligation to collect and remit the tax to National Treasury could be placed on the retirement fund. This removes the uncertainties regarding the interest charged during the three-year or longer waiting period and eliminates the need for the complexities involving the tax credit granted in South Africa later. After the retirement funds have collected and remitted the tax to National Treasury, the nature of the investment could be changed from a retirement fund investment to a non-specific investment (such as a unit trust). Any future receipts or accruals from such investment will be in the form of interest and/or dividends (i.e., it will not be classified as a retirement fund interest) and will be considered for tax in South Africa (as it will not be subject to the provisions of article 18 of the OECD MTC).

#### **4.6.1 Merits of establishing a simplified exit tax on retirement fund interests**

The imposition of a simplified exit tax on retirement fund interests would result in increased fiscal revenue for National Treasury and may be perceived as coherent, given the substantial income tax deductions granted to taxpayers over several years. Furthermore, this alternative ensures that the tax treatment between residents and non-residents is equitable, as taxpayers who cease to be resident in South Africa will be taxed prior to emigration and taxpayers who remain resident in South Africa will be taxed upon retirement. This alternative protects the South African tax base without skewing the tax burden to any one particular group of taxpayers.

If this alternative is pursued by National Treasury, it will eliminate most key issues in the initial proposal as outlined in chapter three previously. There will be no delay between the time the tax is calculated and the time it is due and payable by the taxpayer (meaning there is no prolonged interest charged on the outstanding tax balance), no complexities involving the tax credit granted in South Africa later, and less uncertainties with the proposal itself. This alternative, therefore, maintains stability and simplicity for the taxpayer.

In addition, implementing a simplified exit tax on retirement fund interests removes the potential double taxing of retirement saving amounts. If this alternative is pursued by National Treasury, the deemed withdrawal prior to emigrating from South Africa may result in the amount being subject to tax in South Africa. If the nature of the investment is changed to a non-specific investment (and this change is accepted in the other resident country), there will be no future retirement fund interest receipt or accrual to be taxed in the other resident country (as it will be classified as something else). This alternative is, thus, is coherent as it avoids instances of economic double taxation.

The imposition of a simplified exit tax under this alternative is coherent as it eliminates or avoids treaty override. If the other resident country accepts the change in the nature of the investment, the provisions of article 18 of the OECD MTC will not apply and any future receipts or accruals will no longer be classified as retirement fund interests (i.e., the exclusive taxing rights granted to the other resident country no longer applies). Any subsequent receipts or accruals from the non-specific investment may take the form of interest and/or dividends. Article 10 of the OECD MTC deals with dividends and provides that the dividend amount may be taxed in the other resident country as well as in South Africa. However, the amount taxed in South Africa on any dividends paid to a non-resident individual taxpayer shall not exceed 15% of the gross amount of the dividends.<sup>306</sup> Similarly, article 11 of the OECD MTC deals with interest and provides that the interest amount may be taxed in the other resident country as well as in South Africa. However, the amount taxed in South Africa on any interest paid to a non-resident individual taxpayer shall not exceed 10% of the gross amount of the interest.<sup>307</sup> This means that South Africa will not completely lose out on the right to tax any future receipts or accruals to the non-resident taxpayer after emigrating from South Africa (even though they are not granted exclusive taxing rights), and that any of the abovementioned articles do not have the effect of overriding the source rules provided in the South African Income Tax Act.<sup>308</sup>

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<sup>306</sup> Paragraphs 1 and 2 of article 10 of the OECD Model Tax Convention on Income and on Capital (21 November 2017)

<sup>307</sup> Paragraphs 1 and 2 of article 11 of the OECD Model Tax Convention on Income and on Capital (21 November 2017)

<sup>308</sup> No. 58 of 1962

#### 4.6.2 **Shortcomings of establishing a simplified exit tax on retirement fund interests**

This approach could result in a significant normal tax liability due to SARS. It should be emphasized that such tax liability would be calculated on a deemed withdrawal balance and is not aligned with the actual cash flow to the taxpayer at the time that such tax is due. This could lead to cash flow issues for the taxpayer as they may not be able to pay the tax liability all at once before leaving South Africa permanently. There may be merit in netting off the tax liability against the balance of the retirement fund interest, providing certainty for the taxpayer.

The imposition of a simplified exit tax under this alternative may create significant administrative or non-tax complications for National Treasury. It is questionable whether it is legal<sup>309</sup> for retirement fund administrators to manage non-retirement savings. National Treasury would need to determine whether any future non-retirement savings need to be physically separated from the funds retirement savings and how this would work. Furthermore, there is the risk that the other resident country might not accept the change in the nature of the investment and continue to tax any subsequent receipt or accrual as retirement benefits. If this occurs, it may lead to the same treaty override and double taxing issues previously raised in response to the initial proposal.

The new rules of the two-pot retirement system require that two-thirds of contributions made on or after 1 September 2024 be placed in a retirement component which cannot be accessed by taxpayers prior to retirement (even if such taxpayers emigrate from South Africa). This means that the alternative to include an exit tax on taxpayers emigrating from South Africa prior to retirement cannot include the retirement savings residing in the retirement component, as the taxpayer could not actually have withdrawn such amounts at the date of emigration. This may, thus, be perceived as incoherent for National Treasury as some fiscal loss will remain, unless these rules are amended in respect of emigration (so that these amounts do not escape tax in South Africa).

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<sup>309</sup> in terms of the rules provided in the Pensions Fund Act No. 24 of 1956

Imposing an exit tax on retirement fund interests could reduce the attractiveness of retirement saving in South Africa in general. This could lead to taxpayers choosing to invest in overseas retirement funds, even though they will not receive the paragraph 5 deductions outlined in the Second Schedule.<sup>310</sup> Alternatively, taxpayers may choose to invest their savings in other vehicles which are more favorable from a tax perspective. This could lead to reduced South African retirement fund sizes, as well as have a significant negative impact on the overall South African economy. This issue was raised in response to the initial proposal as well.

#### **4.7 Overall conclusion on a feasible alternative approach**

As established at the beginning of this chapter, the criteria for a feasible alternative approach to the initial proposal issued by National Treasury include the potentially competing needs for 1) equity within the tax system, 2) economic efficiency of the tax system, 3) administrability of the tax system, and 4) coherence of the tax system.<sup>311</sup> This section aims to compare the four possible alternatives against the established criteria. Each possible alternative has its own merits and shortcomings.

As discussed in chapter two, there have already been significant retirement reforms implemented in South Africa in the 2011, 2016, and 2021 years of assessment, with another round of retirement reforms likely to be implemented in the 2025 year of assessment. The imposition of another significant retirement reform under any of the possible alternatives may be perceived as complex and removing much need stability for taxpayers. Therefore, the merits of any alternative approach should be weighed up against the perceived increase in complexity and decrease in stability.

If alternative one is pursued by National Treasury, the current EET taxation regime would be retained and the proposed exit tax on retirement fund interests upon emigration from South Africa would be withdrawn permanently.<sup>312</sup> Under this

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<sup>310</sup> to the Income Tax Act No. 58 of 1962

<sup>311</sup> Fundamentals of Taxation: An introduction to Tax Policy, Tax Law and Tax Administration (Pasquale Pistone, Jennifer Roeleveld, Johann Hattingh, Joao Felix, Pinto Nogueira, Craig West, IBFD 2019), Books IBFD, [https://research.ibfd.org/#/doc?url=/collections/pt/html/pt\\_c02.html](https://research.ibfd.org/#/doc?url=/collections/pt/html/pt_c02.html)

<sup>312</sup> The view to withdraw the current proposal is supported by professional bodies such as The South African Institute of Chartered Accountants (SAICA) and The South African Institute of Taxation (SAIT). The South African Institute of Chartered Accountants, "SAICA comments on the Draft Taxation Laws Amendment Bill and Tax Administration Laws Amendment Bill of 2021 and the second batch of the

alternative, National Treasury would embark on its plan to revise the multiple DTAs with other countries,<sup>313</sup> and would forfeit this tax revenue unless and until it is able to renegotiate such DTAs. Alternatively, National Treasury would not embark on its plan to revise the multiple DTAs with other countries,<sup>314</sup> and would rather forfeit this tax revenue indefinitely. It was established that this alternative is inequitable insofar as the tax treatment differs for residents and non-residents. This alternative is partially economically efficient. The decision to retain the current taxation regime, to not implement another retirement reform, and to grant an upfront tax incentive provides stability and simplicity for taxpayers. This alternative, furthermore, results in simplicity for taxpayers as all issues with the initial proposal are removed. The decision to embark on the process of revising multiple DTAs with other countries could, however, be complex and remove a degree of certainty currently afforded to taxpayers. This alternative is administrable as it supports the principles that a taxpayer should only have an administrative burden to comply with tax obligations in his or her resident country, and because it removes any administrative issues for National Treasury as it concedes to continuing to forfeit fiscal revenue. Finally, this alternative is partially coherent. It is coherent insofar as it avoids the double taxing of retirement savings, and it does not result in treaty override. It is, however, incoherent when considering the significant fiscal loss to the South African government, insofar as it results in a reduction in the South African tax base (linked to the forfeiture of tax revenue) and it is skewed towards shifting the overall tax burden on resident taxpayers (by allowing non-resident taxpayers to avoid such tax liability).

If alternative two is pursued, National Treasury would apply a modified version of the TTE taxation regime by making the section 11F income tax deductions deferred and conditional. Under this alternative, National Treasury would postpone the income tax deduction relating to contributions made or deemed to be made by members to

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2021 Draft Tax Bills”, 27 August 2021, [https://saicawebprstorage.blob.core.windows.net/uploads/resources/INTEGRITAS-770361-v1-2021\\_08\\_27\\_SAICA\\_comments\\_to\\_the\\_Draft\\_TLAB\\_and\\_TALAB\\_2021\\_FINAL.pdf](https://saicawebprstorage.blob.core.windows.net/uploads/resources/INTEGRITAS-770361-v1-2021_08_27_SAICA_comments_to_the_Draft_TLAB_and_TALAB_2021_FINAL.pdf); South African Institute of Taxation, “Comments on the 2021 Draft TLAB”, 27 August 2021, [https://cdn.ymaws.com/www.thesait.org.za/resource/resmgr/2021\\_technical/sars\\_submissions\\_pit\\_et\\_wg\\_submission\\_draft.pdf](https://cdn.ymaws.com/www.thesait.org.za/resource/resmgr/2021_technical/sars_submissions_pit_et_wg_submission_draft.pdf)

<sup>313</sup> National Treasury, “2022 Budget Review”, 23 February 2022, <http://www.treasury.gov.za/documents/national%20budget/2022/review/FullBR.pdf>

<sup>314</sup> Ibid.

retirement funds until such time as the benefits from such funds (be it a lump sum or annuity) are subject to tax in South Africa. It was established that this alternative is partially equitable. It is equitable insofar as the change in the income tax deductions would apply equally to all taxpayers. However, it is inequitable insofar as the tax treatment on returns differs for residents and non-residents, and as the change in the income tax deductions would only apply prospectively. This alternative is partially economically efficient, as the concept of deferred deductions exists in the South African taxation legislation, creating certainty and stability for taxpayers. However, the possibility of reduced retirement savings for taxpayers, the requirement to trust that a future government will not change the tax policy, and the implementation of another significant retirement reform could be seen as complex and reduce the level of certainty afforded to taxpayers. This alternative would result in significant administrability issues, even though other countries may have implemented stricter taxation regimes before. This alternative is a dramatic policy change, would be costly to implement, and the transition period would be lengthy and complicated to manage on an ongoing basis (due to the old versus new system). It was, furthermore, established that this alternative is partially coherent. It is coherent insofar as taxpayers lose the right to claim deductions for contributions made if South Africa loses the right to tax subsequent retirement savings, as it does not result in treaty override, and may be coherent if it avoids economic double taxation (this depends on whether the new country of residence would allow a deduction for undeducted contributions in South Africa and is, however, beyond the scope of this dissertation). However, it is incoherent to the extent that National Treasury continues to lose out on fiscal revenue.

If alternative three is pursued by National Treasury, the taxation regime applied to retirement savings would change from the classical example of expenditure tax,<sup>315</sup> EET, to the pre-paid expenditure tax,<sup>316</sup> TEE. Under this alternative, National Treasury would remove the current section 11F income tax deduction allowed against actual and deemed member contributions (which is simpler than keeping a record of the contributions and providing a deferred, conditional deduction), and allow future retirement saving benefits to be taken tax-free. This alternative is equitable, as the

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<sup>315</sup> Edward Whitehouse, "The tax treatment of funded pensions", 2001 <https://www.oecd.org/finance/private-pensions/2391559.pdf>

<sup>316</sup> Ibid.

returns generated on the investment remain tax-free, the taxpayer receives the same return under either of the two taxation regimes, and because the change under this alternative would apply equally to all taxpayers. This alternative is partially economically efficient. The fact that South Africa is not the first country to implement a TEE taxation regime provides a sense of stability and certainty for taxpayers. However, the possibility of reduced retirement savings for taxpayers, the requirement to trust that a future government will not change the tax policy, and the implementation of another significant retirement reform could be seen as complex and reduce the level of certainty afforded to taxpayers. This alternative is administrable insofar as the upfront tax collected could be redirected to the public social security benefits system, and it results in a reduced administrative burden on retirement funds. The change in tax policy would, however, still result in significant administrability issues, such as being costly to implement, a lengthy and complicated transition period, and ongoing management of the transition (due to the old versus new system). It was, furthermore, established that this alternative is partially coherent. It is coherent insofar as the upfront tax collection protects the South African tax base, it does not result in treaty override, and may be coherent if it avoids economic double taxation (again, this depends on whether the new resident country would allow a deduction for undeducted contributions in South Africa and is, however, beyond the scope of this dissertation). However, it is incoherent to the extent that National Treasury continues to lose out on fiscal revenue.

If alternative four is pursued by National Treasury, it would require amendments to the initial proposal issued so that it does not result in the same concerns raised previously. This would be achieved through a simplified exit tax on retirement fund interests being established in South Africa. The alternative would retain the deemed withdrawal of the individual's interest in the retirement fund on the day before he or she ceases to be tax resident in South Africa but would require consideration of the proposed two-pot retirement system, as well an adjustment to how the tax is calculated. It was established that this alternative is equitable as the tax treatment for residents and non-residents are the same (not only prospectively but before and after the change). This alternative is partially economically efficient. The establishment of a simplified exit tax under this alternative eliminates most of the key issues previously raised in the initial proposal, as well as eliminating potential cash flow issues where the normal tax liability

is netted off against the balance of the retirement fund interest (if possible), and maintains stability and simplicity for the taxpayer. However, the implementation of another significant retirement reform could be seen as complex and reduce stability for taxpayers. This alternative would result in significant administrability issues, as it is questionable whether it is legal for retirement fund administrators to manage non-retirement savings, whether future non-retirement savings need to be physically separated from the funds retirement savings, and whether the other resident country would accept the change in the nature of the investment post-tax. It was, furthermore, established that this alternative is partially coherent. It is coherent insofar as it results in increased fiscal revenue for National Treasury, it protects the South African tax base without skewing the tax burden to one particular group of taxpayers, it removes the potential double taxing of retirement saving amounts (if the nature of the after-tax investment is changed and this is accepted in the other resident country) and eliminates or avoids treaty override (if the other resident country accepts the change in the nature of the after-tax investment). This alternative may, however, be perceived as incoherent insofar as National Treasury continues to lose fiscal revenue on the retirement savings residing in the retirement component.

## 5. Conclusion

### 5.1 Introduction

This study focused on the proposed exit tax on retirement fund interests for residents (as defined)<sup>317</sup> who emigrate from South Africa (i.e., who become non-resident). The Income Tax Act grants significant section 11F income tax deductions for actual and deemed contributions made by members to retirement funds. The section 11F income tax deduction is regarded as the largest tax expenditure for the South African fiscus within the personal income tax system.<sup>318</sup> There is an implicit expectation that any future benefit received or accrued to members from such retirement fund upon withdrawal or retirement ought to be taxed in South Africa. The South African Income Tax Act provides that any non-resident who receives or becomes entitled to receive any benefit from retirement funds will be considered for tax in South Africa, provided the amount is in respect of services rendered within South Africa.<sup>319</sup> These provisions could, however, be overridden by the application of some DTAs between South Africa and other countries. Most South African DTAs with other countries follow article 18 of the OECD MTC,<sup>320</sup> which grants the exclusive taxing right over benefits from retirement funds accruing to the taxpayer's country of residence<sup>321</sup> (even though the services were rendered in South Africa and South African income tax deductions may have been granted to such members).

The 2021 Budget Speech, as well as the 2021 draft Taxation Laws Amendment Bill, included a proposal from National Treasury to amend the South African Income Tax Act to insert a new section 9HC (with effect from 1 March 2022).<sup>322</sup> The proposed new

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<sup>317</sup> in section 1 to the Income Tax Act No.58 of 1962

<sup>318</sup> Mashekwa Maboshe, Ingrid Woolard. "Revisiting the Impact of Direct Taxes and Transfers on Poverty and Inequality in South Africa", WIDER Working Paper 2018/79 Helsinki: UNU-WIDER, 2018. <https://doi.org/10.35188/UNU-WIDER/2018/521-3>.

<sup>319</sup> Section 9(2)(i) of the Income Tax Act No.58 of 1962

<sup>320</sup> Kyle Mandy, Greg Smith, "Emigration and South African retirement funds: Proposal to tax withdrawals of retirement interests", July 2021, <https://www.pwc.co.za/en/assets/pdf/synopsis/synopsis-july-2021.pdf>

<sup>321</sup> OECD Model Tax Convention on Income and on Capital, 21 November 2017; Patricia A. Brown, Articles 18 and 19(2): Pensions/Pensions and Social Security Payments – Global Tax Treaty Commentaries, Global Topics, IBFD, 30 September 2017

<sup>322</sup> Draft Explanatory Memorandum on the Taxation Laws Amendment Bill, 28 July 2021

section provided for an “exit tax” on the deemed withdrawal of retirement fund interests upon emigration from South Africa, which could potentially result in income tax consequences in South Africa.<sup>323</sup> The proposal raised numerous concerns amongst experts in the industry, as the concept of amending domestic legislation to bypass existing DTAs with other countries (i.e., treaty override) was seen as a “breach of good faith”.<sup>324</sup> On 10 November 2021, National Treasury communicated its decision to withdraw the initial proposal and indicated an intention to re-design the proposal in the next legislative cycle.<sup>325</sup> To date, there has been no mention of an updated proposal to tax deemed retirement fund interests upon emigration from South Africa in the 2022 or 2023 Budget Review.<sup>326</sup>

This study addressed two research objectives. Firstly, it investigated the policy objectives and shortcomings of the initial proposal which ultimately led to its withdrawal. Secondly, it addressed how the approach to taxation of retirement fund interests on emigration from South Africa should be re-designed by considering other alternatives available. This study was limited to the taxation of private retirement funds on emigration of a member, the blueprint provided for the allocation of taxing rights in article 18 of the OECD MTC, and only considered South African tax aspects.

## 5.2 Summary of findings

Chapter three analyzed the initial proposal issued by National Treasury and found that the proposed new section 9HC would result in a deemed withdrawal of the individual’s interest in the retirement fund on the day before the taxpayer ceases to be tax resident

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<sup>323</sup> Draft Taxation Laws Amendment Bill, 28 July 2021

<sup>324</sup> Kyle Mandy, Greg Smith, “Emigration and South African retirement funds: Proposal to tax withdrawals of retirement interests”, July 2021, <https://www.pwc.co.za/en/assets/pdf/synopsis/synopsis-july-2021.pdf>; Draft Response Document on the 2021 Draft Tax Law Amendment Bill, 10 November 2021; Lameez Omarjee, “Treasury drops proposed exit tax on retirement interest, for now”, 10 November 2021, <https://www.news24.com/fin24/economy/treasury-drops-proposed-exit-tax-on-retirement-interest-for-now-20211110>

<sup>325</sup> Draft Response Document on the 2021 Draft Taxation Laws Amendment Bill, 10 November 2021

<sup>326</sup> National Treasury, “2022 Budget Review”, Annexure C, 23 February 2022, <https://www.treasury.gov.za/documents/national%20budget/2022/review/Annexure%20C.pdf>; National Treasury, “2023 Budget Review”, Annexure C, 22 February 2023, <https://www.treasury.gov.za/documents/national%20budget/2023/review/Annexure%20C.pdf>

in South Africa. The South African tax on the deemed accrual would be calculated based on the current retirement fund lump sum withdrawal benefits table, regardless of the taxpayer's intention at that time. The deemed tax liability would be due and payable only once an amount was receivable from a retirement fund, and interest would be charged at the rate determined in the TAA from the date of the deemed withdrawal until such time that the tax was paid in full.<sup>327</sup>

The main concern with the initial proposal was that it contravened South Africa's obligations under international law, as it would override some existing DTAs with other countries.<sup>328</sup> Other concerns included, but were not limited to, the risk of double taxing the same amount in the hands of the taxpayer;<sup>329</sup> potential non-compliance with the Constitution, Income Tax Act, Tax Administration Act, and the Promotion of Administrative Justice Act;<sup>330</sup> the various aspects in the initial proposal that are unclear;<sup>331</sup> as well as the risk of discretionary withdrawals of retirement interests upon emigration from South Africa.<sup>332</sup> These were some of the reasons which led to the withdrawal of the initial proposal by National Treasury on 10 November 2021.<sup>333</sup> The above, therefore, supports the view that there is a need to re-design the approach to taxation of retirement fund interests on emigration from South Africa.

Chapter four addressed the second research objective of this dissertation by analysing alternative approaches to consider in the re-design process. The criteria for a feasible

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<sup>327</sup> Draft Explanatory Memorandum on the Taxation Laws Amendment Bill, 28 July 2021

<sup>328</sup> CDH Incorporated, "Exit charge on retirement fund interests when ceasing residency", 16 September 2021, <https://www.cliffedekkerhofmeyr.com/news/publications/2021/Tax/tax-alert-16-september-Exit-charge-on-retirement-fund-interests-when-ceasing-residency.html>

<sup>329</sup> Kyle Mandy, Greg Smith, "Emigration and South African retirement funds: Proposal to tax withdrawals of retirement interests", July 2021, <https://www.pwc.co.za/en/assets/pdf/synopsis/synopsis-july-2021.pdf>

<sup>330</sup> Done Howell, BDO, "Cessation of tax residency: tax triggers for retirement fund interests", 13 September 2021, <https://www.bdo.co.za/en-za/insights/2021/tax/cessation-of-tax-residency-tax-triggers-for-retirement-fund-interests>

<sup>331</sup> Joon Chong, Wesley Grimm, "Tightening the noose on emigrants' retirement assets", Accountancy South Africa, April 2021, <http://magazine.accountancysa.org.za/asa-april-2021?m=52861&i=702647&p=104&ver=html5>; Done Howell, BDO, "Cessation of tax residency: tax triggers for retirement fund interests", 13 September 2021, <https://www.bdo.co.za/en-za/insights/2021/tax/cessation-of-tax-residency-tax-triggers-for-retirement-fund-interests>

<sup>332</sup> Draft Response Document on the 2021 Draft Taxation Laws Amendment Bill, 10 November 2021

<sup>333</sup> Ibid.; Taxation Laws Amendment Bill 22 of 2021

alternative approach to the initial proposal issued by National Treasury included the potentially competing needs for 1) equity within the tax system, 2) economic efficiency of the tax system, 3) administrability of the tax system, and 4) coherence of the tax system. This chapter discussed four possible alternative approaches which could be pursued by National Treasury and compared each one against the established criteria. Each possible alternative has some merits and some shortcomings.

Under alternative one, the current EET taxation regime would be retained by National Treasury and the proposed exit tax on retirement fund interests upon emigration from South Africa would be withdrawn permanently. National Treasury would embark on its plan to revise the multiple DTAs with other countries and would forfeit this tax revenue unless and until it is able to renegotiate such DTAs. Alternatively, National Treasury would not embark on its plan to revise the multiple DTAs with other countries and would rather forfeit this tax revenue indefinitely. This alternative results in stability in a system already managing multiple changes and transitional provisions and removes all concerns previously raised in the initial proposal. However, it results in potentially significant fiscal loss to the South African government as tax revenue is at best delayed or permanently forfeited.

Under alternative two, National Treasury would apply a modified version of the TTE taxation regime by making the section 11F income tax deductions deferred and conditional. National Treasury would postpone the income tax deduction relating to contributions made or deemed to be made by members to retirement funds until such time as the benefits from such funds (be it a lump sum or annuity) are subject to tax in South Africa. This alternative addresses deductions rather than imposing a tax and would apply equally to all taxpayers. It may also avoid economic double taxation if the other resident country allows a deduction for undeducted contributions in South Africa. However, it could lead to significantly reduced retirement savings for taxpayers (due to the upfront tax), the tax treatment on returns differs for residents and non-residents, and may result in significant upfront and ongoing administrative issues (including the cost of implementing another significant retirement reform, the requirement to keep track of contributions under the old and new systems, etc.)

Under alternative three, the taxation regime applied by National Treasury to retirement savings would change from the classical example of expenditure tax, EET, to the pre-

paid expenditure tax, or TEE, model. National Treasury would remove the current section 11F income tax deduction allowed against actual and deemed member contributions (which is simpler than keeping a record of contributions and providing a deferred, conditional deduction) and allow future retirement saving benefits to be received tax-free. This alternative addresses deductions rather than taxing retirement benefits and would apply equally to all taxpayers, the taxpayer receives the same return under either of the two taxation regimes, National Treasury receives the tax revenue upfront (as opposed to facing the risk of losing it at the end), and it may avoid economic double taxation if the new resident country allows a deduction for undeducted contributions in South Africa. However, it could lead to reduced retirement savings for taxpayers, National Treasury would lose the tax on returns for both resident and non-resident taxpayers, and it may result in significant upfront and ongoing administrative issues (similar to those arising under alternative two).

Alternative four would amend the initial proposal issued so that it does not result in the same concerns raised previously. This would be achieved through a simplified exit tax on retirement fund interests being established in South Africa. This alternative would retain the deemed withdrawal of the individual's interest in the retirement fund on the day before he or she ceases to be tax resident in South Africa, which would be subject to an exit tax. It would require consideration of the proposed two-pot retirement system, as well as an adjustment to how the tax is calculated. However, unlike the initial proposal, the tax calculated would be due and payable immediately, would be subtracted by the retirement fund from the taxpayer's retirement savings at that date, and thereafter those savings would be recharacterized as a non-specific investment. This alternative would result in increased fiscal revenue for National Treasury, the same tax treatment for resident and non-resident taxpayers (not only prospectively but before and after the change) and would eliminate most key concerns raised in the initial proposal (including the elimination of potential cash flow issues where the tax liability is netted off against the balance of the retirement fund interest). However, it is questionable whether the other resident country would accept the change in the nature of the investment post-tax, and whether it is legal for retirement fund administrators to manage non-retirement savings. This alternative would also result in another significant retirement reform which may reduce the attractiveness of retirement saving in South Africa.

### **5.3 Recommendations on the way forward for National Treasury**

As determined in the analysis of this study, each alternative has the potential to address some shortcomings of the initial proposal as well as having its own limitations. National Treasury would need to decide whether it wants to fundamentally shift its tax policy in pursuit of addressing this issue. If not, it should follow alternative one and deal with the consequences. If National Treasury wants to recover a measure of the tax revenue quickly without fundamentally changing the tax system, it should follow alternative four. If it is willing to fundamentally change the tax system, and deal with all the once-off and ongoing administrative issues, it should weigh up the merits and shortcomings discussed under alternatives two and three.

### **5.4 Recommendations for further research**

This study did not consider an analysis of the detailed processes through which other countries try to protect their tax basis against similar losses in tax revenue. Further research should be performed on how this compares to the South African retirement fund taxation system.

This study did not consider the guidance provided in the UN MDTC or the detail of any specific DTAs entered between South Africa and another country. Further research should be performed on how this differs or aligns with the guidance provided in the OECD MTC to fully determine the extent of the underlying issue as well as the implications of alternative remedies.

This study did not consider the taxation of state retirement funds on emigration as these funds operate differently to private funds. Further research should be performed on how the taxation of state retirement funds differs to private retirement funds and what implication this may have for any remedies to the issue in question pursued.

### **5.5 Concluding remarks**

The taxation system over retirement benefits has been subject to a lot of change in the last few years, including the current uncertainty regarding the implementation of the “two-pot” retirement system in 2024. National Treasury must decide how important it is to implement a solution to the taxation of retirement fund interests for residents

who emigrate from South Africa (i.e., who become non-resident), and how much change the retirement benefits system can handle.

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