

AN OVERVIEW OF TAXATION IN THE SOUTH AFRICAN RETIREMENT FUNDING INDUSTRY

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I hereby declare that I have read and understood the regulations governing the submission of Post Graduate Diploma in Tax Law dissertations, including those relating to length and plagiarism, as contained in the rules of this University, and that this dissertation conforms to those regulations.

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Introduction

South Africa recently changed its retirement tax regime from an ETT (Exempt, Taxed, Taxed) system to an EET (Exempt, Exempt, Taxed) system. The first E in refers to the tax deductibility of contribution towards pension and retirement annuity funds. The second refers to the investment income earned by the fund during the growth phase of the pension. With the abolishment of the Tax on Retirement Funds the interest, net rental and foreign dividends earned by these funds no longer attracted tax. The last T refers to the taxation of lump sums and annuities in the hands of the individual upon retirement, withdrawal or death.

Tax incentives in the retirement regime delay the payment of tax to a future date when the benefits will accrue to the member. The fact that a member's pre-tax contributions are invested with a retirement vehicle means that the member's credit grows much faster that it would have, had his contributions been subject to tax.

This deferment of tax is an incentive for the public to make sufficient provision for their retirement so as not to become a burden to the state after retirement.

This dissertation aims to provide a complete view of how the current tax regime operates within the retirement funding industry. It is appropriate to discuss the relevant taxes applicable to the industry separately. The chapter has therefore been divided into the 5parts dealing with the taxes below:

- Value Added Tax
- Income Tax
- Tax on Retirement Funds
- Estate Duty
- Capital Gains Tax

Under each of the above parts the effect of taxation on the relevant parties in the industry will be addressed, namely:

- Retirement fund
- Employer
- Individual
- Long-Term Insurer
- Fund administrator

The chapter concludes with a brief overview of social security and retirement reform.

Value added tax

The Value-Added Tax Act¹ (the Act) was introduced in 1991 to replace sales tax (GST). The Act levies a tax on the supply of goods and services by a vendor in the course of any enterprise carried on by him as well as on the imports of goods and services². This is subject to the exemptions, exceptions, deductions and adjustments provided for in the Act.

Any person who carries on an enterprise must register as a VAT vendor if its taxable supplies exceed R300 000 for a twelve-month period, while voluntary registration is possible if taxable supplies exceed R20 000³. The consequences of registration as a VAT vendor is that output VAT must be levied on all taxable supplies. VAT is a tax collected by vendors on behalf of the *fiscus* on the value added in every step of the supply chain. VAT is however a tax borne by the end user.

The basic mechanism of the Act is that input VAT (i.e. the VAT on expenses incurred) is claimable against the output VAT levied on the supply of goods and services. The net amount is paid over to SARS (or claimed from SARS in case of a refund). A vendor is only entitled to claim input VAT on expenses incurred to make taxable supplies. A taxable supply is one that is subject to VAT at the standard rate of 14% or the zero rate (such as exports). Where a vendor incurs an expense in the course of making both taxable and exempt supplies, only the VAT on the portion of the expense relating to the taxable supply is claimable⁴.

Section 12 of the Act exempts from VAT the supply of certain goods and services. The most important of these exemptions with regards to the retirement industry is the exemption of financial services⁵. A financial service is defined in section 2 of the Act. The effect of VAT on the various parties is the discussed below.

Retirement fund

The provision or transfer of ownership of an interest in a superannuation scheme constitutes a financial service⁶. In terms of section 2(2)(vii) a superannuation scheme means a scheme whereby provision is made for the payment or granting of benefits by a benefit fund, pension fund, provident fund or retirement annuity fund as defined in section 1 of the Income Tax Act⁷. Contributions received by a retirement fund constitute consideration for the provision of an interest in a superannuation scheme and is therefore exempt from VAT. Similarly, the

¹ No 89 of 1991.

² Section 7.

³ Section 23.

⁴ Sections 16 and 17.

⁵ Section 12(a).

⁶ Section 2(j).

⁷ No 58 of 1962.

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transfer of a member's fund credit to another fund, or the payment of a benefit to a member, constitutes the transfer of ownership in a superannuation scheme and is also exempt. The making of exempt supplies is excluded from the carrying on of an enterprise¹. Due to a retirement fund mainly making these exempt supplies, the fund does not carry on an enterprise for purposes of the Act and cannot register as a VAT vendor. The VAT on expenses incurred is therefore a cost to the retirement fund. However, some funds may directly hold commercial properties from which rental is derived. This type of rental income constitutes a taxable supply and is subject to VAT if charged by a VAT vendor. A fund may therefore register as a VAT vendor if its rental income exceeds the R20 000 minimum in section 23 and is compelled to register should it exceed R300 000. It should be noted that the fund would only be allowed to claim input VAT deductions on expenditure incurred to produce the rental income, e.g. building maintenance, utility charges etc.

Long-Term Insurer

A pension fund may choose to invest any or all of its assets by way of an insurance policy with a life insurer and it may also outsource the administration function to the life insurer. The premium due to the life insurer is exempt from VAT due to the definition of a financial service including the provision, or transfer of ownership, of a long-term insurance policy². Any benefits payable under the policy does not constitute a good or service supplied and does therefore not attract VAT. The VAT implications of fund administration services performed by the life insurer are dealt with below.

Fund administrator

A fund administrator is responsible for the day-to-day administration of the fund including the receipt of contributions, payment of benefits, drafting financial statements etc. The fund itself, the employer or a third party can undertake the administration of the fund. For this service, a fee is charged to the retirement fund.

The Taxation Laws Amendment Act No. 37 of 1996 changed the provision of these services from an exempt supply to a taxable supply by changing the definition of a financial service. Prior to 1 October 1996 the management of a superannuation scheme was included in the definition of a financial service in section 2(1)(j) which read: *"the provision, or transfer of ownership, of an interest in a superannuation scheme, or the management of a superannuation scheme"*. This was amended to read: *"the provision, or transfer of ownership, of an interest in a superannuation scheme"*. At the same time section 2(1)(i) was amended to read: *"the provision, or transfer of ownership, of a long-term insurance policy or the provision of reinsurance in respect of any such policy: Provided that such an activity shall not be deemed to be a financial service to the extent that it includes the management of a*

¹ Proviso (v) to the definition of 'enterprise' in section 1.

² Section 2(1)(i).

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superannuation scheme". The Amendment Act also added a subsection 22A to section 10 that stated: "*Where any supply is made which comprises the management of a superannuation scheme as contemplated in section 2(1)(i), the consideration in money for such supply shall be deemed to be the greater of the cost of making such supply or any consideration for such supply*".

This posed a problem for life insurers providing these services to audit or valuation exempt funds (previously referred to as underwritten funds). In such cases the life insurer provides the administration service in addition to underwriting the fund's liabilities to its members. The consideration for both these functions was the premium and the life insurer could not accurately determine the portion relating to the administration service. The Registrar of Pension Funds determined under section 13B of the Pension Funds Act¹ (through the issue of BN 24 of 1 March 2002) the conditions that must be met before the administration of a pension fund can be undertaken. In terms of this the administrator must stipulate the basis on which he is to be remunerated for conducting the administration of a pension fund.² It is currently the norm for life insurers to enter into separate administration agreements with pension fund clients and to levy VAT on the fee stipulated in these agreements.

It is not clear whether concluding a separate administration agreement would render section 10(22A) inapplicable. A situation could be envisaged where a nominal administration fee is charged to the fund to escape VAT liability and rather recovering the costs through the inflation of the VAT exempt premium income. In terms of the section 10(2) of the VAT Act the value of a service is the consideration received for it less tax and where that consideration is in money, the consideration is that amount of money. If the consideration is not money, then consideration for the purposes of the Act is the open market value³. Therefore, in the case of a nominal administration fee the amount subject to VAT is the nominal amount only. The only exception to this is where the transaction is between connected persons such as a life insurer and its staff pension fund⁴. In this case the consideration is deemed to be the open market value of the supply.

Given the fact that VAT can only be levied on the nominal fee per the administration contract, it seems that Revenue would then still be able to apply section 10(22A) to the administration element of the insurance policy. It should be noted that section 37 of the VAT Act places the burden of proving that any amount is not liable to tax on the taxpayer.

Where the fund administrator is not a life insurer, the issues above do not arise and VAT is due on the administration fee charged to fund.

¹ No 24 of 1956.

² Para 3.2(a).

³ Sections 10(2) and 10(3).

⁴ Para (g) to definition of 'connected persons' in section 1.

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Another difficulty is that the VAT Act does not define the term “management of a superannuation scheme”, nor does it define what is meant by the “provision of a long-term insurance policy”. The former being a supply subject to VAT and the latter being exempt, this is a very important distinction. As noted above the term “superannuation scheme” means a scheme whereby provision is made for the payment or granting of benefits by a benefit fund, pension fund, provident fund or retirement annuity fund as defined in section 1 of the Income Tax Act¹. This definition is wide enough to include the situation where a life insurer underwrites a risk scheme incorporated into a pension (e.g. an approved Group Life Assurance scheme) or even where the fund merely invested a portion of its assets with a life insurer, without any administration services being provided. The question is what activities are included under “management” of a superannuation scheme and what activities can be regarded as the provisions of insurance.

A life insurer extracts the costs it incurs to provide its services through various policy charges to the policyholder assets. Due to the requirements of the International Financial Reporting Standards some of the fees need to be disclosed on the insurer’s income statement as a “fee”. These, together with other policy charges, are not actual fees charged to a policyholder, but merely represent the allocation of funds between the policyholder and the shareholders of the life insurer. The LOA applied to SARS for a ruling confirming the industry practice set out below:

- Any “policy fees” or “policy charges” referred to in the long-term insurance policy schedule and which are included within the premiums or contributions received from the policyholder forms part of the cost of the activities of the provision of the long-term insurance policy, and therefore falls outside the scope of the VAT Act; and
- Where Life Offices are entitled to levy explicit charges for services rendered in addition to the original premium, i.e. where a service is supplied which is clearly distinguishable from the provision of the long-term insurance policy and generally recognised by the fact that it is treated as a stand alone or ad-hoc service, and has to be paid for in addition to the premium (i.e. other than via an internal charge recovery from premium), such charges are subject to VAT in terms of section 7(1)(a) of the VAT Act.

This was accepted by SARS in a ruling dated the 10th of October 2007 that is binding on the industry for a period of two years.

Broker

Broker commissions relating to the arrangement of various financial services used to be included in the definition of financial services by sections 2(m) and (n). The Taxation Laws

¹ No 58 of 1962.

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Amendment Act No. 37 of 1996 deleted these two paragraphs from the definition. With effect from 1 April 1995 these commissions therefore became taxable supplies. Brokers exceeding the R300 000 turnover limit became obliged to register as VAT vendors and levy VAT on their commissions. In terms of the section 20(1) of the Act a supplier needs to produce a tax invoice within 21 days of the making of the taxable supply. This is complicated by the fact that the commission due to the broker is calculated by the life insurer, the recipient of the service, based on its accounting records. In terms of section 20(2) read with VAT Practice Note 2 of 1991 self-invoicing is allowed by the recipient of the service in certain circumstances. It therefore became the norm for the life insurer to apply for permission from SARS to apply self-invoicing and thereby allowing the commission statement issued to the broker to double as a tax invoice.

The input VAT so incurred by the life insurer cannot be claimed as the commission expense is incurred in the making of exempt supplies, being the premium income. The VAT effectively adds an additional 14% to the commission cost.

Fund member

It is clear that the contributions made by the member to a retirement fund as well as the benefits ultimately received are exempt from VAT. However, the pension fund and the life insurer can not claim the input VAT on costs incurred in providing these benefits and it is therefore ultimately a cost incurred by the member, eroding his retirement savings.

Income Tax

The Income Tax Act¹ (ITA) contains the law relating to the taxation of income, donations, capital gains and dividends declared by companies. Income tax is levied on the taxable income of a person. Taxable income is defined² as income, less deductions allowed by the Act, plus any amounts included or deemed to be included in taxable income by the Act. Income is defined³ as “gross income” less amounts exempted from income tax by the Act. To be able to understand the significance of the provisions of the ITA relating to the retirement industry it is necessary to have an overview of the basic working of the Act.

Gross income

To determine whether an amount is subject to income tax it must first be determined whether the amount falls into the general definition of gross income⁴. The gross income definition reads as follows:

“gross income, in relation to any year or period of assessment, means—

(i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or

(ii) in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within or deemed to be within the Republic,

during such year or period of assessment, excluding receipts or accruals of a capital nature, but including, without in any way limiting the scope of this definition, such amounts (whether of a capital nature or not) so received or accrued as are described hereunder, namely—“

Special inclusions

The definition then continues with paragraphs (a) through (n), referred to as the specific inclusions. The specific inclusions serve to include certain amounts in gross income whether they are of a capital nature or not and also to act as anti-avoidance measures. They do however not limit the scope of the general definition of “gross income”.

Source and Residence

South Africa changed from a source based tax system to a residency based system on 1 January 2001. This means that the worldwide income of a SA resident is subject to tax in the Republic, while only income from a SA source is subject to SA tax in the hands of a non-resident. A natural person is a resident of the Republic for the purposes of the ITA if he is ordinarily resident in the Republic or if he is resident by virtue of a physical presence test.⁵ The term “ordinarily resident” is not defined in the ITA, but in terms of case law it is the place

¹ No 58 of 1962.

² Section 1 of the ITA.

³ Section 1 of the ITA.

⁴ Section 1 of the ITA.

⁵ See definition of “resident” in section 1 of the ITA.

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whereto a person would naturally and as a matter of course return from his wanderings; as contrasted with other lands it might be called his usual or principal residence and it would be described more aptly than other countries as his real home (*Cohen v CIR*¹; *CIR v Kuttel*²). Any other person other than a natural person is a resident of the Republic if it is incorporated, established or formed in the Republic or if its place of effective management is in the Republic.

For an amount to fall within the general definition of gross income there must therefore be:

- an amount (in cash or otherwise);
- received by or accrued to;
- during the year of assessment;
- that is not of a capital nature

Below is a very brief summary of the leading cases regarding the above concepts.

An Amount

“Amount” is not defined in the ITA, but the courts have held that it must have an ascertainable money value and if it’s not money’s worth or cannot be turned into money, it cannot be gross income (*CIR v Butcher Bros (Pty) Ltd*³; *CIR v Delfos*⁴; *Stander v CIR*⁵).

Received by or Accrued to

An amount is only “received” for the purposes of the gross income definition if it’s received by the taxpayer for his own benefit or on his own behalf (*Geldenhuys v CIR*⁶). An amount has “accrued” to a taxpayer when he becomes unconditionally entitled to it (*Lategan v CIR*⁷; *CIR v People’s Stores (Walvis Bay) (Pty) Ltd*⁸; *Mooi v SIR*⁹).

Capital versus Revenue

The distinction between the capital or revenue nature of receipts or accruals has been the subject of much case law. This distinction has however become somewhat less important with the introduction of Capital Gains Tax (CGT) on 1 October 2001. Where previously a capital gain was not taxable, the introduction of CGT now includes a portion (25% for individuals, otherwise 50%) of a capital gain in the taxpayer’s taxable income. Receipts and accruals of a capital nature that are not included in gross income through one of the specific inclusions are subject to CGT. CGT is not a separate tax, but rather normal income tax on the taxable portion of a capital gain. A consistently applied test for distinguishing between capital and

¹ (1946) AD 174

² (1992) 3 SA 242(A)

³ (1945) AD 301

⁴ (1933) AD 242

⁵ (1997) 3 SA 617 (C)

⁶ (1947) 3 SA 256 (C)

⁷ (1926) CPD 203

⁸ (1990) 2 SA 353 (A)

⁹ (1972) 1 SA 675 (A)

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revenue receipts is the enquiry whether the taxpayer was engaged in a “scheme of profit-making” (*CIR v Pick ‘n Pay Share Purchase Trust*¹).

Any capital gain calculated in terms of the Eighth schedule to the ITA is included in taxable income by section 26A. For there to be a capital gain there must be a “disposal” of an “asset”. Both of these terms are defined in paragraph 1 of the Eighth schedule and are very wide. In addition there are a number of deemed disposals listed in paragraph 12. The “capital gain” is defined in paragraph 3 as the amount by which the “proceeds” on disposal exceed the “base cost” of the asset. Both of these terms are also extensively defined in Parts VI and V of the Eighth Schedule.

Face value

The definition of gross income ends with a proviso stating that where a person becomes entitled to an amount during the year of assessment, which is only payable in a subsequent year, the face value of the amount (i.e. not the present value) is deemed to accrue to that person. This proviso was inserted to counteract the decision of Hefer JA in *CIR v People’s Stores (Walvis Bay) (Pty) Ltd*² where it was held that where a right to receive payment in the future accrued to a taxpayer, that right had to be valued and that value was affected by the lack of immediate enforceability.

General deduction formula

Section 11 of the ITA states the deductions allowed in the determination of taxable income. This section must be read together with section 23 that contains certain restrictions on the deductibility of income. The bulk of expenditure deductible against a taxpayer’s income is allowed under section 11(a) of the ITA (known as the “general deduction formula”). This section allows as a deduction from income derived from trade any expenditure and losses actually incurred during the year of assessment in the production of income that is not of a capital nature. In addition, section 23(g) prohibits the deduction of any amount not laid out or expended for the purposes of trade. Paragraphs (b) through (x) of section 11 deals with the deductibility of specific types of expenditure and losses.

Trade

“Trade” is defined very widely in the ITA to include every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of or the grant of permission to use any patent, design, trade mark, any copyright or any other property which is of a similar nature and it is has been held that it should be given its widest possible meaning.³

¹ (1992) 4 SA 39 (A)

² (1990) 2 SA 353 (A)

³ *Burgess v CIR* (1993) 4 SA 161 (A)

Actually incurred

An expense is only “actually incurred” if it is not subject to any suspensive or resolutive condition (*Nasionale Pers v KBI*¹) and although the quantum of the expense may be uncertain the obligation to pay must be certain (*Edgars Stores Ltd v CIR*²). In *ITC1444*³ it was held that for an expense to be “actually incurred” there must be an “absolute and unqualified legal liability to pay”.

In the production of income

For an expense to be incurred “in the production of income” the act to which the expenditure is attached must be performed bona fide for purposes of carrying on the trade that produces the income and the expense must be so closely linked to this act that it can be regarded as part of the cost of performing it. If this is satisfied, then it does not matter whether the expense is necessary, incurred by chance or for improving efficiency (*Port Elizabeth Electric Tramway Co Ltd v CIR*⁴). The closeness of the connection between expenses and the income earning operations must be assessed having regard for both the purpose of the expenditure and what it actually effects (*CIR v Nemojim (Pty) Ltd*⁵). It should be noted that it is irrelevant whether the expenditure actually produced income as long as it was incurred for the purposes of producing income (*Sub-Nigel Ltd v CIR*⁶).

Capital versus Revenue

Expenses of a capital nature are not deductible in terms of the general deduction formula. Certain capital expenses are however allowed as deductions for CGT purposes due to it forming part of the base cost of an asset. In addition, specific provisions of the ITA such as those contained in sections 11(e), 12B and 12C grant certain capital allowances. The courts have developed separate principles for evaluating the capital or revenue nature of expenditure compared to gross income. Money spent in creating or acquiring an income producing concern or a source of future profit is capital (the outlay does not recur while the income does) and money spent working that source is revenue (*CIR v George Forest Timbers Co Ltd*⁷). Expenditure incurred in establishing, improving or adding to the equipment of the income-producing structure is capital, whereas expenditure incurred as part of performing the income-producing operations is revenue. When the capital employed in a business is frequently changing its form from money to goods and vice versa, and this is done for the purpose of making a profit, capital so employed is floating capital which is deductible (*New State Areas Ltd v CIR*⁸). The English courts have also developed what is known as the

¹ (1986) 3 SA 549 (A)

² (1988) 3 SA 876 (A)

³ 51 SATC 35

⁴ (1936) CPD 241

⁵ (1983) 4 SA 935

⁶ (1948) 4 SA 580 (A)

⁷ (1924) AD 516

⁸ (1946) AD 610

“enduring benefit” test. In *British Insulated Helsby Cables v Atherton*¹ it was said that when expenditure incurred not only once and for all but also with a view to bringing into existence an asset or advantage for the enduring benefit of a trade, there is good reason for treating such expenditure as capital.

Retirement Fund

Fund Definitions

The ITA is of crucial importance in the retirement industry. It contains the requirements that a fund must comply with to be able to benefit from the various tax concessions available. The requirements of the ITA restricts benefits to mainly retirement and withdrawal benefits, as well as in-service death benefits and for this reason it is not customary to provide disability benefits under a retirement fund, except those paying out benefits on early retirement due to total or permanent incapacity². Three types of funds are distinguished - pension, provident and retirement annuity funds. Within the definition of “pension fund” another three fund types emerge. Paragraphs (a) and (b) of the definition refer to public sector funds while paragraph (c) refers to private sector or “approved” funds. Paragraph (a) and (b) funds are discussed separately in the section on state funds.

Pension and provident funds operate on an employer-employee relationship while retirement annuity funds (RAF's) allow self-employed individuals to also benefit from the tax advantages relating to retirement fund membership. All three of these funds must be registered under the Pension Funds Act³ if established after 1 July 1986. It is important to note that a fund must be approved by the Commissioner of SARS. The definitions of pension, provident and retirement annuity funds⁴ contain the requirements that must be met before this approval will be given. A brief discussion of these definitions follows below.

Retirement annuity fund

A RAF is defined as any fund (other than a pension or provident fund) that is a permanent fund, bona fide established for the sole purpose of providing life annuities for the members of the fund, or annuities for the dependants or nominees of deceased members. A number of provisions must be contained in the rules of the fund of which the most important are that:

- not more than one-third of the total fund value may be commuted for a lump sum, except where two-thirds of the total value does not exceed R50 000
- no member shall become entitled to the payment of any annuity after he reaches the age of seventy years or, except in the case of a member who becomes permanently

¹ (1926) AC 205

² Tax and Investment Easiguide 1999:volume 1

³ No. 24 of 1956.

⁴ Section 1 of the ITA.

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incapable through infirmity of mind or body of carrying on his occupation, before he reaches the age of fifty-five years

- where a member dies after he has become entitled to an annuity, no further benefit shall be payable other than an annuity or annuities to his dependants or nominees
- a member who discontinues his contributions prematurely shall be entitled to:
 - an annuity payable from the date on which he would have become entitled to the payment of an annuity if he had continued his contributions
 - be reinstated as a full member under conditions prescribed in the rules of the fund; or
 - the payment of one or more lump sum benefits where that member's interest in the fund is less than an amount determined by the Minister by notice in the Gazette from time to time;
- that upon the winding up of the fund a member's interest therein must either be used to purchase a policy of insurance which the Commissioner is satisfied provides benefits similar to those provided by such fund or be paid for the member's benefit into another approved retirement annuity fund;
- no member's rights to benefits shall be capable of surrender, commutation or assignment or of being pledged as security for any loan, except where the member's total fund value is transferred to another approved retirement annuity fund prior to the member becoming entitled to the payment of an annuity
- that no portion of an annuity payable to the dependant or nominee of a deceased member shall be commuted later than six months from the date of death of such member
- where a member dies before he becomes entitled to the payment of an annuity, the benefits shall not exceed a refund of the amounts (with or without reasonable interest thereon) contributed by him and an annuity or annuities to his dependants or nominees

The clear intention of an approved retirement annuity fund is therefore to provide a source of income upon retirement. In terms of the above definition no benefit is payable before the member reaches 55, even where he makes his policy paid-up, or where the fund is wound up. A recent amendment relates to the full commutation of fund values less than R75,000 (see section on lump sum benefits).

Pension funds

A pension fund must be a permanent fund bona fide established for the purpose of providing annuities for employees on retirement from employment or for the dependants or nominees of deceased employees, or mainly for the said purpose and also for the purpose of providing

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benefits other than annuities for these persons. Important provisions to be contained in the rules of the fund are:

- that membership of the fund throughout the period of employment shall be a condition of the employment by the employer of all persons of the class or classes specified therein who enter his employment on or after the date upon which the fund comes into operation
- that not more than one-third of the total value of the annuity or annuities to which any employee becomes entitled, may be commuted for a single payment, except where two-thirds of the total value does not exceed R50 000
- that the employer is precluded from controlling the management of assets of the fund and from deriving any monetary advantage from money paid into or out of the fund
- that no portion of an annuity payable to the dependant or nominee of a deceased member shall be commuted later than six months from the date of death of such member

Currently there is no requirement for an employer to participate in a retirement fund for its employees. Once a retirement fund has however been created for employees or a class of employees, membership must be compulsory. The requirement that an annuity payable to a dependant may not be commuted later than six months after death of the member is necessary to finalise the calculation of estate duty as such a lump sum would form part of the property of the deceased estate (see estate duty section).

Provident funds

The requirements for a provident fund are the same as those for a pension fund except for the fact that the purpose of fund is to provide benefits (as distinguished from annuities only) for employees on retirement from employment or solely for the purpose of providing benefits for the dependants or nominees of deceased employees or deceased former employees. There is no requirement that only one third of the fund value may be commuted and therefore the member can take the full value as a lump sum on retirement. However, no tax deduction is available for contributions made to provident funds (see the section on member contributions). Provident funds are therefore popular with low-income earners whose earnings fall below the tax threshold and effectively have no fiscal incentive to contribute to a pension fund where two thirds of their retirement benefit is restricted to an annuity. National Treasury has however made it clear that the provision of an income upon retirement is preferred to a full lump sum benefit and has proposed changes in this regard (see section on retirement reform).

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Fund rules

The definitions state that the Commissioner shall not approve a fund in respect of any year of assessment unless he is, in respect of that year of assessment, satisfied those provisions are complied with. It is clear that the Commissioner can therefore revoke the approved status of the fund in any year of assessment that the fund is in breach of the mandatory provisions of the fund rules contained in the definitions. To aid this, the definitions also require that the Commissioner must be notified of any amendments to the fund rules. Per a general notice¹ issued by SARS the requirements of circular PF81² issued by the FSB applies *mutatis mutandis* to the submission of rule amendments to SARS. This circular contains detailed procedures to be followed in submitting rules amendments to the FSB. The reasons for the amendments are of particular importance to SARS. Per GN20³ issued by SARS, fund administrators can register a model set of rules for approval. SARS will allocate a reference number to the model set after approval. When the administrator needs to register the rules of a new fund it only needs to submit the reference number of the model set of rules on which the new fund's rules are based, together with any variations thereto.

Powers of the Commissioner

Each of the definitions of a pension, provident and retirement annuity fund includes the proviso that the Commissioner "may approve a fund subject to such limitations or conditions as he may determine". This gives the Commissioner very wide powers regarding the approval of funds as he can issue any conditions of which non-compliance by retirement funds would result in their approved status being revoked. In practice these conditions are communicated through the various General Notes and Practice Notes issued that would, but for the Commissioner's discretionary powers granted in the definitions, not have binding authority.

Taxation of retirement funds

Section 10(1)(d) of the ITA exempts from income tax the receipts and accruals of a pension, provident and retirement annuity fund. The contributions received from members and the investment income earned by the fund is therefore not taxable. Any capital gain realised by such a fund is also free from CGT due to paragraph 63 of the Eighth schedule to the ITA stating that any capital gain or loss of a person, whose entire gross income is exempt in terms of section 10, should be disregarded. Capital gains and losses arising from its investment portfolio are therefore exempt.

A retirement fund is also exempt from donations tax by section 56(1)(h) of the ITA. This section also exempts from donations tax any property disposed of under a donation to a retirement fund. Retirement funds are not liable for Secondary Tax on Companies (STC) due to the definition of dividend excluding institutions to which s10(1)(d) relates.

¹ GN27 issued 17 January 2005.

² Issued October 1993.

³ Reissued 12 September 2007.

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It is clear that a retirement fund is therefore wholly exempt from all taxes levied by the Income Tax Act. The ITA does however impose a duty on a retirement fund to collect income tax on behalf of the *fiscus*, which is discussed below.

Withholding of Employees' Tax

The Fourth Schedule of the Act deals with the withholding of employees' tax where "remuneration" is paid by an "employer" to an "employee".¹ By virtue of the fact that "remuneration" includes annuities as well as retirement lump sums, a retirement fund and its members are included in the definitions of "employer" and "employee" respectively. The fund is required to register as an employer with SARS and withhold employees' tax from payments to members payable within seven days of the end of the month in which the tax was deducted. If the fund fails to deduct or withhold the full amount of employees' tax it shall be personally liable for the payment and any amount paid to SARS in terms of this liability will be deemed to be a penalty payable by the fund. This means that the member is still liable to SARS for the tax that was not withheld from his benefit. Where the Commissioner is satisfied that the failure was not due to an intent to postpone payment of the tax or to evade the employer's obligations under the Schedule, the Commissioner may, if he is satisfied that there is a reasonable prospect of ultimately recovering the tax from the employee, absolve the employer (or retirement fund) from its liability. If this is not the case the fund has a right of recovery against the employee.² The fund must ascertain the amount of tax to be deducted from any lump sum from the Commissioner before paying out the benefit. Where the member's taxable income in the previous year of assessment did not exceed the tax threshold, no employees' tax is to be withheld.³

Administrator

As noted above annuities and lump sums are included in the definition of "remuneration" in the Fourth Schedule. An administrator of a benefit fund, pension fund, provident fund, retirement annuity fund or any other fund that pays remuneration is specifically included in the definition of "employer". The administrator is therefore required to withhold PAYE from lump sum and annuity payments to members in the same manner as described above where the retirement fund is self-administered.

Long-Term Insurer

A Long-Term insurer is taxed on the basis of the trustee principal. This recognises that the insurer holds assets on behalf of various types of taxpayers and seeks to tax any income derived from these assets in the same manner they would have been taxed had the assets been held by the taxpayer directly. At the same time the life insurer should be taxed on the

¹ Defined in Part I of the Fourth Schedule.

² Para 5 of the Fourth Schedule.

³ Para 9(3) of the Fourth Schedule.

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profits it derives from conducting its business. Per section 29A of the ITA the insurer must split its assets between four funds – three policyholder funds and one corporate fund, also known as the shareholders' fund. The three policyholder funds are distinguished based on categories of policyholders. Each fund is then taxed separately based on its own taxable income with the exception of the Untaxed Policyholders Funds (UPF) which is completely exempt from income tax in terms of section 29A(9). The funds are deemed to be separate companies for the purposes of the Act, and are also connected persons in relation to each other.¹ The transfer of any assets between these funds is deemed to be a disposal in the one fund and an acquisition in the other², for CGT purposes.

Premiums received are not taxable while claims paid are not deductible³. The basic idea of the section is to tax a fund on its investment income and to only allow as a deduction, expenditure directly incurred to produce this income.⁴ In addition each fund is allowed to deduct a portion of its selling and administration expenses as well as a portion of all other expenses not directly incurred to produce exempt income (e.g. local dividends received). The portion is calculated based on formulas contained in section 29(11) and is known as the "expense ratio". The ratio basically calculates the extent (based on predetermined weightings given to each type of income) to which these expenses were incurred to produce taxable investment income (interest, net rental and foreign dividends) as a percentage of total investment income (interest, net rental, foreign dividends and local dividends). Lastly, each of the policyholder funds is allowed a deduction for profits transferred to the shareholders' fund. This deduction is calculated as the 50% transfer multiplied by the expense ratio. This profit transfer is taxed in full in the shareholders' fund. This mechanism therefore gives effect to the principal that a policyholder fund should be taxed on its investment income less the life insurer's profit margin. The shareholders' fund is taxed on the investment income derived from its own assets (i.e. not those held to cover policyholder liabilities) and the profit it extracts from each of the three policyholder funds.

The profit transfer from each of the policyholder funds is determined by comparing the market value of the fund's assets to the actuarial value of its liabilities. Assets with a market value equal to the excess (if any) of assets over liabilities are then transferred to the shareholders' fund. This must be determined within four months of the life insurer's financial year-end. If there is a shortfall in any of the policyholder funds, assets equal to the shortfall must be transferred from the corporate fund to the relevant policyholder fund. Such transfers are not taxed in the policyholder fund and not deductible in the corporate fund. Any subsequent

¹ Section 29A(10).

² Section 29A(8).

³ Section 29A(11)(g).

⁴ Income as defined in section 1, therefore not gross income that is exempt, such as local dividends.

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transfer from that policyholder fund back to the corporate fund is not taxed in the latter fund to the extent that it does not exceed the previous shortfall.¹

Untaxed Policyholder Fund

Assets backing the policyholder liabilities of any pension, provident or retirement annuity fund fall into this fund. Any other business where the policyholder is exempt from income tax as per section 10 of the ITA also falls into the untaxed fund. This would normally include exempt institutions such as Government, public benefit organisations etc. A proviso to this inclusion is that the insurer must satisfy himself beyond all reasonable doubt that the policyholder is such a person or body. Lastly, the assets backing any annuity in payment, is also included in this fund. It is clear that the tax-free status of the UPF is in line with the general concept that members of retirement funds as well as pensioners' savings should be allowed to grow free of taxation. Had the retirement fund chosen to invest in assets directly, as opposed to an insurance policy, the investment income derived would have been free from income tax in terms of section 10(1)(d). It should be noted that until recently the Tax on Retirement Funds Act (TORFA) did subject the investment income of retirement funds and the UPF to tax (see section on TORFA).

Individual Policyholder Fund

Asset backing the liabilities of policies (excluding those allocated to the UPF) owned by persons other than companies are allocated to this fund. The fund's investment income (after deducting direct expenditure, the allowed portion of other expenses and the profit transfer) and 25% of capital gains is taxed at a flat rate of 30%. The 30% is meant to be representative of the average rate of tax applicable to the underlying policyholders. There is a strong argument for the fact that this percentage is very far removed from reality, considering that for a person to pay tax at an average rate of 30%, taxable income (for a person under 65 years old) must equal R561,742 for the 2008 year of assessment. This makes the purchase of an investment policy, from a tax point of view, unattractive compared to other investment vehicles where the individual would pay tax at a rate based on his actual taxable income. The taxpayer is further prejudiced by the fact that the annual capital gain exclusion of R15,000 applicable to individuals is not available in the IPF.

Company Policyholder Fund

This fund contains the assets backing the liabilities of policyholders that are companies. A "company" is defined in section 1 of the ITA and includes:

- any association, corporation or company incorporated under any law in force in the Republic or any other country, or any body corporate formed or established under any such law; or
- any co-operative; or

¹ Sections 29A(8) and 29A(11)(d).

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- any association formed in the Republic to serve a specified purpose, beneficial to the public or a section of the public; or
- any portfolio comprised in any collective investment scheme in securities¹
- foreign collective investment scheme; or
- a close corporation.

This fund is taxed in the same manner as the IPF above. The tax rate applicable to this fund is however 29% (the normal company rate) while the CGT inclusion rate is 50% of any capital gain.

Employer

Contributions towards retirement fund

The contributions made by the employer to an employee's pension, provident or retirement annuity fund are deductible under section 11(l) of the ITA. In terms of this section, the Commissioner has the discretion to disallow any deduction in excess of 10% of the employee's remuneration that he considers to be fair and reasonable in relation to the value of the services rendered by such employee. Where the Commissioner has exercised his discretion in this regard it is subject to objection and appeal by the taxpayer. In practice up to 20% of the approved remuneration is allowed as a deduction².

When calculating monthly employees' tax the employer is required to take into account the deductible portion of the employee's contribution towards a pension fund and at his option can also take into account contributions towards RAF's. In the latter case the employee must provide the employer with proof of payment.³

Annuities to former employees and dependants

In terms of section 11(m) an employer is also allowed a deduction for any annuity it pays to a former employee that retired from his employ due to old age, ill health or infirmity. In addition, a deduction is allowed for an annuity paid to a dependant of a deceased employee in relation to maintenance of that dependant. In the absence of this provision these payments would not have been deductible. This is due to payments made for past service not being made in the production of the employer's income as required by the general deduction formula.⁴

Surplus apportionment

Surplus apportionment distributions made by a pension or provident fund to an employer is taxable in the hands of the employer in terms of paragraph (eB) of the gross income definition. It should be noted that the paragraph does not limit the taxable amount to the

¹ Contemplated in Part IV of the Collective Investment Schemes Control Act, 2002.

² Keith Huxham and Phillip Haupt, Notes on South African Income Tax, page 98

³ Para 4 of the Fourth Schedule.

⁴ Section 11(a).

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contributions previously deducted by the employer in terms of section 11(l). Instead, any amount received by or accrued to the employer by way of any distribution by any pension fund or provident fund to such employer is included. The only exception is an amount recoverable in terms of section 37D of the Pension Funds Act.¹ These would be amounts due to the employer in terms of a loan granted to the employee or compensation in respect of any damage caused to the employer by the employee.

Employee

Contributions

Section 23(m) limits the deductions a salaried employee may claim against his income. The section prohibits the deduction of any expenditure, loss or allowance contemplated in section 11 of the ITA which relates to any employment of, or office held by, any person (other than an agent or representative whose remuneration is normally derived mainly in the form of commissions based on his or her sales or the turnover attributable to him or her) in respect of which he or she derives any remuneration, as defined in paragraph 1 of the Fourth Schedule. The subsection lists certain exceptions to this, amongst which the contributions made by an employee to a pension fund or retirement annuity fund deductible under sections 11(k) and 11(m) respectively. Contributions to a provident fund are not deductible. The entire benefit from a provident fund can, however, be taken as a lump sum of which the tax-free portion will be increased with the non-deductible contributions made (see section on lump sum benefits).

Pension fund contributions

In the case of a member's contribution to a pension fund the deduction is limited (in terms of section 11(k)) to the greater of R1,750 or 7.5% of his income from "retirement-funding employment". This term is defined in section 1 of the ITA and it basically means that part of his income that is taken into account in the determination of the contributions made by him or on his behalf to a pension or provident fund. Although provident fund contributions are not deductible the reference to provident fund is included so that that contributions to any RAF would only be deductible based on the portion of remuneration that did not fund either the pension fund or provident fund contribution.

Retirement Annuity Fund contributions

Section 11(n) limits the deduction of RAF contributions to the greater of 15% of the taxpayer's income (that does not fund his pension or provident fund contributions and before the deduction of certain soil erosion, farming, medical and dental expenses as well as donations to "public benefit organisations"), the amount by which R3,500 exceeds any deduction allowed under 11(k)(i) or R1,750. The first limit above refers to "income" after setting off any assessed loss and deducting admissible deductions and allowances. Capital gains and losses are added to "taxable income" by section 26A of the ITA and are therefore not taken

¹ No. 24 of 1956.

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into account for purposes of calculating the 11(n) deduction. It should be noted that in the case of an individual that earns income outside of employment (e.g. business or investment income) to which the limitations of section 23(m) does not apply, a section 11(a) deduction is not allowed for the portion of the RAF contribution exceeding the deduction allowed by section 11(n). This is due to section 23B(3) that disallows any deduction under section 11 (a) in respect of any expenditure or loss of a type for which a deduction or allowance is granted under any other provision of the ITA, even though such other provision limits the amount of such deduction. It is submitted, however, that even in the absence of section 23B(3), a member's contribution to a retirement fund is not deductible under section 11(a), as these contributions are most probably of a capital nature due to it representing the accumulation of the base of funds from which a pension will be derived upon retirement. It is therefore adding to the income producing structure rather than being incurred as part of performing the income-producing operations.

Contributions in excess of tax deduction

Current contributions to a pension fund in excess of the deduction allowed by section 11(k) may not be carried forward to the subsequent year of assessment. Excess contributions to a RAF may however be carried forward to, and deducted in the subsequent year of assessment again subject to the limits of 11(n). Any contributions not allowed as a deduction in terms of both sections 11(k) and (n) will increase the tax-free portion of the lump sum benefit upon retirement, death or withdrawal.

Past service and reinstatement

Section 11(k) also allows a R1,800 deduction for any past service contribution made by the member to the pension fund. Unlike current service contributions, past service contributions towards a pension fund in excess of the R1,800 may be carried forward to a subsequent year of assessment subject again to the limit. Reinstatement contributions towards a RAF are also subject to a R1,800 deduction limit and may also be carried forward.

Employer contributions

The contributions by the employer to an employee's retirement fund does not fall into the employee's gross income as it does not constitute a "receipt" or "accrual"¹ in the hands of the employee. It is also not included in gross income through any of the special inclusions to the "gross income" definition. For example, it is not taxable as a fringe benefit² due to it not being included in the definition of taxable benefit contained in the Seventh schedule.

¹ See definition of 'gross income' in section 1 of the ITA.

² Para (i) of the 'gross income' definition in section 1 of the ITA specifically includes in a taxpayer's gross income the cash equivalent, as determined under the provisions of the Seventh schedule, of the value during the year of assessment of any benefit or advantage granted in respect of employment or to the holder of any office, being a taxable benefit as defined in the schedule.

Salary sacrifice

Due to there being no deductions available for employee contributions to provident funds, these funds are usually of a non-contributory nature. Employees can also benefit from salary sacrifice schemes whereby a portion of the salary is sacrificed in return for an employer contribution to the employee's provident fund. The contribution so made by the employer does not constitute gross income in the hands of the employee as it does not accrue to him. The employee's resulting lower taxable income could subject him to a lower marginal tax rate resulting in an increased "take home" salary. The payment of tax is also deferred to when the employee retires and is taxed on the resulting benefits. The employer is tax neutral as where previously he deducted the portion of the salary under the general deduction formula¹ he is now entitled to a deduction under section 11(l). Care should be taken when setting up these schemes to ensure that SARS can't attack it under the general anti-avoidance rules contained in sections 80A through 80L (see section on anti-avoidance). The Commissioner has identified a number of factors that would be considered in assessing the validity of a salary restructure. In short, a *bona fide* salary sacrifice would have the effect of decreasing the employee's entitlement to leave and bonus payments, decreased UIF and pension fund contributions, etc. It is also important that the employee is completely divested from the liability to pay the contributions to the provident fund.² I.e. the situation must be avoided where the amount accrues to the employee who then has the liability to pay the contribution to the fund. Instead, the liability to make the contribution must be that of the employer's. There is an important distinction between a disposal of income to the fund after it has accrued to the employee and disposal of a right to receive income in the future. In the former case the income remains taxable in the hands of the employee while in the latter case the income accrues to the fund³ (*Taxpayer v COT (Botswana)*)⁴.

Benefits (lump sum)

Lump sum benefits from retirement funds are generally of a capital nature and should therefore be excluded from gross income unless specifically included. Paragraph (e) of the "gross income" definition includes in a taxpayer's gross income any amount determined in accordance with the Second Schedule in respect of lump sum benefits received by or accrued to such person from or in consequence of his membership or past membership of any pension, provident or retirement annuity fund approved by the Commissioner if such person was a member or past member of such fund. A lump sum benefit as defined in the Second Schedule is exempt from capital gains tax. Any lump sum benefit from a fund, arrangement or instrument situated outside the Republic that provides similar benefits under similar conditions to an approved pension, provident or retirement annuity fund is also exempt.⁵

¹ Section 11(a).

² M Botha *et al*, The South African Financial Planning Handbook 2006, page 734

³ See Emslie, Hatton, Davis & Olivier; Income Tax Cases & Materials, page 86

⁴ 43 SATC 118

⁵ See paragraph 54 of the Eighth Schedule to the ITA.

Maximum lump sum available

In terms of the definitions of pension, provident and retirement annuity funds, only one third of the fund value can be commuted for a lump sum benefit upon retirement in the case of a pension fund and retirement annuity fund, while the entire fund value may be commuted in the case of a provident fund. Before the amendments made by the Taxation Laws Amendment Act¹, benefits from a pension fund or retirement annuity fund could only be commuted in full if the resulting annual annuity value payable did not exceed R1,800. After the changes a fund value not exceeding R75,000 can be commuted in full. The reasoning behind this was to prevent the erosion of small fund values through administration charges levied over the term of the annuity. Note that SARS has accepted that this commutation parameter should apply to each specific fund from which the member might be entitled to receive an annuity and not across all funds in aggregate.

Upon death, the full benefit is available as a lump sum in the case of a pension and provident fund. Paragraph (b)(vi) of the definition of “retirement annuity fund” reads: “*where a member dies before he becomes entitled to the payment of an annuity, the benefits shall not exceed a refund to his estate or to his dependants or nominees of the sum of the amounts (with or without reasonable interest thereon) contributed by him and an annuity or annuities to his dependants or nominees*”. Current practice is to allow a lump sum equal to the contributions made by the member compounded by 7% p.a. as well as one third of the difference between the total benefit and aforementioned compounded contributions.

Taxation of lump sum before 1 October 2007

A lump sum is partly taxable and partly tax-free. The tax-free portion was generally calculated with reference to two formulas, “formula A” and “formula B”² depending on the type of fund the benefit is derived from and the event that caused the benefit payment, i.e. retirement, withdrawal or death. For state funds an additional “formula C” applied (see section on state funds). In the case of pension and provident funds the formulas took into account the number of years the person was a member of the fund as well as his highest average annual salary during any five consecutive years in the service of the employer. The formulas contained certain fixed minimum and maximum values. In terms of section 5(10) the taxable portion was then subject to tax at the taxpayer’s highest average annual rate of tax in the year the benefit is paid or the previous year calculated before taking into account the taxable portion of the lump sum. Due to the progressive rate of tax applicable to individuals, the taxable lump sum, in the absence of the section 5(10) would have been subject to a higher than normal marginal rate of tax. The above method of determining a tax-free amount was complex and dependent on information that the retirement fund, or member, could not easily access or determine. The fixed minimum and maximum amounts that formed part of

¹ No. 8 of 2007

² As per the Second Schedule to the ITA before the 2007 amendments.

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the calculation had also not been regularly reviewed or adjusted. In addition, the average rate at which the taxable portion was taxed provided scope for tax planning opportunities by way of artificially suppressing taxable income for the two-year period mentioned in section 5(10), in order to limit the rate of tax applicable to the taxable portion of the lump sum.¹

Lump sum on retirement or death – current taxation

The taxation of lump sum retirement benefits changed substantially due to the amendments to the ITA brought about by the Taxation Laws Amendment Act, the changes being effective 1 October 2007. This act repealed "formula A", simplified formula B and included a new term in section one of the ITA, namely the "retirement fund lump sum benefit". This term is defined as the amount determined in terms of paragraph 2(a) of the Second Schedule after taking into account paragraphs 2A, 2B and 2C of the schedule. The result of these changes is that from 1 October 2007 the tax-free lump sum portion upon retirement or death is set at a fixed amount of R300,000. The tax free portion is increased with any contributions towards the retirement fund not previously allowed as a deduction and decreased with any lump sums from retirement funds previously paid out free of tax. The taxable portion is ring-fenced in that no other expenditure, losses or allowances can be set off against this income. In effect, it is directly included in the taxpayer's taxable income. The tax due on the taxable lump sum benefit is calculated based on a separate scale of rates. The primary and secondary tax rebates cannot be set-off against the tax calculated on the benefit.² In effect, this means that where in the past a person had a low average tax rate due to losses incurred from one of his trades he would be taxed much more favourably under the previous Second Schedule. The position after the changes to the Second Schedule is that he is taxed on his benefit regardless of whether he is in fact in an assessed loss position. The separate rate scale subjects the first and second R300,000 of the taxable lump sum to tax at 18% and 27% respectively, with any amount in excess of R600,000 being taxed at 36%.

The tax-free amount of R300,000 is cumulative over the lifetime of the taxpayer for retirement fund lump sums received. Taxpayers that are members of more than one retirement fund may, however, benefit by retiring in different years of assessment, thereby taking advantage of the lower rate of tax on the first and second increments of R300,000 more than once.

Section 1 of the ITA defines the terms "retire" and "retirement". In relation to a pension fund it means to retire from employment and become entitled to the payment of an annuity from such fund. The minimum retirement age is therefore dependant on the rules of the fund. With regards to a provident fund it means to retire from employment and become entitled to the payment of full benefits in terms of the rules of the fund. It should be noted that it is impossible to retire from a pension or provident fund without also retiring from employment.

¹ Explanatory memorandum to the draft Taxation Laws Amendment Bill, 2007, relating to the proposed provisions in respect of lump sum benefits derived upon retirement or death.

² Section 6(1) of the ITA.

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In the case of person belonging to both a pension and provident fund, he can't retire from the provident fund without also retiring from employment and the pension fund.¹ Paragraph 4(3) of the Second Schedule states that if a member of a provident fund retires from such fund before he reaches the age of 55 years on grounds other than ill-health, any resulting lump sum benefits received by or accrued to such member, unless the Commissioner having regard to the circumstances of the case otherwise directs, be taxed as a withdrawal benefit and not as a retirement benefit. For a retirement annuity fund, "retire" means to become entitled to the payment of an annuity from such fund. According to subparagraphs (v) and (viii) of paragraph (b) of the definition of "retirement annuity fund" the member is not entitled to an annuity from the fund before the age of 55 is reached. Where contributions towards the fund are discontinued prematurely the member is only entitled to an annuity when he would have become entitled to the benefits.

In terms of paragraph three of the Second Schedule any lump sum benefit that becomes recoverable upon the death of a member (or past member) of a pension, provident or retirement annuity fund is deemed to accrue to such member immediately prior to his death. Where any annuity which became payable in consequence of the death of a member (or past member) of any such fund has been commuted for a lump sum, such lump sum is also deemed to accrue to the member. It is clear that the lump benefit payable when a member dies in service of the employer, as well after retirement is taxable in the hands of the member. A proviso to the paragraph states that so much of any tax payable as is due to the provisions of this deemed accrual, may be recovered from the person to whom or in whose favour the lump sum benefit in question actually accrues, i.e. the dependants. In terms of the definitions of "pension fund" and "retirement annuity fund", no portion of any annuity payable to the dependant or nominee of a deceased member may be commuted later than six months from the date of the death such member.²

Lump sum on withdrawal – current taxation

The Taxation Laws Amendment Act did not amend the calculation of the tax-free portion on withdrawal and the resulting taxable amount included in gross income is still taxed at the taxpayer's average rate in terms of section 5(10). The tax-free portion upon withdrawal, resignation or winding up of the fund is R1,800. In addition, the any portion transferred to a new fund (as stipulated in paragraph 6 of the Second Schedule) is tax-free. A transfer from a pension fund to another pension fund or retirement annuity fund is tax-free. Transfer from a provident fund to a pension, provident or retirement annuity fund is also tax-free. An approved retirement annuity fund³ cannot pay a lump sum benefit on resignation or withdrawal and therefore the only time that a lump sum is available prior to retirement or

¹ M Botha *et al*, The South African Financial Planning Handbook 2006, page 730.

² See paragraph (c)(ii)(gg) of definition of "pension fund" and (b)(iii) of definition of "retirement annuity fund".

³ As per the definition in section 1 of the ITA.

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death is when the fund is wound up.¹ In this case the amount is tax-free to the extent that it is used to purchase an insurance policy or it is transferred to another retirement annuity fund.

A proviso to paragraph 6 provides that the tax-free portion shall not be less than the lesser of the benefit or the contributions not allowed as deductions under sections 11(k) and 11(n).

It is obvious that there is a substantial fiscal incentive to remain a member of a retirement vehicle until retirement. Withdrawing from a fund before retirement and taking the cash is met with severe tax implications.

Benefits (annuities)

As per the definition of a pension and retirement annuity fund the purpose of these funds are to provide an annuity on retirement. The “compulsory” annuity from a retirement fund is included in the gross income of the taxpayer by virtue of paragraph (a) of the definition of gross income. This paragraph includes in gross income any amount received or accrued by way of annuity, including any amount contemplated in the definition of “annuity amount” in section 10A(1) (voluntary annuities – discussed separately below) regardless of whether the amount is of capital or revenue nature. Compulsory annuities received by the pensioner are therefore taxed in full at his marginal rate of tax. Upon the death of the pensioner, any annuity payable to dependants is taxable in the hands of these beneficiaries. In terms of SARS General Note 23² no death benefit may be provided by a pension fund or retirement annuity fund on the death of a pensioner with the exceptions of the payment of an annuity to a dependant or nominee of a deceased pensioner. The definitions of “pension fund” and “retirement annuity fund” do not provide for the payment of such a benefit.

The dependants or nominees of a deceased pensioner may commute such an annuity within six months after the death of the pensioner. Where the annuity policy was purchased by a pension fund, the policy may provide for a total commutation of the annuity. Where the annuity policy was purchased by a retirement annuity fund, the policy may provide for a commutation of up to one-third of the annuity payable to the dependant or nominee. The approval of a pension fund or retirement annuity fund will be withdrawn if it permits the purchase of an annuity policy that provides for the payment of a death benefit other than a (commutable) annuity.

¹ Except in the situation envisaged by paragraph (b)(x)(cc) of the definition of ‘retirement annuity fund’ that allows the payment of one or more lump sum benefits where that member’s interest in the fund is less than an amount determined by the Minister by notice in the *Gazette* from time to time.

² Issued 6 October 2000.

Voluntary annuities

Section 10A deals with the taxation of purchased annuities, i.e. voluntary annuities. The definition of “annuity contract” in this section excludes the annuity payable under the rules of pension, provident or retirement annuity fund. The purpose of the section is to exempt the capital portion of the purchased annuity from tax. The capital portion is calculated in terms of a specified formula, which applies the ratio of the purchase price of the annuity to the total expected benefits over the term of the annuity to the annuity actually received by or accrued to the taxpayer during the year of assessment.¹ This exemption for voluntary annuities is necessary as they are purchased with “after-tax” monies as opposed to compulsory annuities, which are bought, with “pre-tax” monies through the contribution deductions granted by sections 11(n) and (k). Where a voluntary annuity is commuted to a lump sum or the annuity contract is terminated, the remaining capital portion of the amounts so received is exempt.²

Meaning of annuity

The ITA does not define what is meant by “annuity” but it has been addressed in a number of cases. In *CIR v Milstein*³ it was held that “*Annuities differ from other investments in that the capital sum invested is not returnable when the annuity ceases to be payable ... The test, in determining whether a series of annual payments amounts to an annuity, is whether the principal continues to exist as a debt or is liquidated when the transaction takes place. If it is liquidated the payments constitute an annuity.*” And in *ITC 761*⁴ referred to in *KBI en ‘n Ander v Hogan*⁵ the main characteristics of an annuity were identified: “*that it is an annual payment (this would probably not be defeated if it were to be divided into instalments; that it is repetitive – payable from year to year for, at any rate, some period; that it is chargeable against some person*”. It should be noted that when an annuity is purchased the cash contribution becomes the property of the life insurer. The annuitant has no right to that capital anymore, only the agreed annuity payments.

Fund may purchase annuity from insurer

An approved pension, provident or retirement annuity fund may provide a compulsory life annuity on a member's retirement from employment in one (or a combination) of two ways, namely by paying the annuity itself or by purchasing the annuity from a registered insurer. It should be noted that while the rules of the fund may provide for both the abovementioned methods the member may select only one and not a combination. The purpose of a compulsory annuity is to provide a life annuity for a member or an annuity for dependants or nominees of a deceased member. SARS General Note 18⁶ allows retirement funds to

¹ Section 10A(2) subparagraphs (a) and (b).

² Section 10A(3)(c).

³ (1942) TPD 57

⁴ 19 SATC 103

⁵ (1943) 4 SA 150 (A)

⁶ Issued August 1996.

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purchase annuities for their members from a South African registered insurer in the name and on the life of the member. It also sets out the conditions that must be met to obtain approval for such funds. The annuity purchased must be compulsory, non-commutable and payable for the lifetime of the member. It may not be transferred, assigned, reduced, hypothecated or attached by creditors as contemplated by the provisions of sections 37A and 37B of the Pension Funds Act. The rules of the fund must provide for the purchase of an annuity in the name of the member from a registered insurer and the concomitant transfer of the liability to the insurer. The annuity must be purchased with the full value of the member's fund value that is available for the provision of an annuity (i.e. after commutation of the allowed portion).¹

Living annuities

Living annuities (also known as linked or flexible annuities) have enjoyed increasing popularity due to their transparency and flexibility regarding investment choices. They differ from conventional annuities in that the annuitant takes on the risk of the market performance affecting the underlying assets. The insurer does not guarantee an annuity amount, as is the case with a conventional annuity. Directive 135 issued by the Financial Services Board defines linked (living) annuities as a compulsory annuity policy in respect of which: a) the liability of the insurer is limited to the value of an investment account which is credited with an initial amount, net of initial expenses, and subsequent net investment return earned, and which is debited with annuity payments and ongoing expenses; and b) the annuitant may vary the size of the annuity payments within limits determined by Practice Note RF 1/96 or Practice Notes which may replace it, issued by the South African Revenue Service. A compulsory conventional annuity policy means a compulsory annuity policy in respect of which the liability of the insurer is the payment of a contractual periodic payment (i.e. the annuity with or without profit) for the remainder of the life of the annuitant or to one or more dependants or nominees after the death of the annuitant.

Allowed income levels

SARS issued Practice Note RF1/96², which sets out certain requirements regarding the calculation of living annuities and states that flexible annuities provided on some other basis will not be recognised by Inland Revenue and funds providing such annuities will not be approved. Amongst other requirements, the practice note states that the income levels must be based on a minimum of 2.5% simple interest rate of return calculation and a maximum of 17.5% simple interest rate of return calculation³, and must at all times produce a life annuity. Flexible annuity benefits paid to an annuitant are to be reviewed on an annual basis. On the anniversary date of inception, the revised fund value should be determined in order to

¹ Clarified in SARS General Note 18A issued January 2007.

² Issued June 1996.

³ The original RF1/96 set the minimum and maximum income levels at 5% and 20% respectively. Addendum B to RF1/96 issued 21 February 2007, which is effective from 1 March 2007, amended this to the current 2.5% and 17.5%.

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calculate the minimum and maximum annuity benefits payable. The minimum and maximum rates were introduced to prevent past practices of setting the annuity rate at a level so high that it quickly erodes the pension or too low, deferring the payment of tax.

The requirement that the income level must at all times produce a life annuity means that the administrator of the annuity must ensure that the rate at which the annuity is currently paid can continue for at least the expected lifetime of the retiree. This places a duty on the administrator to reduce the rate at which the annuity is paid whenever the underlying capital becomes insufficient to guarantee a life annuity. The ongoing monitoring of the underlying capital by the administrator in respect of each annuity policy is therefore also a requirement. It is not a requirement for an administrator to ask permission from SARS for an annuity to be reduced in these circumstances. No other provision is made for such an annuity to be increased or reduced, and no authority exists in terms of which SARS can approve a request for a change other than on the anniversary date.¹

The flexibility of living annuities provide scope for tax planning as the minimum income level (currently 2.5%) is very low compared to the current market returns and as such the living annuity might theoretically continue in perpetuity. As annuities do not form part of the property of deceased estate for estate duty purposes (see section on estate duty) a retirement benefit in the form of a living annuity is able to avoid taxation for a whole generation (apart from the taxation of the small annuity receivable).

Administration costs of living annuities

As the pensioner receiving a living annuity is provided with detailed statements showing the costs deducted from his pension, the question arises whether these costs are deductible from his annuity income received. SARS has issued General Note 26² in this regard, in which it states that such fees are not deductible under section 11(a) in the hands of the annuitant. SARS is of the opinion that since the assets backing the annuity belongs to the life insurer and not the annuitant, the expenses incurred to administer the annuity is for the insurer's account and is therefore not incurred by the annuitant.

Is a living annuity an annuity?

In a recent High Court decision³ it was held that the living annuity bought by a taxpayer's pension fund did not constitute an "annuity" for the purposes of paragraph (a) of the definition of gross income. Foxcroft J held: *"In my view the money which (the insurer) received on behalf of Respondent was money which it was obliged to invest for the benefit of Respondent in order to carry out its contractual obligation to make periodic payments to Respondent. The*

¹ Addendum A to SARS Practice Note RF1/96 issued 24 March 2004.

² Issued 14 January 2002.

³ Commissioner, SARS v Higgo 2007 (2) SA 189 (C)

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money which had been transferred by (the pension fund) to (the insurer) and used to purchase the underlying assets was not “merely the measure of the cash payments which Momentum was obliged to make”, as Mr Rogers submitted, but was the guarantee for payment to him of that to which he, and after his death his dependants, were entitled.

It seems to me that the ‘disappearance of capital’ test is particularly misleading in a situation such as the present. As HILL J said, money is a fungible and the actual money obviously disappears when investments are bought with that money. Throughout his life, the Respondent will be in control of the investment of his capital or the capital, which was paid by RCPF to Momentum for his benefit, whichever way one wishes to describe it. Respondent is entitled to regulate within agreed limits how much of this fund is to be paid to him annually. In a very real sense, therefore, the capital paid to Momentum on Respondent’s behalf and for his benefit cannot be said to have ‘disappeared’. It had to be held by Momentum to cover Momentum’s obligation to Respondent until that obligation was entirely fulfilled.”

The court took the view that under the annuity contract between the annuitant and the life insurer, the former was in control of the capital invested held by the life insurer on his behalf.

Normally when an annuity is purchased annuitant no longer has any claim to the assets transferred to fund such annuity. The assets become the property of the life insurer and the annuitant is entitled to claim the agreed annuity from the insurer. It is submitted that this decision does not automatically apply to all living annuities; the wording of the particular contract should be carefully interpreted to ascertain the intention of the parties. It is also submitted that the far-reaching income tax consequences of a living annuity not being held to be an annuity (for income tax purposes) is enough of a deterrent not to exploit this judgement. As described in the sections above a fund’s approved status is what allows the member to deduct contributions towards it. The Commissioner will only approve pension and retirement annuity funds of which the purpose is to provide annuities upon retirement, of which no more than one third may be commuted for a lump sum payment¹. If the taxpayer receives an amount upon retirement that does not constitute an annuity, the fund would therefore lose its approved status. This entails that the contributions made by members would not be deductible in terms of sections 11(k) and 11(n) and that the taxpayer’s total fund value would accrue to him upon retirement. Due to the capital nature thereof, this benefit would not be included in gross income, but will be subject to capital gains tax as the exemption afforded by paragraph 54 of the Eighth Schedule only applies to those lump sum benefits defined in the Second Schedule. Prior to retirement, the fund itself would be taxable on the investment income produced by the assets held on behalf of its members as it would not qualify for the section 10(1)(d) exemption of all of its receipts and accruals.

¹ See definition of pension and retirement annuity fund in section 1 of the ITA.

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Furthermore, the life insurer would have to move the assets backing these living annuities out of its Untaxed Policyholder Fund, as it no longer represents an annuity contract. Past Retirement Funds Tax payments could also be calculated incorrectly as the pensioner factor used in this calculation would be affected.

There may also be Estate Duty implications as annuities provided by or in consequence of membership or past membership of a pension fund, a provident fund or a retirement annuity fund do not form part of the deceased estate. Assets owned by the taxpayer that are held on his behalf do however form part of his estate.

Surplus apportionment and Statement of intent

Paragraph 2C of the Second Schedule was inserted by the Taxation Laws Amendment Act No.8 of 2007. This paragraph excludes from gross income any lump sum benefit received or accrued subsequent to the relevant person's retirement or death, or withdrawal from any retirement fund or the winding up of any such fund, and in consequence of or following upon an event contemplated by the rules of the fund or in consequence of the approval of a scheme in terms of section 15B of the Pensions Funds Act¹ or regulation 5.3 (1) (b) of the Regulations under the Long-Term Insurance Act². This new paragraph mentions three types of extraordinary benefits. The first being one that must be a result of an event contemplated in the rules of the fund. This is meant to include the redistribution of the so-called "bulking" profits taken by fund administrators in the past.³ The second refers to surplus apportionment schemes. It should be noted that any amount due to the employer in terms of such a scheme is taxable in full in the hands of the employer (see Employer section above). The last benefit mentioned is what is known as the "Statement of Intent" benefits. A Statement of Intent was signed by the Long-term Insurance Industry and the Minister of Finance in December 2005 to set minimum standards on all policies where savings is the primary objective and where policyholders made contractual changes to their policies, such as stopping or reducing their premiums. The tax-free status of these rectifying payments were necessary as in the opinion of National Treasury these payments are small due to low-income individuals bearing a disproportionate share of the burden and the amounts at issue were spread over a large number of member interests. The administrative burden and costs to obtain tax directives accordingly outweigh the monetary benefit payable to individual former members.⁴

Paragraph 2C is effective 1 January 2006.

The tax-free status of these enhancements only applies to the past members of a fund. The fund value of current members' is enhanced with these amounts and will form part of their

¹ No. 24 of 1956.

² No. 52 of 1998.

³ The explanatory memorandum to the Taxation Laws Amendment Bill 2007 specifically mentioned the intention to exclude these types of benefits from gross income.

⁴ The explanatory memorandum to the Taxation Laws Amendment Bill 2007.

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normal benefits upon retirement, withdrawal, death or winding up of the fund and will be taxable according to the normal principles.

Preservation funds

Preservation funds are popular vehicles used to “park” pension fund monies subsequent to resignation from an employer pension or provident fund. From here the money can be transferred to the new employer’s pension or provident fund or to a retirement annuity fund. One of the advantages of a preservation fund was that it preserved the “N” factor used to calculate the tax-free portion of a lump sum on retirement before the deletion of “formula A” and the amendments to formula B in the Second Schedule. The “N” factor was the number of years that the employee was a member of the pension or provident fund. This number was divided by 10 and multiplied by the employee’s average salary¹ and used to as input to calculate the tax-free portion. Therefore, the higher “N”, the larger the tax-free portion. Hence he need to preserve it when changing employers. With the changes to the Second Schedule brought by the Taxation Laws Amendment Act, the tax-free portion is now calculated without regard for the number of years of service and this advantage of a preservation fund has therefore fallen away. There is one other advantage of a preservation fund, namely that one withdrawal is allowed from it. Any amount can be withdrawn including the entire fund value. It therefore provides more flexibility than if the employee transferred his pension to a retirement annuity fund upon resignation, since no withdrawal is allowed from such a fund until the age of 55.

Pension or provident fund

A preservation fund can be either a preservation pension fund or a preservation provident fund. The provisions of the Income Tax Act as well as the Pension Funds Act applicable to pension and provident funds apply equally to preservation funds. Therefore, upon resignation, withdrawal or the winding up of the fund, a transfer from a pension or provident fund to a preservation fund will be treated in the same manner as explained above (see section on lump sum benefits) depending on whether the preservation fund is an approved pension or provident fund, e.g. a transfer from a pension fund to a preservation provident fund will be taxed in full in terms of paragraph 6 of the Second Schedule.² Similarly, benefits from a preservation fund on retirement, death or withdrawal will be taxed in the same manner as a pension or provident fund benefit.

Requirements for SARS approval

SARS has issued Practice Note RF1/98 to lay down the conditions under which a preservation fund will be approved for the purposes of the ITA.

¹ Highest annual average salary for any consecutive 5 year period in the service of the employer by whom he was employed during his membership of the fund (limited to a maximum of R60,000).

² Except for the R1,800 tax free amount.

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The first requirement is that the employer must be a participating employer in the preservation fund. To participate in a preservation fund, the trustees of the preservation fund must have accepted a written application from the employer to participate in the fund and the trustees must have approved the employer's participation. Participation must commence on the date on which the trustees of the preservation fund approve the employer's participation. Backdating of the employer's participation is not allowed and will result in the approval of the preservation being withdrawn. To be eligible for membership of a preservation pension and provident fund respectively the member must have been a member of the employer's pension fund in the former case or employer's provident fund in the latter. Translocation benefits¹ may be paid to a preservation fund if a member *bona fide* resigns from the employment of his employer or is retrenched or dismissed from employment or if the whole business of the fund, or the portion thereof that is attributable to members in the present or past employment of a particular employer, is winding-up in terms of section 28 or 29 of the Pension Funds Act. No translocation to a preservation fund is permitted in circumstances where an employer has either merged with or been taken over by another entity and where an employee of that employer enters in employment with the merged employer or entity.

In terms of Practice Note RF1/98 and Addendum A thereto the only deductions allowed from a translocation benefit before it is paid into a preservation fund is the transfer to a retirement annuity fund, deduction permitted by section 37D of the Pension Funds Act (housing loans and certain damages caused by employee) and the claim if a non-member ex-spouse in terms of section 7(8) of the Divorce Act.²

No more than one withdrawal may be paid from the preservation fund. In terms of Addendum D to RF1/98, the allowed deductions from the translocation benefit (noted above) do not count as a withdrawal. The benefits of a member of a preservation fund who is in new employment may, irrespective of whether the preservation fund paid a withdrawal benefit to the member in the past, be paid into the approved pension or provident fund in which his or her new employer participates if he or she is a member of the new fund. The member's full benefits, less income tax if the translocation occurs from a preservation pension fund to a provident fund, must be paid into the new fund and will be subject to the rules of the new fund. No transfer from a preservation fund to a retirement annuity fund is permitted.

In terms of paragraph 4 to the original Practice Note RF1/98 the paid-up benefit in a preservation fund must be paid in the form of a retirement benefit with effect from the date of

¹ Explained in RF1/98 to mean resignation, retrenchment, dismissal or winding-up benefits from employer funds.

² No 70 of 1979.

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the member's actual retirement from his employment with his current employer. However, in terms of Addendum C to this Practice Note (issued 1 February 2007) it is accepted by SARS that a member who has attained the age of 55 years but not yet 70 may become entitled to a retirement benefit from the preservation fund prior to retirement from the employment of his or her current employer. A member who is not in employment and who wishes to take a retirement benefit may do so before he reaches the age of 70 years, but not before he reaches the age of 55 years. Before the age of 55 the benefit of such unemployed member must remain paid-up.

Marriage and Divorce

Married persons are taxable in their own right and registered as separate taxpayers. Section 7(2A)(b) provides that in the case of a community of property marriage, income derived from the letting of fixed property and any income derived other than from the carrying on of a trade is deemed to accrue in equal shares to each spouse. This would, for example, apply to where one of the spouses has a passive interest bearing investment. In such a case half the interest accrues to each spouse. This would also apply to lump sums and annuities received by a spouse from a retirement fund. This is however addressed by section 7(2C) that deems any benefit payable to a spouse in his capacity as a member or past member of a pension, provident, retirement annuity fund or any other fund of a similar nature to be income derived by such spouse from trade. This effectively renders section 7(2A)(b) inapplicable to retirement benefits, which means that each spouse is taxable on his retirement benefits in his own right.

In terms of paragraph 2B of the Second Schedule where a portion of a member's pension interest in a pension, provident or retirement annuity fund is payable to a former spouse in terms of a court order as provided for in the Divorce Act¹ the amount so payable is deemed to accrue to the member. Any tax payable on this portion may be recovered from the former spouse. Note that the amount would be exempt from tax in the hands of the receiving spouse in terms of section 10(1)(u).

Any transfer of assets between spouses is disregarded for CGT purposes in terms of paragraph 67 of the Eighth Schedule. In terms of paragraph 2(b) a person must be treated as having disposed of an asset to his spouse if that asset is transferred to that spouse in consequence of a divorce order.

¹ No 70 of 1979.

Anti-avoidance

Due to retirement funds being tax neutral it is often used for tax planning purposes. These schemes are met with specific anti-avoidance provisions contained in the ITA as well as the general anti-avoidance rules contained in section 80A through 80L.

Sale and leaseback

These arrangements involved taxpayers that owned assets with substantial market values that have been completely written down for tax purposes. To claim further deductions on such an asset, the taxpayer would find a tax indifferent party (such as a retirement fund) and enter into a sale and leaseback agreement with it. The lease payments would be fully deductible in the hands of the employer and exempt from tax in the hands of the fund. Section 23G puts a stop to these type of arrangements and applies to all sale and leaseback arrangements where the receipts and accruals of either the lessee or the lessor do not constitute "income" for the purposes of the ITA. The section prohibits the lessee from deducting the full rental for tax purposes. Instead, only the portion that constitutes interest on a yield to maturity basis is allowed. This effectively places the lessee in the same position it would have been had it refinanced its asset through a bank.

General anti-avoidance rules

Sections 80A through 80L were introduced into the ITA by the Revenue Laws Amendment Act, 2006 and replaced the previous general anti-avoidance provisions contained in section 103(1). The section gives the Commissioner the power to determine the income tax consequences of any impermissible avoidance arrangement for any party thereto. An avoidance arrangement is one that results in a "tax benefit".¹ To determine whether an arrangement constitutes an impermissible avoidance arrangement the sole or main purpose must have been to obtain a tax benefit and the arrangement must include some form of abnormality such as a lack of commercial substance.² An arrangement lacks commercial substance if it would result in a significant tax benefit for the taxpayer, but not have a significant effect upon either the business risks or net cash flows of that taxpayer.³ Of particular importance is that where an accommodating or tax-indifferent party (such as a retirement fund) is included in an arrangement, section 80C(2) deems this indicative of a lack of commercial substance. Taxpayers entering into transactions with retirement funds should therefore be aware of the consequences of these provisions. If found to be an impermissible

¹ Includes any avoidance, postponement or reduction of any liability for "tax". "Tax" includes any tax, levy or duty imposed by the ITA or any other law administered by the Commissioner. See definitions in section 80L.

² Section 80A(a)(ii).

³ Section 80C(1).

avoidance arrangement, the Commissioner can (among other remedies) disregard the tax-indifferent party completely, or treat the tax-indifferent part and any other person as one.¹

Housing loans

In terms of section 19(5)(a) of the Pension Funds Act a fund member may use his fund benefit as security for obtaining a housing loan from a third party or the fund may grant the loan to the member itself. Neither the loan nor the interest due on it has any income tax consequences for the member or the fund. The definition of “gross income”² as well as the specific inclusion of lump sums from retirement funds contained in paragraph (e) of the definition requires there to be a receipt or accrual of an amount. For there to be an accrual of an amount the member must be unconditionally entitled to that amount. As such entitlement only arises upon the member’s retirement, death or withdrawal from the fund, no amount has accrued to the member. The receipt of the actual loan amount from the fund does also not constitute a “receipt” in the hands of the member for the purposes of gross income. This is due to loans in general not constituting receipts in the hands of the borrower. As Schreiner JA put it in *CIR v Genn & Co (Pty) Ltd*³: *“It is certainly not every obtaining of physical control over money or money’s worth that constitutes a receipt for the purposes of these provisions. ... At the same moment that the borrower is given possession he falls under an obligation to pay. What is borrowed does not become his”*.

The member cannot deduct the interest on the loan as it can only be granted for the purposes of a residence occupied by himself or his dependants. It is therefore “private expenditure” which is specifically disallowed by section 23 of the ITA.⁴ If the fund granted the loan, the interest it received is not taxable as is the case for all other receipts and accruals of a retirement fund.

State funds

The definition of “pension fund” distinguishes between state funds in paragraphs (a) and (b) of the definition and other (private sector) funds in paragraph (c). Up to 1 March 1998 a lump sum from a state fund was completely exempt from income tax while members’ contributions were deductible in full. With effect from 1 March 1998 the taxable portion of a lump sum benefit from public sector fund is included in gross income by paragraph (e)(ii) of the that definition. Annuities received from public sector funds are included in gross income through the specific inclusion of annuities in paragraph (a) as is any other annuity.

¹ Section 80B.

² In section 1 of the ITA.

³ (1955) 3 SA 293 (A)

⁴ Note, however, that section 23(b) allows the expenditure incurred on that portion of the premises occupied for the purposes of trade subject to very specific requirements.

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Although the public sector funds are included under the definition of “pension fund” in the Act, the Second schedule to the Act distinguishes between public sector pension funds and public sector provident funds by having its own definitions of “pension fund” and “provident fund” – a public sector provident fund being a fund the rules of which provide for benefits in a lump sum exceeding one-third of the capitalised value of all benefits to its members on retirement.¹

Taxation of benefits

As is the case with private sector funds a lump sum retirement benefit is only partly taxable. The tax-free portion is also determined by the provisions of the Second Schedule and is calculated in the same manner as tax-free portion of the private sector funds with the exception that the tax-free portion calculated in “formula B” is increased with any pre 1 March 1998 rights to a benefit. The pre-March 1998 rights are calculated through the application of a “formula C” that applies to public sector funds only. This formula simply apportions the lump sum benefit between pre- and post 1 March 1998 portions based on the number of years the taxpayer was a member of the fund before and after that date. The result is that the tax-free portion of a public sector fund lump sum is R300,000, plus any disallowed contributions, plus the value of pre-1998 rights (calculated in formula C), less any lump sums from retirement funds previously paid out free of tax. A lump sum on death of the member is calculated in the same way. On withdrawal from the fund the tax-free portion is R1800 in addition to any portion that was transferred to a pension or retirement annuity fund.

Transfer from pension to provident fund

As the pre-1998 portion of a member’s benefit is tax-free it is advantageous to be able to take the maximum as a lump sum instead of an annuity since there is no similar exemption for annuities. To prevent state funds to convert from pension to provident funds and members from transferring from pension to provident funds to take advantage of the increased lump payable by a provident fund, paragraph (eA) was introduced to the gross income definition. This paragraph seeks to discourage such transfers and conversions by including in the member’s gross income two thirds of the amount transferred or converted, which is taxable at the marginal rate. Essentially, the portion of the member’s benefit that would have been used to purchase an annuity upon retirement is now taxed upfront instead of as and when the annuity is received.

¹ Paragraph (b) of the definition of “provident fund” in the Second schedule defines a public sector provident fund as “a fund referred to in paragraph (a) or (b) of the definition of “pension fund” in section 1, the rules of which provide for benefits in a lump sum exceeding one-third of the capitalised value of all benefits to its members on retirement”. Paragraph (b) of the definition of “pension fund” includes “a fund referred to in paragraph (a) or (b) of the definition of “pension fund” in section 1 of this Act (other than a fund referred to in paragraph (b) of the definition of “provident fund”), the rules of which wholly or mainly provide for annuities on retirement to its members”.

Benefits from a foreign source

Resident receives benefit from SA fund for foreign service

A resident of the Republic is taxable on his worldwide income regardless of source¹. Lump sum retirement benefits are usually of capital nature, but are specifically included in the member's gross income through the specific inclusion contained in paragraph (e). This paragraph includes in gross income the amount as determined by the Second Schedule of any lump sum benefits received by or accrued to a person in consequence of his membership (or past membership) of any approved fund or state fund. Section 10(1)(gC)(ii) exempts any pension from a source outside the Republic in consideration for past employment outside the Republic that is not deemed to be from a source within the Republic in terms of section 9(1)(g). Section 9(1)(g) deems certain pensions or annuities to be from an SA source. Subparagraph (ii) of section 9(1)(g) refers to any pension or annuity received from any source where the services in respect of which the pension was granted were rendered partly in SA. In such case, the portion of the pension or annuity that is deemed to be from a SA source is calculated based on the ratio of period of service in SA bears to the total period during which services were rendered. It also provides that any services rendered in the territory of the former Republic of Transkei, Bophuthatswana, Venda or Ciskei is deemed to have been rendered within the Republic. This subparagraph only applies if services were rendered within the Republic for at least two of the ten years immediately preceding the date from which the pension or annuity first became due.

To summarise, the lump sum included in gross income will be determined in terms of the Second Schedule. An exemption can then be claimed for the portion of the taxable lump sum that is from a foreign source.

Similarly, any annuity received by a resident will be included in the taxpayer's gross income (due to paragraph (a) of the definition of gross income) against which the section 10(1)(gC) exemption can be claimed for the portion of the annuity deemed to be from a foreign source.

Resident receives pension from foreign fund

Foreign retirement funds are not approved funds as required by the definitions of pension, provident and retirement annuity funds in section 1 of the ITA. The Second Schedule of the ITA and the paragraph (e) does therefore not apply to these benefits and therefore these lump sums do not form part of the taxpayer's gross income due to it being of a capital nature and not otherwise included in gross income. Any lump sum benefit from a fund, arrangement or instrument situated outside the Republic that provides similar benefits under similar

¹ The principal test for of source was devised in CIR v Lever Brothers and Unilever Ltd (1946 AD). It is the location of the originating cause of the income. The originating cause is the *quid pro quo* that the taxpayer gives in return. This could be the business he carries on, the enterprise he undertakes, the activity in which he engages and it may take the form personal exertion, mental or physical, or it may take the form of employment of capital.

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conditions to an approved pension, provident or retirement annuity fund is also exempt from CGT.¹

Also note that in terms of the “Model tax convention on income and capital” produced by the Organisation for Economic Co-operation and Development (OECD), on which most Double Taxation Agreements are based, a pension is only taxable in the country of which the taxpayer is (for tax purposes) a resident.²

It would therefore seem that a resident receiving a lump sum from a foreign fund, such a lump sum would completely escape taxation.

Any annuity received by the resident would, however, still be included in the taxpayer’s gross income though the paragraph (a) of the definition, which includes in gross income “*any amount received by way of annuity...*”

Non-resident receives pension from SA public sector fund

A non-resident is only subject to SA income tax on income from a source within or deemed to be within the Republic. Section 9(1)(g)(i) deems any pension or annuity granted from Government, provincial administration or municipality in the Republic to be from a SA source. The non-resident is therefore subject to SA income tax any such benefit received.

Resident receives pension from SA public sector fund

Unlike a private sector fund, a resident receiving a pension or annuity from a SA public sector fund cannot claim an exemption for the portion of the benefit produced by foreign service. As is the case with the non-resident any such benefit is taxable in full in SA.

Non-resident receives pension from approved SA private sector fund

As explained above paragraph (e) of the gross income definition includes in gross income the amount as determined by the Second Schedule of any lump sum benefits received by or accrued to a person in consequence of his membership (or past membership) of any approved fund or state fund. A proviso to paragraph (e) of the gross income definition states that the provisions of section 9(1)(g) applies *mutatis mutandis* in the case of any amount determined as aforesaid. In the opinion of SARS this must be taken to mean that the apportionment required by section 9(1)(g) must only take place after the taxable amount has been calculated in terms of the Second Schedule.³ In essence, the R300,000 exemption granted by the Second Schedule is therefore reduced by the proportion of the benefit that is from a foreign source. As discussed above, section 9(1)(g)(i) deems the source of a pension to be where the services were rendered that entitled the taxpayer to such pension.

¹ See paragraph 54 of the Eighth Schedule to the ITA.

² See article 18.

³ See General Note 7 issued 20 July 1995.

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The portion deemed to from an SA source of any annuity received by the non-resident from such a fund would be included in gross income by paragraph (a) of that definition.

Resident receives foreign social security

Section 10(1)(gC)(i) exempts any amount under the social security system of any other country received by or accrued to a resident.

The Tax on Retirement Funds Act¹ (TORFA)

The third report of the Katz commission recommended that EET system of taxation (as it then was) should be changed to an ETT system. The result was the introduction of the TORFA with effect from 1 March 1996. The tax was levied on interest, net rental and foreign dividend income. It applied to all retirement funds as well as the untaxed policyholder fund of a life insurer. The tax was unpopular with the retirement industry due to it creating complex systems of double administration. It also caused double taxation as a retirement benefit was now taxed during its growth phase by TORFA and then again when it accrued to the member through the ITA. It also prejudiced low-income earners as their ultimate benefits were being taxed without regard for whether their taxable income exceeds the tax threshold. The Act relied heavily on the provisions of the ITA. This led to differing interpretations regarding the taxation of certain income (see notes on interpretation of “dividend” below). The Act was abolished with effect from 1 March 2007 after successive reductions in the tax rate from a high of 25% to 9%.

TORFA divided a calendar year into two assessment periods ending 28 February and 31 August respectively. For each period two provisional payments were required as well as one final top-up payment. These tax periods caused problems for insurers where administration systems are more geared towards reporting on calendar years (the year-end of a long-term insurer being 31 December).

For a retirement fund, the taxable amount was calculated as the sum of net rental, interest, foreign dividends and income allocated to the fund by an insurer, multiplied by the “pensioner factor”. The pensioner factor was a ratio of the value of fund assets relating to active members over the total value of fund assets, i.e. $1 - \frac{\text{pensioner liabilities}}{\text{actuarial value of total assets}}$. This “pensioner factor” served to avoid the taxation of annuities in terms of TORFA as they are included in the gross income (for income tax purposes) of the annuitant and therefore taxing the growth of the assets providing that annuity would amount to double taxation. Relief was given to retirement funds with an exposure to interest bearing investments exceeding 50% of total fund value through limiting the taxable amount accordingly.²

Regarding the taxable amount of the UPF of a life insurer, a different formula was used. From the total interest, net rental and foreign dividends of the UPF such amounts allocated to retirement funds participating in the insurer’s UPF could be deducted. Amounts so allocated would then be taxable in the hands of the retirement fund.³ For this purpose the insurer needed to issue a certificate to the retirement fund stating the income so allocated. The

¹ No. 38 of 1996.

² TORFA, section 3 and 5.

³ TORFA, section 9.

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insurer also had to notify SARS of such an allocation through the submission of a prescribed form. If the insurer did not comply with these documentation requirements, the income was taxable in the hands of the insurer's UPF.¹

As is the case with the taxation of the retirement funds, the formula for the UPF allowed income relating to assets backing annuities to go untaxed. Here a distinction was made between guaranteed annuities and all other annuities. The Income relating to guaranteed annuities² could be deducted from the income of the UPF while the income of all other annuities were excluded through an apportionment formula similar to the "pensioner factor" explained above. Note that the income relating to policies owned by persons exempt from income tax by virtue of section 10 of the ITA were also excluded by the this formula.

As noted above, TORFA was highly reliant on the ITA. In section 1 of the TORFA the link between these two acts are established: *"For the purposes of this Act any word or expression to which a meaning has been assigned in the Income Tax Act, 1962 (Act No. 58 of 1962), hereinafter referred to as the Income Tax Act, bears the meaning so assigned, unless the context within which such word or expression is used otherwise indicates..."*. An interpretation issue that arose related to the treatment of dividend distributions from Collective Investment Schemes in Securities (CISS). A CISS is a "company" as defined in the ITA³. Any amount distributed by a CISS is therefore a "dividend" as defined in the ITA.⁴ It should be noted that such a dividend is taxable in the hands of the unit holder to the extent that it does not represent dividends that the CISS itself received.⁵ I.e., so much of the distribution received from the CISS as represents interest, for example, is taxable under the income tax act. However, this does not detract from the fact that such a distribution is still a dividend as defined and it follows that it should be excluded from income as determined by section 3 of the TORFA⁶. SARS does not agree with this view and maintains that the interest portion of the CISS distribution is taxable for the purposes of TORFA. In the opinion of SARS the context (referring to the preamble to section 1 of the TORFA quoted above) does "indicate the

¹ TORFA, section 10.

² In terms of the definition in section 1 of the TORFA a "guaranteed annuity" means: *"an annuity contemplated in section 29A (4) (a) (iii) of the Income Tax Act, where such annuity is contractually subject to a guaranteed increase at a fixed rate, which rate may be zero, over the full term of the annuity, excluding any annuity which may participate in any bonus distributions by the insurer"*

³ Definition of "company" in paragraph (e)(i) in section 1 of the ITA includes any *"portfolio comprised in any collective investment scheme in securities contemplated in Part IV of the Collective Investment Schemes Control Act, 2002, managed or carried on by any company registered as a manager under section 42 of that Act for purposes of that Part"*

⁴ Definition of dividend in section 1 of the ITA *"means any amount distributed by a company (not being an institution to which section 10 (1) (d) applies) to its shareholders or any amount distributed out of the assets pertaining to any portfolio referred to in paragraph (e) of the definition of "company"..."*

⁵ Section 10(1)(iA) read with section 10(1)(k)(i)(bb) of the ITA.

⁶ Due to section 3 defining the income of a fund as the interest, net rental and foreign dividends, i.e. local dividends are excluded.

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contrary”, so it would be inappropriate to ascribe the term “dividend” per the ITA to distributions from CISS under the TORFA.

Although the TORFA has been abolished disputes regarding this interpretation issue has, to date, not been resolved. In this regard section 13 of the TORFA reads: *“Where the Commissioner is satisfied that any amount of tax has not been paid or has not been paid in full, the Commissioner may make a reasonable estimate of the unpaid amount and issue to the retirement fund or insurer concerned, as the case may be, a notice of assessment of the unpaid amount.”* It is interesting to note that the Revenue Laws Second Amendment Act no. 36 of 2007¹ amended this section by adding a proviso that the Commissioner may not issue an assessment in respect of unpaid taxes under the TORFA after 31 Aug 2008 unless he is satisfied that the non-payment is due to fraud, misrepresentation or non-disclosure of material facts. In addition, it further provides that no assessment may be issued under any circumstances after 28 Feb 2010.

¹ Promulgated 8 January 2008.

Estate duty

Estate duty is levied on the estate of every person and is charged upon the dutiable amount of the estate in terms of the Estate Duty Act¹ (“the Act”). This applies to the worldwide assets of a person that is ordinarily resident in the Republic as well as the SA assets of a person that is not ordinarily resident.² An estate consists of all property of that person as at the date of his death as well all property deemed to be property of that person at that date. In terms of section 3 of the Act “property” means any right in or to property, movable or immovable, corporeal or incorporeal. The section also sets out what constitutes “deemed property”. Section 5 of the Act prescribes how the property and deemed property should be valued. In terms of section 4A the dutiable amount of any estate is determined by deducting from the net value of the estate, as determined in accordance with section 4, an amount of R3,5 million. Section 4 lists a number of allowable deductions from the gross value of the estate.

Lump sums

In terms of section 3(3)(a)*bis* deemed property includes so much of any benefit which is due and payable by, or in consequence of membership or past membership of, any fund on or as a result of the death of the deceased as exceeds the aggregate amount of any contributions or consideration proved to the satisfaction of the Commissioner to have been paid by the beneficiary, together with interest at six per cent per annum calculated upon such contributions or consideration from the date of payment to the date of death. However, it is generally only the employer and the member that contributes to the fund. The wording of the section refers to “*any annuity provided by or in consequence of membership or past membership*”. This serves to include annuities not paid directly by the fund itself such as annuities purchased from a life insurer in the name of the member as allowed by General Note 18 (discussed above).

Annuities

In terms of the first proviso to section 3(3)(a)*bis*, the inclusion of retirement benefits as part of “property” for estate duty purposes does not apply to any annuity provided by or in consequence of membership or past membership of a pension fund, a provident fund or a retirement annuity fund as respectively defined in section 1 of the ITA.

Annuities commuted by beneficiaries of the estate

The second proviso to section 3(3)(a)*bis*, however, makes it clear that the subsection does apply to the commutation of any annuity which on or after the date of the death of the deceased is provided or may be provided by or in consequence of membership or past

¹ No. 45 of 1955.

² Note that the Estate Duty Act does not define the term “resident” and case law should be referred to.

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membership of a fund referred to in the first proviso. In terms of the definitions of “pension fund” and “retirement annuity fund” contained in the ITA, no portion of any annuity payable to the dependant or nominee of a deceased member may be commuted later than six months from the date of the death such member.¹ Where such annuity is commuted, the beneficiary is liable for the estate duty due, unless the commuted value is paid into the estate in which case the executor is liable.² The duty payable by the beneficiary is determined as the ratio of the net value (after deduction of income tax payable) of the commuted lump sum over the total net value of the estate applied to the total estate duty due.

Income tax and Estate duty

As can be seen from the above, any lump sum retirement benefit forms part of the estate, while an annuity payable to the member’s beneficiaries do not, unless it is commuted. In terms of paragraph three of the Second Schedule of the ITA any lump sum benefit that becomes recoverable or any annuity which became payable and is commuted upon the death of a member (or past member) is deemed to accrue to such member immediately prior to his death. These lump sums are therefore included in the gross income of the deceased. The income tax due on such lump sums may be deducted from the value of the property for estate duty purposes.³

Property accruing to surviving spouse

In terms of section 4(q) of the Estate Duty Act a deduction is allowed for any property or deemed property that accrues to the surviving spouse. The subsection does, however, contain two anti-avoidance provisos. Firstly, the deduction is reduced by the amount of which the surviving spouse has to dispose of to any other person or trust in terms of the will. Secondly, where the property accrues to a trust established by the deceased for the benefit of the surviving spouse, no deduction is allowed if anyone other than the surviving spouse can benefit from the trust. A retirement fund lump (as with any other form of property) will therefore not attract estate duty if it exclusively accrues to the surviving spouse.

¹ See paragraph (c)(ii)(gg) of definition of “pension fund” and (b)(iii) of definition of “retirement annuity fund”

² Section 11(b)(iA) of the Estate Duty Act.

³ In terms of section 4(b) a deduction is allowed for “*all debts due by the deceased to persons ordinarily resident within the Republic..., which it is proved to the satisfaction of the Commissioner have been discharged from property included in the estate*”.

Capital Gains Tax (CGT)

Where prior to 1 October 2001 a capital gain was not taxable, the introduction of CGT now includes a portion (25% for individuals, otherwise 50%) of a capital gain in the taxpayer's taxable income. Receipts and accruals of a capital nature that are not included in gross income through one of the specific inclusions are subject to CGT. CGT is not a separate tax, but rather normal income tax on the taxable portion of a capital gain. Section 26A of the ITA includes in a taxpayer's gross income the "taxable capital gain" as determined by the Eighth Schedule. Paragraph 10 of the Eighth Schedule defines the "taxable capital gain" as that person's net capital gain multiplied by an inclusion rate. The applicable inclusion rate depends on the nature of the taxpayer. The "net capital gain" is the amount by which the person's aggregate capital gain exceeds the assessed capital loss brought forward from the previous year of assessment. For there to be a capital gain there must be a "disposal" of an "asset". Both of these terms are defined in paragraph 1 of the Eighth schedule and are very wide. In addition there are a number of deemed disposals listed in paragraph 12. The "capital gain" is defined in paragraph 3 as the amount by which the "proceeds" on disposal exceed the "base cost" of the asset. Both of these terms are also extensively defined in Parts VI and V of the Eighth Schedule.

Retirement Funds

Section 10(1)(d) of the ITA exempts from income tax the receipts and accruals of a pension, provident and retirement annuity fund. Any capital gain realised by such a fund is also free from CGT due to paragraph 63 of the Eighth schedule to the ITA stating that any capital gain or loss of a person, whose entire gross income is exempt in terms of section 10, should be disregarded. Capital gains and losses arising from its investment portfolio are therefore exempt.

Life insurer

For a detailed explanation of the taxation of a life insurer and the "four fund principle" see the section on income tax above. The three policyholder funds and the shareholders' fund are deemed to be separate companies for the purposes of the ITA, and are also connected persons in relation to each other.¹ The transfer of any assets between these funds is deemed to be a disposal in the one fund and an acquisition in the other², for CGT purposes.

Untaxed Policyholder Fund

An inclusion rate of 0% is applicable to the net capital gains of such a fund. The capital gains realised in the assets backing annuities and retirement fund obligations, is therefore free from CGT.

¹ Section 29A(10)

² Section 29A(8)

Individual Policyholder Fund

The net capital gain of this fund is included its gross income at a rate of 25%. This is the same rate that applies to natural persons. As explained in the section on income tax, this fund is taxed at a rate of 30%, which is taken to be representative of the average tax rate of policyholders grouped into this fund. The effective tax rate of capital gains is therefore 7.5%. The annual capital gain exclusion of R15,000 applicable to individuals is not available in the IPF.

Company Policyholder Fund

The tax rate applicable to this fund is 29% (the normal company rate) while the CGT inclusion rate is 50% of any capital gain. The effective rate of tax applicable to capital gains in this fund is therefore 14.5%.

Individual

The net capital gain of a natural person, after the deduction of an annual exclusion, is included in his gross income at a rate of 25%. The annual exclusion is currently R15,000. In the year of death this is increased to R120,000.¹

Retirement and withdrawal

A person must disregard any capital gain or loss determined in respect of a disposal that resulted in that person receiving a lump sum benefit from a pension, provident or retirement annuity fund. Any lump sum benefit from a fund, arrangement or instrument situated outside the Republic, which provides similar benefits under similar conditions to an approved pension, provident, or retirement annuity fund is also exempt from CGT.² Retirement, withdrawal or resignation from a retirement fund therefore has no CGT consequences for the member.

Death

When a person dies he is, deemed to have disposed of all his assets to the deceased estate at market value. This means that the deceased is liable for CGT on any unrealised capital gains.³ However, any interest in a pension, provident or retirement annuity fund as well as a fund outside of the Republic, the proceeds of which would have been disregarded in terms of paragraph 54 is excluded from this deemed disposal.⁴ Similar to retirement and withdrawal, retirement benefits received upon death are not subject to CGT.

¹ Paragraph 5 of the Eighth Schedule.

² Paragraph 54 of the Eighth Schedule to the ITA.

³ Paragraph 40 of the Eighth Schedule.

⁴ See paragraph 40(1)(d).

Social security and retirement reform

The “Three Pillars” of a Retirement Funding System

The three “pillars” of the South African retirement funding system can be distinguished as follows.¹

Public benefit programmes

These programs are funded from general government revenue. The purpose of such programmes is to prevent poverty at old age. It involves the redistribution of funds from the rich to the poor. The old age grant fulfils this function in SA. The value of the grant is subject to a means test. This means test has the unfortunate effect that low-income earners that have managed to save for their own retirement might not be entitled to this benefit.² This creates a disincentive amongst low-income earners to provide for their own retirement.

Privately managed funds

This “pillar” comprises the pension and provident arrangements within the private and public sector where membership is compulsory. The current tax regime contains a retirement savings incentive that particularly benefits higher-income individuals. As contributions to pension funds are deductible based on a % of earnings, high-income individuals are subsidised at a much higher marginal rate of tax than low-income individuals. As many of low-income individuals fall below the tax threshold these deductions fail to provide these individuals with an incentive for saving.

Voluntary savings

Self-employed persons are encouraged (through tax deductions) to make provision for their own retirement through contributing to retirement annuity funds. Employees often also supplement their normal pension or provident fund arrangements with contributions to such funds. Another form of voluntary retirement savings is the tax-free transfer of benefits to a preservation fund upon withdrawal from a pension or provident fund instead of taking the lump sum and paying the resulting tax due.

Budget speech

In his 2007 budget speech the Minister of Finance proposed a mandatory, earnings-related social security scheme to provide improved unemployment insurance, disability and death benefits targeted at the income needs of dependants and a standard retirement savings arrangement to be financed by a social security tax administered by SARS. A wage subsidy was also proposed to offset the cost of this tax to low-income earners.

¹ Retirement Fund Reform – a discussion paper, National Treasury 2004.

² Budget speech 2007, Minister of Finance.

National Treasury discussion paper

A second discussion paper regarding social security and retirement reform was issued by National Treasury during February 2007 shortly after the announcement of these reforms in the Minister of Finance's 2007 budget speech.¹

Key proposals

The proposed social security and retirement reforms will see the introduction of a multi-pillar system, consisting of:

- Social assistance grants, funded from general government revenue, with the means test threshold either removed or significantly increased, providing a safety net against poverty in old age, and providing basic support to the disabled, children and care-givers;
- Mandatory participation in a national social security system, up to an agreed earnings threshold, providing basic retirement, unemployment, death and disability benefits. This will aim to close the wide gap that exists between social assistance grants and current private sector provision.
- Additional mandatory participation in private occupational or individual retirement funds, for individuals with earnings above the threshold – ensuring that individuals at all earnings levels make appropriate provision for insurance coverage and income replacement in retirement.
- Supplementary voluntary savings, permitting individuals to choose how they allocate income over their lifetime.

This will be supported by the following reforms:

- A wage subsidy to offset the costs of social security contributions for low-wage employees and to encourage employment creation.
- Administrative reforms to enable SARS to maintain individual contributor records and to ensure efficient and reliable benefits administration.
- Complementary reforms of the governance and regulation of the retirement fund industry, which will continue to provide occupational and individual retirement funding arrangements to supplement the basic social security scheme.
- Reforms to the tax system which will seek to maintain sufficient incentive to provide adequately for retirement, while addressing inequities and complexity in the current system.

Reforms to the tax system

This paper noted that there is effectively no fiscal support for saving and social insurance. The report concluded on the future retirement regime as follows: *“The broad division of roles and responsibilities is clear: the state will continue to provide basic social assistance through the grants system; all South Africans will share in a basic contributory social security system;*

¹ Social Security and Retirement Reform – Second discussion paper, 23 February 2007.

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the private retirement fund sector will continue to provide supplementary retirement funding and risk benefits in a regulated, competitive industry.”

The discussion paper identified three areas where tax legislation would play a role in retirement reform.

Contributions

The paper states that continued fiscal incentives will remain appropriate over and above the basic retirement provision through social assistance and the proposed national security fund. The tax treatment of pension, provident, retirement annuity funds and the proposed national security fund will be consistent. Mandatory contributions towards the national security fund and private funds will be deductible, but limited with a monetary cap. Low-income earners will be supported by the wage subsidy. High-income earners will be given the opportunity to change their existing retirement funding arrangements to offset the additional social security contribution. Fiscal incentives for voluntary contributions in excess of the mandatory contributions noted above will be given, but it will be limited. This means that there will be no tax benefit in for contributions exceeding a certain ceiling. These measures are intended to address the inequity of the current tax regime that favours high-income earners.

Abolition of retirement fund tax

This has already been abolished with effect from 1 March 2007. The paper noted that this would enhance fund values through the removal of the compounding effect of annual taxation on the fund growth.

Taxation of benefits

The paper also raised concerns that the payment of lump sums on retirement defeats the purpose of a retirement fund of producing sufficient income upon retirement. It is, however, recognised that lump sum portions are still necessary in particular circumstances such as paying off mortgages. The paper proposed that a consistent approach should be applied to payment of benefits by pension, provident and retirement annuity funds and that only a modest proportion of the benefit should be allowed in the form of a lump sum. The balance should be used to purchase a conventional annuity, except for benefits below a certain threshold. The intention, it seems, is do to away with the differentiation between pension, provident and retirement annuity fund regarding the proportions these fund can pay out as lump sums. It was also proposed that the tax treatment of benefits should be simplified and that the withholding of tax on lump sum benefits to persons below the tax threshold should be abolished.

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Subsequently, the Taxation Laws Amendment Act, 2007¹ amended the definitions of pension, provident and retirement annuity funds in section 1 of the ITA to allow a full commutation of a benefit of R75,000 or less. In addition, the determination of the tax due on lump benefits on retirement and withdrawal was greatly simplified, while no changes were made to the taxation of withdrawal benefits.

The paper identifies poor withdrawal benefits and the fact that these are paid in lump sums as reasons for the inadequate retirement funding. To address this, compulsory preservation of these benefits are proposed through transfer to the new employer's fund or even to the proposed national social security fund. Note that currently the ITA only provides an incentive for the preservation of such benefits and the individual can still opt to take the entire benefit in cash.

Poor early withdrawal benefits have been addressed by the minimum benefit legislation as well as the "Statement of Intent" signed between the life industry and the Minister of Finance. Note that the benefits payable to pensioners in terms of this agreement is now tax-free.

¹ No. 8 of 2007.