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Legal update 1 of 2022: Taxation Laws Amendment Act No. 20 of 2021

Introduction

The Taxation Laws Amendment Act No. 20 of 2021 (the Amendment Act) was promulgated in Government Gazette No. 45787 on 19 January 2022.

The following changes are relevant for the retirement fund industry:

1. Combination of types of annuities and payment methods on retirement.
2. Transfers of preservation fund members after normal retirement age.
3. Fringe benefits on employer contributions relating to risk benefits.
4. Taxation of annuities where annuitant receives more than one remuneration.

These amendments are discussed in more detail below.

1. Combination of types of annuities and payment methods

Background

From 1 March 2021, annuitisation applies to all retirement funds subject to the protection of the vested benefits of persons who were members of a provident fund on 1 March 2021. Refer to paragraph 1 of Legal Update 3 of 2021 for more information on the annuitisation of provident funds.

The impact of annuitisation is that a member must use at least two-thirds of his non-vested retirement benefit to purchase an annuity. If the total retirement benefit is R247,500 or less, the member may take the full benefit as a lump sum.

The definitions of the different retirement funds in the Income Tax Act state that the annuity to be purchased can be a life annuity or a living annuity. The Income Tax Act, however, does not specify whether the retirement fund should provide the annuity or whether it could be purchased from a registered insurer. It also does not prescribe the number of annuities or the nature or characteristics thereof. This was mainly dealt with in various General Notes that SARS issued over the years.

Methods of providing annuities

GN12 – Retirement from employment, issued on 20 July 1995, confirmed the requirement that an approved fund was not allowed to terminate or relinquish its liability to pay an annuity on a member's retirement from employment. This meant that a fund's rules could not state that if an annuity was purchased from an insurer, the fund would not have any further liability with regards to the provision of that annuity. The fund would therefore have had a continued liability in respect of the retiring member, even though the fund did not directly provide the annuity.

GN 18 (Issue 2) – Providing annuities on retirement from employment, issued on 1 September 2008, allowed a fund to terminate this continued liability where the annuity was purchased from an insurer. The fund's rules had to provide for the purchase of an annuity for a retiring member from a registered insurer and the transfer of the liability to that insurer.

There were certain conditions though. The annuity had to be *compulsory, non-commutable, payable for lifetime of retiring member*. Furthermore, it was not allowed to be *transferred, assigned, reduced, hypothecated or attached by creditors as contemplated by the provisions of sections 37A and 37B of the Pension Funds Act*.

GN18 allowed a retirement fund to provide an annuity via <u>one</u> of the following three methods:

1) paying the annuity directly;
2) purchasing the annuity in the fund's name; or
3) purchasing the annuity in the retiring member's name.

GN18 did not allow for a combination of these three methods.

SARS withdrew GN12 on 26 February 2021 due to it being replaced by GN18 (Issue 2).

SARS also withdrew GN18 on that same day stating that "it became obsolete due to legislative change".

Number and value of annuities

On 19 December 1997, SARS issued *GN19 - Purchase of more than one annuity at retirement*. This allowed a fund to purchase up to four annuities for a retiring member, subject to certain requirements being met and provided that the fund's rules permitted it.

The two most relevant requirements were that one of the annuities had to produce income in excess of the annual equivalent of R150,000 at all times during its existence, and none of the annuities could have a capital value of less than R25,000.

GN 19 was withdrawn on 27 February 2015.

Commutation of life annuities

GN16 - Commutation of small annuities, issued on 31 March 2010, provided for the commutation of an existing life annuity if the original retirement fund benefit from which the annuity was purchased was less than R75,000. This did not apply to a living annuity.

GN16 was withdrawn on 17 February 2021.

The implication of the withdrawal of GN16 is that a member only has one opportunity to commute a pension for a lump sum, and that is on retirement from the fund. The *de minimis* (currently R247,500) applies on that date only, which means that if the member's total retirement benefit is less than R247,500, he can take it as a lump sum. If he however, chooses to use it to purchase a life annuity, he cannot thereafter choose to commute that life annuity and have it paid to him as a lump sum.

Commutation of living annuities

Government Notice 1164, published in Government Gazette No. 31554 on 30 October 2008, allowed an annuitant to take his full living annuity as a lump sum if the value fell below:

- R50,000 if he had already taken a lump sum at retirement, or
- R75,000 if he had not taken any portion of his retirement benefit as a lump sum.

Government Notice 619, published in Government Gazette No. 43380 on 1 June 2020, replaced Government Notice 1164, and provides that if an annuitant's living annuity at any time falls below R125,000, the annuitant may take his full living annuity as a lump sum.

Combination of annuities

On 4 November 2021, SARS issued *Binding General Ruling (Income Tax) 58 - Purchase of Different Types of Annuities at Retirement* (the BGR).

The BGR confirmed the requirement that an annuity must be compulsory, non-commutable, payable for and based on the lifetime of the retiring member or the value of the member's retirement interest, if applicable, and that 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. This is similar to the requirements stated in GN18.

The BGR allows for the same three methods through which annuities can be provided as stated in GN18, ie direct payment by the retirement fund, purchasing the annuity in the fund's name or purchasing it in the member's name. It then goes further by adding that any combination of these three methods can be used, and that more than one annuity of each type is allowed. This means that a member can

purchase more than one annuity and can opt for any one or more of the payment methods.

The effective date of the BGR is 26 February 2021.

Amendment

The Amendment Act amends the definitions of "pension fund", "pension preservation fund", "provident fund", "provident preservation fund" and "retirement annuity fund" in section 1(1) of the Income Tax Act to allow for a combination of annuities (including a combination of methods of paying the annuity) or a combination of types of annuities, on condition that the amount utilised to provide or purchase each annuity must be more than R165,000. There is no limit on the number of annuities that can be purchased. A member can therefore, for example choose a life annuity provided by the retirement fund and a living annuity purchased in his name from a registered insurer.

Effective date

The amendments come into operation on 1 March 2022 and apply in respect of annuities purchased on or after that date.

2. Transfers of preservation fund members after normal retirement

Background

The Taxation Laws Amendment Act No. 17 of 2017 amended the Income Tax Act with effect from 1 March 2018 to allow a member of a pension or provident fund (an occupational fund) to transfer his benefit in that fund on or after normal retirement age but before retirement date (referred to as his post-retirement benefit) to a retirement annuity fund from which he can then access it at a later date. The normal retirement age for a member of an occupational fund is the date on which the member becomes entitled to retire from employment other than due to medical disability.

The Taxation Laws Amendment Act No. 23 of 2018 in turn entitled a member of an occupational fund to transfer his post-retirement benefit to a preservation fund with effect from 1 March 2019. Such a member will not be entitled to the one pre-retirement withdrawal option that is available to a member who transferred his withdrawal benefit to the preservation fund.

A member of a preservation fund was, however, not allowed to transfer his post-retirement benefit to either a retirement annuity fund or another preservation fund.

The normal retirement age for a member of a preservation fund is 55.

The effect of this was that if a member of a preservation fund were to transfer his post-retirement benefit in the preservation fund to another fund, the transfer benefit would be taxed.

Amendment

The Amendment Act amends the definitions of "pension preservation fund" and "provident preservation fund" in section 1(1) of the Income Tax Act, and paragraph 6A of the Second Schedule to the Income Tax Act, to allow a member of a preservation fund to transfer his post-retirement benefit to another preservation fund or a retirement annuity fund, without triggering any tax.

Note

Legislation still does not allow for a tax-free transfer of a post-retirement benefit between retirement annuity funds or from a preservation fund to an occupational fund. With regards to the latter, National Treasury has stated the following in its Draft Response Document on the Bill issued on 10 November 2021:

> *The concern with allowing transfers between occupational funds (be they transfers between same employer occupational funds or transfers between different employer occupational funds) is that the transferor and transferee retirement funds may have different rules with regards to their respective normal retirement ages. A member may therefore be able to access retirement benefits that were not available in the retirement fund transferred from.*

Effective date

The amendments come into operation on 1 March 2022 and apply in respect of years of assessment commencing on or after that date.

3. Fringe benefits on employer contributions relating to risk benefits

Background

The Taxation Laws Amendment Act No. 25 of 2015 brought about the taxation of all employer contributions to retirement funds as fringe benefits in the hands of the member, with effect from 1 March 2016.

A pension or provident fund can either be a defined benefit or a defined contribution fund. In a defined benefit fund, the retirement benefit is calculated by using a formula. This usually takes into account the member's final salary, his years of completed service, and a factor determined by the fund's actuary. In a defined contribution fund, the retirement benefit is based on the total contributions and transfer amounts received by the fund.

In a defined benefit fund, the contributions are classified as a "defined benefit component" as defined in paragraph 12D(1) of the Seventh Schedule to the Income Tax Act and the value of the fringe benefit must be determined by using the formula set out in paragraph 12D(3) of that Schedule. To enable the employer to determine the value of its contribution to be included as a fringe benefit for its employees, the fund must issue a contribution certificate to the employer.

In a defined contribution fund, the contributions are classified as a "defined contribution component" as defined in paragraph 12D(1) and the value of the fringe benefit is equal to the employer contribution. No contribution certificate is required.

Paragraph (b) of the definition of "defined contribution component" in paragraph 12D(1) includes risk benefits that are provided via an insurance policy, ie reinsured risk benefits. This means that as long as the fund provides reinsured risk benefits, contributions to that fund will be classified as a "defined contribution component". However, since *only* reinsured benefits are included under the definition of "defined contribution component", it means that if the risk benefits are *not* reinsured, eg self-insured, all the contributions to the fund will be classified as a "defined benefit component". The value of the fringe benefit will then have to be calculated in accordance with the formula in paragraph 12D(3) and the fund will have to issue a contribution certificate to the employer.

Amendment

To address this anomaly, the Amendment Act amends paragraph (b) of the definition of "defined contribution component" in paragraph 12D(1) of the Seventh Schedule to the Income Tax Act to include risk benefits provided by means other than a policy of insurance. This will ensure that the contributions to a defined contribution fund will be classified as a "defined contribution component" irrespective of whether the risk benefits are reinsured or self-insured. The value of the fringe benefit will then be equal to the employer contribution.

Effective date

The amendment comes into operation on 1 March 2022 and applies in respect of years of assessment commencing on or after that date.

4. Taxation of annuities where annuitant receives more than one remuneration

Background

The Taxation Laws Amendment Act No. 34 of 2019 amended paragraph 2 of the Fourth Schedule to the Income Tax Act to provide that a retirement fund or an insurer who pays an annuity to an annuitant who receives remuneration from more than one employer, must disregard the tax rebates referred to in section 6 of the Income Tax Act to determine how much tax it must withhold if SARS issues a tax directive to that effect. 'Employer' in this context includes a retirement fund or an insurer. Paragraph 1 of Legal Update 3 of 2020 gives more information about this.

The Taxation Laws Amendment Act No. 23 of 2020 postponed the initial effective date of 1 March 2021 to 1 March 2022.

Amendment

Instead of referring to the fund or insurer having to disregard the section 6 tax rebates if SARS issued a tax

directive to that effect, the Amendment Act now states that the retirement fund or insurer that pays an annuity to an annuitant who receives remuneration from more than one employer must apply the fixed tax rate that SARS directs must be used.

SARS has undertaken to provide these directives to employers by early February of each year.

On 18 January 2022, SARS published a letter to be sent to annuitants which explains the situation where they are in receipt of more than one source of income. It points out that these incomes are combined at the end of the tax year to determine the correct amount of tax that the annuitant must pay. The combined income places the annuitant in a higher tax bracket. However, each income payer only deducts PAYE on the income that they pay during the year, which leads to an under-recovery of tax during the year and results in the annuitant then having to pay in the shortfall at the end of the tax year. From 1 March 2022, SARS will use the latest data available to them, which will be based on the annuitant's tax assessment of the previous tax year, to determine a more accurate PAYE deduction during the year. SARS will provide the PAYE deduction percentage to the fund administrator or insurer, who must then use that rate to deduct PAYE from the annuity. This rate will be valid for the whole tax year. The fund administrator or insurer can go back to applying the normal PAYE deduction rate with effect from the month in which it becomes aware of a change in an annuitant's circumstances that influences the annuitant's year-end tax liability. An annuitant may still ask the fund administrator or insurer to deduct tax at a rate higher than the rate provided by SARS. The annuitant may also ask the fund administrator or insurer to deduct tax at the normal PAYE deduction rate, and not the one provided by SARS, but should then expect to have to pay in at the end of the tax year.

Effective date

The amendment comes into operation on 1 March 2022.

Hettie Joubert
Head: Wealth & Retirement Fund Legal

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