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Legal update 3 of 2020: Taxation Laws Amendment Act No. 34 of 2019

Introduction

The Taxation Laws Amendment Act No. 34 of 2019 (the Amendment Act) was promulgated in Government Gazette No. 42951 on 15 January 2020.

The following changes are relevant for the retirement fund industry:

- Surviving spouse pensions
- Bulk payments to former members of closed retirement funds
- Provident and provident preservation fund annuity exemptions
- Alignment of tax-neutral transfers between retirement funds with the effective date of all retirement reforms
- Transfer of withdrawal interest from provident to pension funds
- Non-deductible contributions and estate duty avoidance

These amendments are discussed in more detail below

1. Surviving spouse pensions

Background: Active members of retirement funds may deduct their contributions from their taxable income.

When the member passes away, the lump sum death benefit payable by the fund will be taxed on the retirement table and the monthly pension (if applicable) paid by the fund or the insurer will be taxable in the hands of the recipient at the recipient's marginal tax rate. The higher the taxable income, the higher the tax rate.

Where the retirement fund pays a pension to a surviving spouse, the fund must deduct tax at the applicable rate and pay it over to Sars, after taking into account the rebates, as specified in section 6 of the Income Tax Act. These rebates are currently as follows:

- Primary rebate = R14 958
- Secondary rebate: 65 or older = R8 199
- Tertiary rebate: 75 or older = R2 736

If the surviving spouse also receives a salary, his/her employer will determine the tax payable on his/her salary, taking into account the rebates, as specified in section 6 of the Income Tax Act, and pay it to Sars.

The section 6 rebates may only be applied once, by either the fund or the employer. If both the fund and the employer apply the section 6 deductions, it might result in less tax being deducted during the year. In addition, if the surviving

spouse also has other sources of taxable income, which, if added to the pension/annuity would push his/her taxable income into a higher tax bracket, it might result in the surviving spouse having to pay in underpaid tax at the end of the year when he/she files his/her tax return. More often than not, the surviving spouse would not have budgeted for this additional tax liability, resulting in financial hardship.

This is not limited only to surviving spouses; it applies to any taxpayer who receives an income from a retirement fund or an insurer and who also has other sources of taxable income.

Amendment: Paragraph 2 of the Fourth Schedule to the Income Tax Act has been expanded to include more than just spouse's pensions and amended to provide that a retirement fund or an insurer who pays a pension/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 he/she must withhold if Sars issues a tax directive to that effect. 'Employer' in this context includes a retirement fund or an insurer.

The effect of this is that the fund and/or the insurer must first request a tax directive from Sars every year for each person it pays a pension/annuity to. Sars will then issue a directive indicating whether the fund/insurer should apply the section 6 rebates or not.

Effective date: Following comments that the amendment will result in system changes being made on administrators' and Sars' side, the implementation date of this change has been postponed to 1 March 2021. Industry bodies are, however, still concerned about the changes being extremely administratively onerous, requiring annuity providers to apply for a tax directive on all annuities (including voluntary purchase annuities) every year before applying any rebates.

Note: There is already a provision in the Income Tax Act that can be used to avoid an underpayment of tax upon assessment. Pensioners/annuitants can request an insurer to withhold more tax on a source of income under paragraph 2(1)(2) of the Fourth Schedule.

Although the explanatory memorandum on the Taxation Laws Amendment Bill, 2019 initially limited the scope of paragraph 2B to surviving spouses only, the Amendment Act now includes any annuitant/pensioner.

Annuity providers will have to submit the required information to Sars and once they receive Sars' response, split the annuitants into two categories, which are those on which the rebates must be applied and those on which it must not be applied. The providers will then also have to explain to the annuitants on whose annuities the rebates will not be applied and what the reason is for the tax being higher and the net annuity lower.

Another issue raised by the industry is that the amendment does not apply to GN18 annuities, as it refers to "a person that is a pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund or a person that pays an annuity amount as defined in section 10A(1)". This does not include an annuity purchased by a retirement fund from an insurer.

Industry bodies are engaging with National Treasury about the practicalities of this amendment. National Treasury is insistent that the under-deduction of PAYE has led to assessment liabilities, mainly because rebates are applied more than once in the PAYE calculations, while it is only allowed once on assessment. There was a request from National Treasury that the industry educates annuitants on the implication of the under-deduction of tax during the year, negatively impacting on the taxpayer upon assessment, and its ability to request the deduction of more tax under paragraph 2(1)(2) of the Fourth Schedule.

National Treasury has agreed to form a joint task team between Sars and industry representatives to look at the implementation of processes and procedures leading to rebates being removed in the calculation of PAYE by one or more annuity/pension providers for taxpayers that either have annuities/pensions with more than one provider (based on Sars directives), or have a pension/annuity and receive salary payments. The task team will also consider the possibility of allowing a taxpayer to object to a directive issued under the amendment.

The industry has asked National Treasury to consider:

- that Sars issues a tax directive (or an equivalent of an agent appointment/AA88) to administrators only for those taxpayers that would be affected by an

under-deduction on assessment,
- changing the legislation to make it clear that it applies to all annuities /pensions, and
- reflecting the outcome of the discussions of the task team in legislation.

Further feedback regarding this is still awaited.

2. Bulk payments to former members of closed retirement funds

Background: Section 49 of the Taxation Laws Amendment Act No. 8 of 2007 introduced paragraph 2C of the Second Schedule to the Income Tax Act. This paragraph allows the Minister of Finance to prescribe certain events which would result in a lump sum benefit not being included in a former member's gross income and accordingly being free of tax.

On 11 March 2009, the finance minister prescribed the following three events in Government Gazette No. 32005 under Notice 289 as falling under paragraph 2C:

'any amount received by or accrued to a person from a pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund in consequence of a payment to such fund by the administrator of such fund as a result of income received by the administrator prior to 1 January 2008 that was not disclosed to such funds;

(a) any amount received by or accrued to a person from a pension fund or provident fund contemplated in paragraph (a) or (b) of the definition of "pension fund" in section 1 of the Income Tax Act, 1962 to the extent that that amount is similar to a payment in terms of a surplus apportionment scheme contemplated in section 15 B of the Pension Funds Act, 1956 (Act No. 24 of 1956);

(b) any amount received by or accrued to a person from a pension preservation fund or provident preservation fund to the extent that it was paid or transferred to such a fund–

i. as an unclaimed benefit contemplated in paragraph (c) of the definition of "unclaimed benefit" in section 1 of the Pension Funds Act; or

ii. as a result of or in consequence of an event contemplated in paragraph (a)...

These events can broadly be classified as:
- secret profits;
- surplus, and
- preservation fund unclaimed benefits and secret profits,

payable by retirement funds.

Some of the retirement funds from which these payments were to be made have already made the payments to their administrators and were then subsequently deregistered, even before 11 March 2009. These amounts were not paid to the intended recipients and were instead held by those administrators. There was no mechanism to enable tax-free payments similar to those applying to active retirement funds for these amounts.

Amendment: Paragraph 2D was added to the Second Schedule to the Income Tax Act. It allows administrators, who hold benefits on behalf of deregistered retirement funds to pay these benefits to the intended former members or their beneficiaries tax free, where it relates to events prescribed by the Minister of Finance in the Government Gazette.

Effective date: The effective date of this amendment will be published in the Government Gazette.

3. Provident and provident preservation fund annuity exemptions

Background: From 1 March 2014, members of a pension fund, pension preservation fund or retirement annuity fund was allowed an exemption for contributions to these funds, which did not qualify for a deduction under the current section 11F (previously sections 11(k) and 11(n)) or paragraph 5(1)(a) or 6(1)(b)(i) of the Second Schedule to the Income Tax Act. The effect of this is that where such a member's total contributions to these funds were more than the allowable deductions applying on their lump sum retirement benefits, it could be carried forward to their compulsory annuities.

This exemption did not apply to provident fund and provident preservation fund members. The members of these funds were not obliged to annuitise on retirement (ie they were not forced to use part of their retirement benefit to buy an annuity); they were allowed to take their full retirement benefit as a lump sum. Their contributions also did not qualify for a tax deduction. This, however,

changed from 1 March 2016, when the first leg of retirement reform was implemented and contributions to all retirement funds qualified for a tax deduction, subject to the prescribed maximums. Rolled over/excess contributions that did not previously qualify as a deduction upon retirement under paragraph 5(1)(a) of the Second Schedule to the Income Tax Act, did not qualify as an exemption when the members decided to take a part of their retirement benefit as an annuity. Members who did not get all their excess contributions deducted under paragraph 5(1)(a) would therefore lose these deductions, unless they choose a higher lump-sum retirement benefit.

Amendment: Paragraph 10C of the Income Tax Act was amended to allow the exemption for members of provident funds and provident preservation funds. The words "compulsory annuities" have been replaced with "qualifying annuities" to reflect that currently, annuitisation in a provident fund and a provident preservation fund is voluntary, as opposed to compulsory. Furthermore, members of a provident fund or provident preservation fund are not obliged to use at least two thirds of their retirement benefit to buy an annuity. That restriction will only be applicable once annuitisation becomes effective, which is currently set for 1 March 2021.

Effective date: The ability to deduct any non-deductible contributions made to a provident fund in determining the taxable annuity received from such fund will apply in relation to annuities received on or after 1 March 2020.

4. Alignment of tax-neutral transfers between retirement funds with the effective date of all retirement reforms

Background: The Taxation Laws Amendment Act No. 31 of 2013 published in Government Gazette No. 37158 on 12 December 2013 changed the tax treatment of contributions and aligned the annuitisation requirements between pension, provident and retirement annuity funds with effect from 1 March 2015. The first leg of these changes, being 'the uniform tax treatment of contributions, was postponed under the Taxation Laws Amendment Act No. 25 of 2015 published in Government Gazette No. 39588 on 8 January 2016 and became effective on 1 March 2016. The second leg, being 'the alignment of the annuitisation requirements between retirement funds' has been postponed on three more occasions to 1 March 2018, 1 March 2019 and 1 March 2021.
In the Taxation Laws Amendment Act No. 23 of 2018, published in Government Gazette No. 42172 on 17 January 2019, the effective date of paragraph 6(1)(a) of the Second Schedule to the Income Tax Act was not changed to align with the last postponement of the annuitisation alignment. This resulted in tax-neutral transfers from pension funds to provident or provident preservation funds with effect from 1 March 2019, which is not in line with the normal rule of allowing tax-free transfers from a more restrictive retirement fund to a less restrictive fund. Only once the annuitisation requirements of all retirement funds have been implemented would a transfer from a pension fund to a provident fund or a provident preservation fund be tax-neutral.

Amendment: Paragraph 6(1)(a) of the Second Schedule to the Income Tax Act was amended to make it clear that only the following fund transfers will be tax free:

From	To
Pension fund	Pension
	Pension preservation
	Retirement annuity
Pension preservation	Pension
	Pension preservation
	Retirement annuity
Provident	Pension
	Pension preservation
	Provident
	Provident preservation
	Retirement annuity
Provident preservation	Pension
	Pension preservation
	Provident
	Provident preservation
	Retirement annuity
Retirement annuity	Retirement annuity

Effective date: 1 March 2019.

Note: This amendment relates to an oversight. Although the legislation technically allowed for a transfer from a pension fund to a provident fund or a provident preservation fund to be tax free, Sars treated it as a taxable transfer, in line with the policy that only a transfer from a less restrictive to a more restrictive fund would be tax free.

5. Transfer of withdrawal interest from provident fund to pension fund

Background: Employers often participate in pension and provident funds. In some instances, certain categories of employees are members of the pension fund, while other categories are members of the provident fund.

Employees often also have a choice about which fund they want to become members of. When members who chose to join the provident fund reach retirement and decide to purchase an annuity, they often find that there is no better annuity than the in-fund annuity offered by the pension fund. Members who chose to join both the pension and the provident fund, may also want to consolidate their retirement benefits to purchase one annuity, being the one offered by the pension fund.

Amendment: Paragraph (b)(ii) of the definition of 'provident fund' in section 1 of the Income Tax Act has been amended to allow members to transfer their withdrawal interests from the provident fund in which their employer participates to the pension fund of that same employer. The definition of 'withdrawal interest' has also been amended to refer to the *'value of the member's share of the fund value on the date on which the member elects to withdraw due to an event other than the member attaining normal retirement age'*. This allows members to transfer from the provident fund in which their employer participates to the pension fund of the same employer at any stage. This is not in line with the initial Explanatory Memorandum, which referred to a transfer immediately before retirement.

Effective date: The amendment is deemed to have come into operation on 1 March 2019.

6. Non-deductible contributions and estate duty avoidance

Background: The amendment to the Estate Duty Act by the Revenue Laws Amendment Act, No. 60 of 2008 to exclude retirement fund death benefits from the property that constitutes a deceased member's estate and consequently from estate duty presented an opportunity for using retirement annuity funds to avoid estate duty.

Any contributions that did not previously qualify for a tax deduction qualified as a tax deduction against the lump-sum benefit, which became payable upon the member's death under paragraph 5 of the Second Schedule to the Income Tax Act. The balance of the benefit was subject to the retirement tax table. Members on their death beds could contribute a large capital amount to a retirement annuity fund. If they then passed away shortly afterwards, this total capital amount could be deducted from their retirement annuity fund benefit. If the balance to be taxed was less than R500 000, the total benefit from the retirement annuity fund would be tax free. The capital, which would otherwise have been subject to estate duty if it fell into their deceased estates, would then effectively become tax free.

The Taxation Laws Amendment Act No. 25 of 2015 closed this loophole. Section 3(2) of the Estate Duty Act was changed by inserting a new paragraph (bA), which provided that so much of the contributions made to a retirement fund that did not qualify for a tax deduction under sections 11(k), 11(n) or 11F of the Income Tax Act would be included in the property that constituted a deceased member's estate. Contributions made to a retirement fund after 1 March 2015 by a member who died after 1 January 2016 and which did not qualify as a tax deduction, still qualified for a tax deduction under paragraph 5 of the Second Schedule to the Income Tax Act. Under the amendment it would, however, have to be included under 'property', as stipulated in section 3 of the Estate Duty Act, which meant that it would be subject to estate duty.

The Explanatory Memorandum to the Taxation Laws Amendment Act No. 34 of 2019 states that *'section 3(2)(bA) erroneously includes not only excess contributions in terms of sections 11(k), 11(n) or 11F, but also amounts which are not*

taken into consideration in terms of the Second Schedule of the Income Tax Act'.

Amendment: To close this loophole, section 3(2)(bA) of the Estate Duty Act was amended retrospectively to not refer to contributions not allowed as deductions under section 11(k), 11(n) or 11F of the Income Tax Act, but instead to contributions allowed as '*a deduction in terms of paragraph 5 of the Second Schedule to the Income Tax Act, 1962 (Act No. 58 of 1962), to determine the taxable portion of the lump sum benefit that is deemed to have accrued to the deceased immediately prior to his or her death'.*

When members die, their benefits are deemed to have accrued to them as lump sums immediately before their death. The effect of the amendment is that all the contributions that did not previously qualify as deductions (ie during the deceased members' lifetime) and that will now be allowed under paragraph 5 will be included as property in their estates and will accordingly be subject to estate duty.

Effective date: The amendment is deemed to have come into operation on 30 October 2019 and applies in respect of the estate of a person who dies on or after that date, and any contributions made on or after 1 March 2016.

The effect of the amendment is illustrated in the following example:

Peter contributed R2 million to a retirement annuity fund on 28 February 2018.
He claimed the following deductions under section 11F:

- *February 2018: R45 000*
- *February 2019: R60 000.*

He died on 13 October 2019 and the retirement fund lump sum death benefit of R2.8 million is paid to his estate.

The inclusion for estate duty purposes is
R2 000 000 – (R45 000 + R60 000)
= R2 000 000 – R102 000
= R1 898 000
The paragraph 5 deduction of R1 898 000 is treated as property in Peter's estate in terms of section 3(2)(bA).
An amount of R2 800 000 less R1 898 000 (R902 000) is deemed to accrue as a lump sum benefit before Peter's death and is taxed on the lump sum retirement benefit table.

Hettie Joubert
Head: Wealth & Retirement Fund Legal

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