LEVERAGE

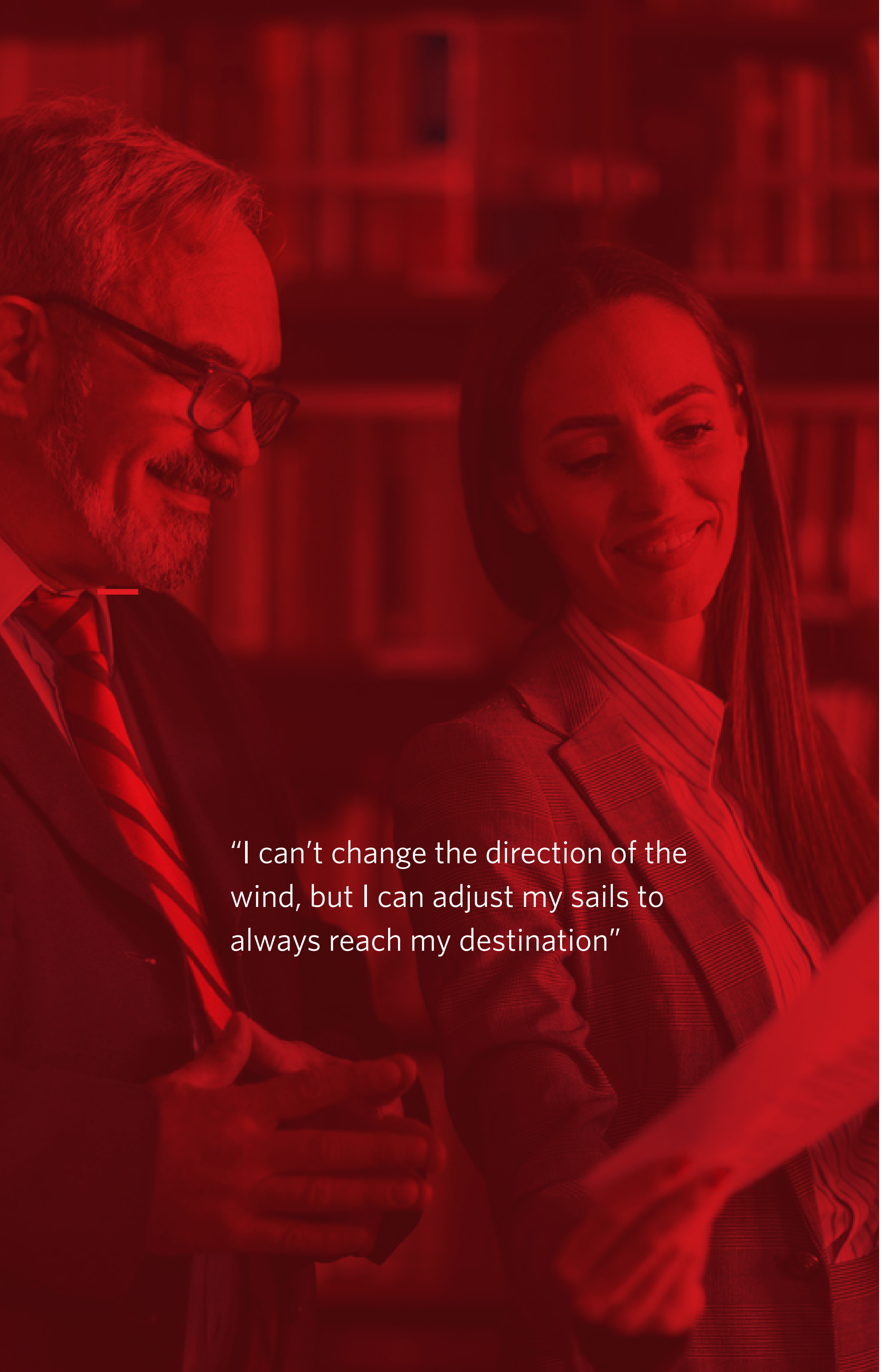
Legal and technical update: April 2018

Note from the editor

Sharon Hamman (née Teubes), Senior Legal Adviser: Advice and Wealth Management

I am sure most consumers wish that the value-added tax (VAT) increase and fuel levies were nasty April Fool's jokes, but alas, they were not and the spending power of the public will once again shrink. In this issue of *Leverage*, Sanusha Naidoo gives us a glimpse of her day to day interaction and again highlights the value that a legal adviser can add when working alongside a financial adviser in their practice. Annemie Nieman reminds us why a retirement annuity (RA) should not be thrown away as an investment option when looking at it from an estate planning point of view. Tying up the retirement theme, Arthie Kander highlights the rules applicable when a member of a retirement fund dies.

Happy reading!



A day in the life of a legal adviser

By Sanusha Naidoo, Legal Adviser: Financial Planning, KZN

In my experience, most clients demonstrate a genuine desire to create sustainable wealth and a wish to pay attention to the factors that influence sustainable wealth creation. This has been evident through the questions that I have received since the Budget speech which focused on some of the proposed changes:

- Value-added tax (VAT) increased from 14% to 15% from 1 April 2018. This will result in an increase in executors' fees from 3.99% to 4.025% (3.5% plus VAT at 15%). It will also result in the increase of general costs associated with estates; for example, fees charged by attorneys, valuators and accountants and an overall increase of costs and expenses on policies, bank charges, etc. The client's estate liquidity calculation must be reviewed to ensure that there is sufficient liquidity in the estate.

- Estate duty increased from 20% to 25% for estates valued at R30 million and above from 1 March 2018. To prevent donations from being used to circumvent the above changes, donations tax rates have been amended to be in line with the above. Estate duty as an expense must be revisited for estates larger than R30 million as the liquidity need will change. Remember to review joint estates where the parties are leaving their estates to the survivor and the joint estate will be in excess of R30 million. It might be a good time to review 'last survivor policies' for these clients. In addition, the use of a trust as an estate planning tool may also become more viable for these clients.

Jimmy Dean has been quoted as saying, "I can't change the direction of the wind, but I can adjust my sails to always reach my destination". For us, this means that whilst we are unable to influence the changes around us, we can work together to ensure that our joint experience and expertise is at the disposal of the client. Together, we will contribute to the financial wellness of the client.

Legislation:

Twin Peaks and the Financial Sector Regulation Act

By Denzil Ohlson, Legal Adviser: Financial Planning

Perhaps you have heard about the implementation of the new Twin Peaks model of financial regulation for SA in the news or at various seminars and conferences? Perhaps you are not quite sure what it is all about? Well, we can clarify that it has nothing to do with the relaunch last year of the popular 1990s American television series of the same name; rather, it deals with the way in which our financial services industry will be governed and regulated in future.

The global financial crisis of 2008 taught the world many painful lessons, one of which was that the legal financial regulatory frameworks and systems of countries worldwide needed to be reviewed and bolstered to ensure that they are better protected. It is a global imperative that events similar to the financial crisis do not occur again. Further, should it occur again, the impact of such an event on an individual, national and global level should not be as severe.

SA as a member of the G20 and BRICS association (that is, Brazil, Russia, India, China and South Africa) undertook to take on the challenge of reviewing and strengthening the legal and regulatory framework of its financial systems which essentially rest on two pillars or two peaks so to speak:

1. How the financial services industry behaves in its day to day dealings with clients, customers or consumers.
2. Whether or not the SA financial system is stable and resilient? Put another way, should an unfortunate event occur, is sufficient provision available to be able to manage the financial risk or impact of the event?

The SA financial services regulatory framework has undergone an extensive analysis and inspection to ensure that the industry's behaviour is appropriate in dealing with customers. Thus, it was decided that it would be important for a new and appropriate regulator to be created to drive the appropriate conduct. With the introduction of the Financial Sector Regulation Act of 2017 (which was passed into law on 21 August 2017), the Financial Services Board (FSB) which previously held this role will essentially evolve into the Financial Sector Conduct Authority (FSCA) which will have a focused approach to ensure the fair treatment of customers through licensing, product design, distribution, complaints resolution, information disclosure, the provision of financial education and the enforcement of matters relating to the market conduct of the financial services industry.

The Prudential Authority (PA)'s objective will be to promote and enhance the safety and soundness of regulated financial institutions with the purpose of ensuring financial stability. The PA will be independent of the FSCA and housed within the structures of the South African Reserve Bank (SARB). Thus, the PA together with the FSCA, will form the Twin Peaks of the SA financial sector regulation. Together with the Financial Intelligence Centre (FIC) and the National Credit Regulator (NCR), the Twin Peaks will now and in future endeavour to ensure a safer financial services sector for SA.

Financial planning

The use of retirement annuities (RAs) for estate planning purposes

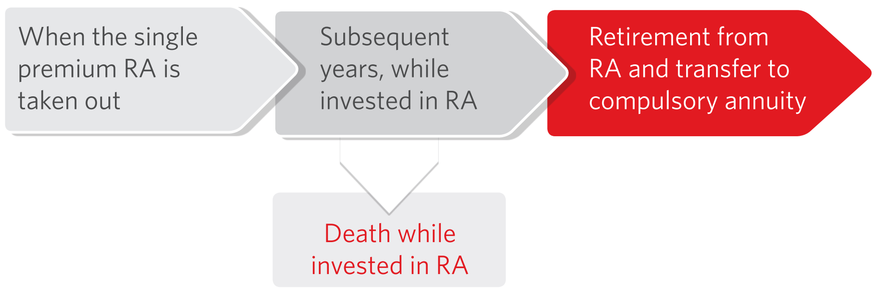
By Annemie Nieman, Legal Adviser: Financial Planning

Prior to March 2015, making large lump sum contributions to retirement annuities (RAs) was a popular estate planning tool used by clients to immediately reduce their dutiable estates due to the exclusion of retirement funds from the dutiable estate.

This changed in March 2015 when loopholes were closed to result in the disallowed contributions remaining on date of death to be included in the deceased estate as property (only contributions made after the effective date) for estate duty purposes. It meant that making large lump sum contributions to retirement funds were no longer effective to immediately reduce a taxpayer's dutiable estate and quickly fell out of favour.

But should it have? If we consider the long-term impact of making disallowed contributions to retirement funds, we might find that it still is a great estate planning tool. Any disallowed contributions, irrespective of the types of retirement funds the contributions were made to, will hold the benefits discussed below.

To determine whether making large disallowed contributions is an effective estate planning tool for a client, it is important to understand the various 'rules' and implications of RAs during its different stages. These stages are as follows.



When the retirement annuity (RA) is taken out

When the contribution is made, the client becomes a member of the fund and the restrictions imposed by the Pension Funds Act will apply to the RA. The RA cannot be accessed before age 55 and the RA does not form part of the client's estate for estate duty purposes.

The client qualifies for a tax deduction in the year in which the RA contribution is made. The amount of the tax deduction is limited to the lesser of:

- R350 000,
- 27.5% of the higher of taxable income or remuneration, or
- Taxable income (without taking taxable capital gains into account).

For the purposes of this article we assume a tax deduction equal to R350 000.

The portion of the contribution that is not deductible (because it exceeds the allowable deduction) is referred to as the non-deductible contribution or disallowed contribution. If we assume a R4 million lump sum contribution, the disallowed contribution will be R3 650 000.

Subsequent years of investment in the retirement annuity (RA)

All returns within the RA are tax exempt. Therefore, the RA can 'grow' faster than other investments where the returns are subject to tax. In addition, the disallowed contribution of the previous year is deemed a contribution in the current year and can be claimed during that following tax year, even if no further contributions were actually made.

Continued on next page

Continued from previous page

If we assume that the client qualifies for a R350 000 deduction every year, the disallowed contribution will ensure a tax deduction for the following 10 years, even if no further contribution is made.

Whilst invested in the RA, the underlying investments must comply with the requirements of Regulation 28 of the Pension Funds Act (PFA), which limits the exposure to certain asset classes in an attempt to manage the investment risk.

Death while invested in the retirement annuity (RA)

The freedom of the client (the member) to appoint beneficiaries is limited by Section 37C of the PFA (discussed in greater detail in *Fiduciary Corner*). The PFA gives the trustees the discretion to determine where the benefits should go.

Once the trustees have decided which amounts to award to the beneficiaries, the beneficiaries have the following options insofar as their benefits are concerned:

- Transfer the entire benefit to a compulsory annuity for themselves; or
- Take a portion of the benefit in cash and transfer the balance to a compulsory annuity, or
- Take the entire benefit in cash.

Income tax implications

If the beneficiaries take a cash amount, the value equal to the disallowed contribution still remaining at death will be tax-free. The surplus is taxed "in the deceased's hands" using the table below (the previous lump sums taken by the deceased will be aggregated when determining the tax payable).

Any amounts transferred to compulsory annuities are transferred tax-free. The beneficiaries will pay income tax on the income that they receive from the compulsory annuities and they will not be able to offset the remaining disallowed contributions made by the deceased against their annuity income. It can only be set off against lump sum cash amounts.

Retirement lump sum tax table (taxable lump sum)	Tax
R0 – R500 000	R0
R500 001 – R700 000	18% on the amount above R500 000
R700 001 – R1 050 000	R36 000 + 27% on the amount above R700 000
R1 050 000 +	R130 500 + 36% on the amount above R1 050 000

Estate duty implications

The RA is excluded from the deceased's estate and is not subject to estate duty. However, the value of the disallowed contributions at the time of death is included. The difference between the value of the deceased's RA and the value of any remaining disallowed contribution results in a potential estate duty saving, which would not have been enjoyed had the RA contribution not been made.

Retirement from RA and transfer to living annuity

At retirement from the RA, the member can withdraw up to a third in cash. At least two thirds of the RA must be used to provide compulsory annuity income.

If the taxpayer elects to take a lump sum, the disallowed contribution remaining at that point can be 'set-off' against the amount taken in cash when determining the taxable lump sum. The same tax table is applied to that taxable lump sum.

If no lump sum is taken or if the disallowed contributions exceeded the lump sum taken, the balance of the disallowed contributions will provide for an exemption against any income from the compulsory annuity. If the income is R500 000 per annum and the disallowed contributions remaining is equal to R1 000 000, it will result in the income being totally exempt from income tax for the following two years.

Conclusion

If clients are comfortable with the various restrictions applicable to retirement funds, making contributions in excess of what would qualify for tax deduction each year, still makes for a useful estate planning tool. As a matter of fact, the benefits and estate duty savings increase over time. Therefore, it is still an option well worth exploring.

Fiduciary Corner

Section 37C of the Pension Funds Act and the treatment of conflicting nominations

By Arthie Kander, Fiduciary Specialist

Fund members commonly misunderstand the process which is followed to award the death benefits in a retirement fund and it can have far reaching consequences when planning for heirs. Dependants or beneficiaries often do not understand the process which can cause frustration.

It becomes more cumbersome where the beneficiary nomination and the provisions of Section 37C are in conflict with each other. The section provides that benefits payable on the death of a member shall be dealt with by the board of trustees of that particular fund in terms of the legislation. The trustees will determine the manner in which the member's death benefit should be distributed between the legal dependants and nominated non-dependant beneficiaries

The 'general rule' regarding the disposition of benefits payable on the death of a member of a retirement fund in terms of Section 37C is that the trustees must distribute the member's death benefit between the dependants which the trustees became aware of within a period of 12 months after the date of the death of a member. Only if no dependants are found during that twelve-month period, will the trustees award the benefit to the non-dependant nominated beneficiary or beneficiaries.

The Pension Funds Act defines a 'dependant' to include a spouse of the deceased member, a child (no matter the age of that child and including an adopted, illegitimate and a posthumous child), a person that is financially dependent on the deceased member or someone who would have become legally dependent on the member if the member did not die.

The application of this section proves to go against the idea that freedom of testation takes precedence above all else. Many court cases have been heard on this matter and the outcome is generally unanimous in that the main objective behind this piece of legislation is to ensure that the persons that are dependent on the deceased will not be left without support after death. So in short, Section 37C exits to protect dependency over the wishes of the deceased.

Another common misunderstanding is that parties nominated as a beneficiary on the retirement fund nomination form has a right to claim from the fund upon the death of a member. A nomination form is regarded by the trustees as a guideline that assists the trustees when identifying persons that would potentially qualify as dependants.

In the case of *Berge v Alexander Forbes Retirement Fund (Pension Section) and Another* an application was brought by the only biological relative of the deceased. The member was unhappily married to his third wife, at time of his death. The member left his wife out of his will and bequeathed his entire estate equally between the applicant and his stepdaughter. However, the trustees distributed the death benefit as follows: 82% to his third wife, 10% to the applicant and 8% to his stepdaughter. The court had to determine whether grounds existed to interfere with the decision. The judge held that the board of trustees had a broad discretion in terms of the Act. The judge was satisfied that the objects and social purpose of the section were considered and factors such as the fact that the third wife was a legal dependant of the deceased and that she did not inherit from the deceased estate, as the applicant did. The applicant was also, unlike the third wife, younger, employed and earning a relatively good salary. The court found that the trustees exercised their discretion lawfully, rationally and reasonably; thus, would make it unwarranted for the court to interfere with the exercise of their discretion. The application was dismissed with costs.

In conclusion, the purpose of this legislation is to benefit the deceased member's dependants and promote social protection. This legislation serves to ensure that dependants are looked after in circumstances where they would not otherwise have been. Members of funds are cautioned to view the result of this section seriously and pursue estate planning measures to achieve the desired intent.

About Leverage

Momentum Leverage is prepared by the Momentum Legal Advisers: Financial Planning and Fiduciary Specialists from Momentum Fiduciary Services. For financial advisers, please contact your legal adviser or fiduciary specialist should you have any questions. For clients, please contact your financial adviser should you have any questions.