

ASAP

Legal and Technical Update

Divorce and retirement fund

The Divorce Order

The legislation

The Divorce Act was amended in 1989 to make provision for the division of “pension interest” between parties of a divorce (excluding those married out of community of property without the accrual). At that time, the non-member spouse had to wait until the pension benefit accrued to the member, before he/she could get their share (no growth accrued on that amount).

The “clean break” was introduced in the Pension Fund Act through the amendment of Section 37D(1)(d) (effective 13 September 2007) to allow a retirement fund to deduct from the member’s benefit or minimum individual reserve:

- any amount assigned to a non-member spouse in terms of a divorce order granted under the Divorce Act, and
- employee’s tax required to be deducted or withheld as per the Income Tax Act.

A further amendment was made in 2008 to make the “clean break” applicable to all divorce orders granted after 1989. The amount allocated to the non-member spouse has to be paid to that person or to an approved retirement fund of his/her choice.

Deferred pensions

The Financial Services Laws General Amendment Act, 45 of 2013 brought about a change to section 37D of the Pension Funds Act, to extend the ‘clean break’ to deferred pension benefits. The amendments became effective on 28 February 2014.

Section 37D(1)(d)(i) provides that an amount assigned to a non-member spouse in terms of a decree of divorce granted under section 7(8) of the Divorce Act or in terms of a court order in respect of the division of assets of a marriage under Islamic law may be deducted from:

- a deferred pensioner's benefit,
- member's interest, or
- minimum individual reserve, or
- the capital value of the pensioner's pension after retirement.

The intention of the legislature is clear - that the same rules should apply to deferred pensioners' benefits as applies to active members. However, the Divorce Act wording has not been amended to reflect this.

Pension interest

In terms of the Divorce Act, section 7(8), it is only the pension interest, as defined, that is included in the divisible assets upon a divorce of persons married in community of property or with the accrual system. It does not provide for the inclusion of:

- a deferred pensioner's benefit,
- member's interest, or
- minimum individual reserve, or
- the capital value of the pensioner's pension after retirement.

Pension interest is defined to be the following:

- in the case of a retirement annuity, it is the contributions made to the fund from inception until the date of divorce, plus simple interest at the rate published by the Minister in the Government Gazette from time to time (currently 10% per annum);
- in the case of a pension or provident fund, it will be the resignation benefit the member will be entitled to on the date of divorce; and
- in the case of a preservation fund, it will be the termination benefit the member will be entitled to on the date of divorce.

The impact that this oversight can have on the successful payment of a divorce order is questionable, but it is expected that the legislature will attend to this.

The Government Employee Pension Fund

The principle also applies to the Government Employees Pension Fund (GEPF) from 1 March 2012. Where a benefit is awarded and paid to a non-member, it is accounted for as a loan made to the member (on which interest is charged). This can have a devastating effect on that member's future resignation or retirement benefit.

There are signs that this accounting rule will be amended in future but no timeline has been confirmed.

At the moment the pre-1998 tax-free lump sum as determined in terms of paragraph 2A of the Second Schedule (the old formula C) will be apportioned between the member and non-member spouse.)

Tax implications

If the divorce order was granted **before** 13 September 2007 and the benefit is deducted from the individual reserve **on or after** 1 March 2009, the amount will be totally tax-free.

If the divorce order was granted **after** 13 September 2007 and the benefit was deducted from the individual reserve:

- **before** 1 March 2009, the member was liable for the tax. (He/she could claim it back from the non-member spouse);
- **after** 1 March 2009, the non-member spouse is liable for the tax. The non-member spouse can elect to have the amount transferred to another approved fund tax-free.

(The tax table applicable to retirement fund withdrawals will apply.)

The divorce order wording

In practice, payment to the non-member spouse is often hampered due to the divorce order wording being incorrect. This can be avoided by taking note of the following guidelines as prescribed by the Pension Funds Act:

- the retirement fund must be identifiable from the divorce order – name the fund by its registered name and indicate the number of the fund member policy,

- reference should be made to an amount or a percentage of pension interest as defined in the Divorce Act to be deducted from the member's benefit or member's minimum individual reserve,
- the fund must be instructed in the settlement agreement to make payment or transfer of the amount assigned to the non-member spouse,
- the fund member policy cannot be ceded to the non-member spouse, so this instruction should not be made in the divorce order.

The Maintenance Order

The legislation

Section 37D(1)(d)(iA) of the Pension Funds Act provides for the deduction of any amount payable in terms of a maintenance order as defined in section 1 of the Maintenance Act from:

- a member's or a deferred pensioner's benefit, or
- a member's interest, or
- a member's minimum individual reserve, or
- the capital value of a pensioner's pension after retirement.

Section 1 of the Maintenance Act defines a maintenance order as any order for the payment, including the periodical payment, of sums of money towards the maintenance of any person issued by a court in the Republic.

Where a member fails to meet their obligation to pay maintenance under a maintenance order, the non-member may approach the court to obtain a maintenance order against the fund, directing the fund to deduct the maintenance from the member's minimum individual reserve in the retirement fund. In this instance the order is issued against the fund in addition to the member and the fund has to adhere to it. If the fund does not adhere to this order, the fund will be in contempt of court.

Income tax implications

Section 7(11) of the Income Tax Act applies in this instance (part of the deeming provisions), read with paragraph (f) of the remuneration definition in the Fourth Schedule.

The result is that the maintenance order payments made to the non-member spouse is seen as remuneration of the member and is deemed income in the hands of the member and therefore subject to income tax in the hands of the member.

In practice, where a payment is made in terms of such an order, the tax is not deducted from the maintenance amount, instead, the full amount payable plus the tax liability is deducted from the member's benefit or minimum individual reserve. Therefore the maintenance amount plus the tax on this amount is taxed in the hands of the member at the marginal tax rate.

There is no tax directive required and a tax certificate is issued to the member.

SARS issued interpretation note 89 that clarified the tax treatment of maintenance payments that are deducted from an active member's minimum individual reserve and the tax-on-tax relating to this payment.

SARS recommended the following formula to calculate the tax-on-tax effect:

1. Calculate the tax on the amount awarded under the maintenance order,
2. Multiply the tax determined in step 1 by $100/(100-\text{marginal tax rate applicable})$,
3. Add the amount determined in step 2 to the amount of the maintenance award.

Where the grossed up amount determined in step 3 falls into a higher tax bracket than the tax bracket applied in step 2:

4. Calculate the additional tax on the grossed up amount,
5. Subtract the amount determined in step 2 from the tax calculated in step 4,
6. Multiply the figure determined in step 5 by $100/(100-\text{marginal tax rate applicable})$.
7. The taxable benefit derived by the member is equal to the result of step 2 plus the result of step 6.
8. Add the taxable benefit to the amount of the maintenance award to arrive at the member's income.

The following example will illustrate the calculation:

Abigail received a maintenance order in her favour against Momentum Retirement Annuity Fund. In terms of this order, the fund has to pay her an amount of R100 000. Clive, the member of the fund, is currently on a marginal tax rate of 26%.

To determine the total amount to be deducted from the member's minimum individual reserve, the following calculation is done:

1. $R100\ 000 \times 26\% = R26\ 000$
2. $R26\ 000 \times (100/(100-26)) = R35\ 135$
3. $R100\ 000 + R35\ 135 = R135\ 135$

If one assumes that the additional gross income results in his marginal tax rate being increased to 31%, the following steps must be done to determine the total amount to be deducted from the member's minimum individual reserve to result in Abigail receiving R100 000:

4. $R135\ 135 \times 31\% = R41\ 892$
5. $R41\ 892 - R35\ 135 = R6\ 757$
6. $R6\ 757 \times (100/(100-31)) = R9\ 793$
7. $R135\ 135 + R9\ 793 = R144\ 928$

Tax on R144 928 @ 31% = R44 928 resulting in a net amount being paid of R100 000.
