# LEVERAGE

## Legal and technical update: February 2019

## At a Glance: Legislative Update

In this edition Sharon Hamman (Senior Legal Adviser) gives a practical perspective on recent amendments to the Taxation Laws Amendment Act as these relate to and have an impact on financial planning. She also pays attention to some of the 'dots on the horizon' – changes being contemplated and/or discussed.

Happy reading!

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# Taxation Laws Amendment Act, 2018

By Sharon Hamman, Senior Legal Adviser

This Act, promulgated on 17 January 2019, brought into being the tax proposals made in last year's Budget. At the same time, it provided an opportunity to postpone the implementation of the annuitisation of provident funds and tie up some other loose ends.

The most pertinent amendments, from a financial planning point of view, are as follows:

## Provident fund annuitisation

Plans to annuitise provident funds have been on the cards since 2014, with numerous effective dates being postponed. It has now happened again.

Allowing for further deliberations on the matter, it has now been postponed to 1 March 2021.

What is annuitisation of provident funds again? If you have perhaps forgotten what this is all about or only joined the industry after the spotlight was on this amendment, herewith a quick recap on what annuitisation of provident funds entails:

- It will bring the rules of provident funds in line with that of pension funds regarding access at retirement: a maximum of one third may be taken as a lump sum on retirement, while the remaining funds must be used for a monthly pension;
- The motivation behind it is to limit members' access to ensure that some benefits remain to provide for a monthly pension and reduce the burden on the state in respect of government pension grants; and
- Once implemented, all new contributions to the fund, after this date (1 March 2021), will be subject to the new rules and the limitation. The fund value as on 28 February 2021 will be referred to as the vested benefit and will remain fully accessible at retirement.

## Post-retirement retirement benefit preservation

This concept has been developing over the last few years. In 2015, the definition of retirement date in the Income Tax Act (ITA) was amended to allow for a wider application. It refers to the retirement date of a member as the date on which that member elects to retire from the fund (most fund rules would require certain administrative requirements to be met for the retirement date to have occurred). This is the retirement date for the purpose of the Income Tax Act, which will then trigger the tax consequences (applicable to retirement) on that fund. It does not retract that a member has a contractual retirement age in terms of the member's employment contact and their employer-provided retirement fund rules.

The amendment had a positive impact on retirement planning in general, as it allowed a member to control when they actually retire from their retirement fund, rather than being subjected to a set retirement date contained in the fund rules. So even if they reached their contractual retirement date, the member could leave the retirement benefit in the fund until they wish to formally retire, in which case they would inform the fund and meet the administrative requirements to do so and then trigger the retirement date definition for tax purposes.

In 2018, another amendment brought about the ability for a member to transfer their retirement benefit to a retirement annuity (RA). In this case, the member reaches their contractual retirement date/age in terms of their employment contract and the fund rules, and then decides to transfer their retirement benefit to a RA to postpone the retirement date and 'preserve' that retirement benefit for future use. The only downside to this amendment is when a member of a provident fund uses the RA for post-retirement benefit preservation: it would bring the provident fund benefits under the rules of the RA, resulting in limited access at retirement (the one third lump sum limitation applies). At the time, preservation funds were not considered as an option for this type of post-retirement preservation due to the one pre-retirement withdrawal option available. As it is a retirement benefit that is being preserved, the principle is that no withdrawal options should be possible prior to retirement.

From 1 March 2019, the preservation fund is being introduced as another alternative, with the restriction that no withdrawal option is available on the retirement benefits transferred into the preservation fund. The benefit is that a retirement benefit can now be transferred from a pension fund to a pension preservation fund or RA and from a provident fund to a provident preservation fund, a pension preservation fund, or a RA. The member of the provident fund can therefore retain the full lump sum access they would have been entitled to if they retired directly from the provident fund.

It is important to note:

- A member cannot stagger the retirement from the fund. If the post-retirement preservation is selected, the member has to transfer the full retirement benefit to either the RA or the preservation fund. It is not possible to access a portion of the retirement benefit and then preserve the rest – it is all or nothing.



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**Example:**

Peter is employed and his employment contract states that the retirement age of all employees is 63 and the employer provided provident fund's rules also reflect this age as its retirement age. Peter's employer already indicated that they would retain his services post-retirement on a contract basis, as they cannot afford to lose his expertise and experience. However, because the requirement for fund membership is permanent employment, Peter will not be able to remain on the fund.

**Situation prior to the amendment:**

When Peter reaches his normal retirement age, his permanent employment would come to an end and he would revert to working on a contract basis. As a result of him not meeting the eligibility criteria for fund membership and due to him having reached the normal retirement age of 63, he would also be forced to retire from his provident fund. He has no option to preserve the retirement benefit to a later stage other than leaving it in the fund or transfer it to a retirement annuity fund until such time as he wishes to take his retirement benefit. He does not want to restrict his ability to take his whole retirement benefit as a lump sum, which effectively means that leaving his benefit in the provident fund is his only option. Many funds restrict investment options to deferred members. It should also be noted that all risk benefits attached to the fund would generally cease upon reaching the fund's normal retirement age.

**Situation post the amendment:**

When Peter reaches his retirement age of 63, he will be able to preserve his retirement benefit in one of three ways:

- Leave the benefit in the provident fund until actual retirement;
- Transfer the retirement benefit to a RA. An existing RA can also be used and Peter can continue to contribute to the RA until he wishes to retire from it. The RA does not have a set retirement date and will only action the retirement when Peter chooses to do so and meets all administrative requirements;
- Transfer the retirement benefit to a preservation fund. An existing preservation fund can also be used. Peter will not enjoy the one withdrawal option on this portion of the preservation fund (if it is added to an existing preservation fund), but the one withdrawal option will still be available on the other fund sources held in that preservation fund if he has not yet used it.

The amendments allow for more flexibility when doing retirement planning later in life, specifically in an environment where people are living longer and continue to work post-retirement.

## Access to preservation fund benefits due to emigration or the cessation of a visa

Preservation funds are being brought in line with RAs when a member emigrates prior to the retirement date.

At the moment, a member of a RA can access the funds as a withdrawal by following the process through the SA Reserve Bank if the member formally emigrates, or their visa expires. Preservation funds would not be accessible due to emigration or the cessation of a visa, except if the member has not used the one withdrawal option, in which case the one withdrawal could be used to withdraw the total fund value.

This posed a problem for members who have benefits in a preservation fund, but already used the one withdrawal option. In this case, the member was forced to wait until the retirement date to access the retirement benefit, which would be limited in terms of the rules of the fund. The pension preservation fund would limit access at retirement to a maximum of one third, resulting in the remainder of the funds staying behind, paying a monthly pension in SA, subject to tax in SA and then having to be repatriated offshore, fully subjected to the exchange rate every month.

From 1 March 2019 this will change. Where a member of a preservation fund has already formally emigrated, or their visa has expired by this date, they will be able to withdraw the funds, irrespective of any prior one withdrawal being made. A member who is in the process of emigrating or their visa expires after this date, will be able to access the funds as soon as the administrative requirements are met, irrespective of any prior one withdrawal made.

As is the case with the withdrawal due to emigration or the cessation of a visa occurs pre-retirement, the full withdrawal amount will be taxable in terms of the withdrawal tax table – please remember that aggregation of previous retirement fund lump sums can impact the tax payable quite significantly.

**Important to note:**

- Any retirement benefit transferred to a RA or a preservation fund (as discussed under point 2 above) will not be accessible due to emigration or the cessation of a visa; and
- If a member has transferred their retirement benefit to an existing RA or preservation fund, this retirement benefit will not be accessible. However, any other pre-retirement benefits in the funds will be accessible as a withdrawal if the member emigrates or their visa ceases.

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## Extending the tax-free transfer between retirement funds as a result of a divorce order

From 1 March 2019 the definition of a pension preservation fund has been amended to accept transfers from provident funds and provident preservation funds in terms of a divorce order. Such transfers will be tax-free.

When funds are transferred from a provident fund or provident preservation fund to a pension preservation fund, the transferred funds are subject to the rules of the pension preservation fund, which will result in limited access at retirement. This should be highlighted to the divorced non-member spouse when making their decision.

## Clarifying the principle when using contributions made to retirement funds as a section 10C exemption against compulsory annuity income

To give this amendment the right context, let's take a step back. Where a taxpayer contributes to retirement funds during a tax year, section 11F of the Act provides the parameters to determine the maximum tax deductible contributions made. Where contributions made exceed the allowed deduction, excess contributions that did not rank as a deduction during that tax year will roll-over to the following tax year (the industry refers to these as disallowed contributions). In that following tax year, all disallowed contributions would be added to the actual contributions made during that year, the sum of which would then be deductible and once again any amount in excess of the maximum allowable deduction during that tax-year will roll over.

In addition of rolling over to the following tax year for the purposes of section 11F, the ITA also provides for two other instances where a taxpayer may benefit from disallowed contributions:

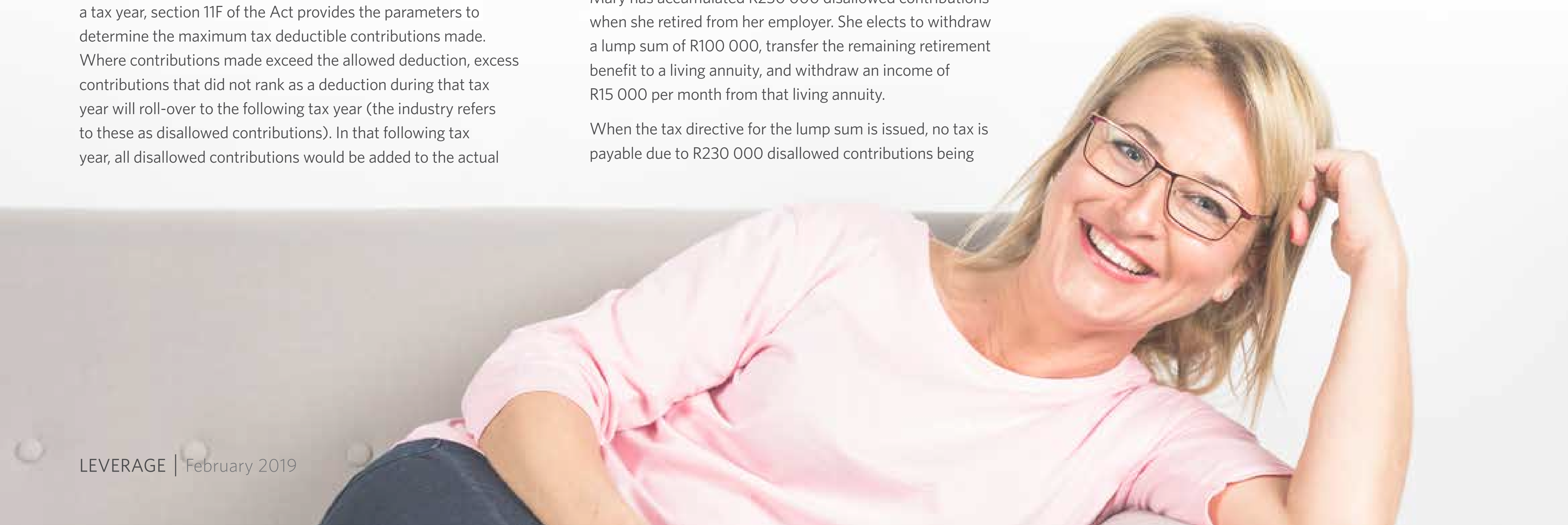
- Paragraph 5 or 6 of the Second Schedule to the ITA, which allows for a deduction of contributions that did not rank as a deduction under section 11F when determining the taxable lump sum coming from a retirement fund (upon withdrawal, retirement or death), and
- Section 10C that allows for contributions that did not rank as a deduction under section 11F to be used as an exemption against compulsory annuity income received.

Example:

> Mary has accumulated R230 000 disallowed contributions when she retired from her employer. She elects to withdraw a lump sum of R100 000, transfer the remaining retirement benefit to a living annuity, and withdraw an income of R15 000 per month from that living annuity.
>
> When the tax directive for the lump sum is issued, no tax is payable due to R230 000 disallowed contributions being available. Therefore, R100 000 of this amount is used against the lump sum under paragraph 6 of the Second Schedule.

The living annuity will be subject to PAYE during the year and the administrator is obliged to withhold that PAYE. At the end of the tax year, Mary will enjoy the section 10C exemption against the living annuity income, to the extent of R130 000 (R230 000 – R100 000). The outcome is that only R50 000 (R180 000 – R130 000) of the living annuity will be subject to tax, and Mary will be refunded any PAYE deducted during the tax year over and above this amount.

The introduction of section 10C resulted in some creativity from the industry and a practice that saw individuals (over the age of 55) investing large lump sums into RAs, then immediately transferring the RA's retirement benefit to a living annuity to start receiving a monthly pension from that living annuity – all in the same tax year. They would then claim the large contribution as a section 10C exemption in the same tax year to secure tax-free income from the living annuity.



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Example:

Carl (57) won the Lotto and has R10 million to invest to provide for an income. He decides to invest it in a RA and then immediately into a living annuity. He made the contribution to the RA on 1 June 2018 and received his first income from the living annuity on 1 August 2018. He elected an income of R80 000 per month. During the year, he also received contracting fees of R1 500 000. He does not have any other disallowed contributions at his disposal.

At the end of the tax year his tax calculation will be as follows:

| | |
|---|---|
| Contracting fees | R1 500 000 |
| Living annuity | R 560 000 (7 x R80 000) |
| Gross income | R2 060 000 |
| *Less exemptions:* | |
| Section 10C | R 560 000 (total living annuity income due to R10m contribution made that will not be deductible) |
| *Less deduction:* | |
| RA contribution ito S11F | R 350 000 (maximum deductible amount) |
| Taxable income | R1 150 000 |

Remaining disallowed contribution will be as follows:

| | |
|---|---|
| Contribution made | R10 000 000 |
| Less section 10C application | R 560 000 |
| Less section 11F deduction | R 350 000 |
| Roll over amount | R 9 090 000 (to be applied in following tax years) |

The amendment will result in the section 10C exemption being applicable to the extent that an amount did not rank as a deduction in any **prior** year of assessment. It eliminates the possibility that a person can enjoy the section 10C exemption in the same tax year that the contribution was made. This amendment will apply from 1 March 2016, which was the date when the section 10C exemption was introduced.

Carl's situation will therefore change as follows:

Carl (57) won the Lotto and has R10 million to invest to provide for an income. He decides to invest it in a RA and then immediately into a living annuity. He made the contribution to the RA on 1 June 2018 and received his first income from the living annuity on 1 August 2018. He elected an income of R80 000 per month. During the year he also received contracting fees of R1 500 000. He does not have any other disallowed contributions at his disposal.

At the end of the tax year his tax calculation will be as follows:

| | |
|---|---|
| Contracting fees | R1 500 000 |
| Living annuity | R 560 000 (7 x R80 000) |
| Gross income | R2 060 000 |

*Less exemptions:*

No exemption is available, as there was no amount that did not rank as a deduction in a prior year of assessment.

| | |
|---|---|
| *Less deduction:* | |
| RA contribution | R 350 000 (maximum deductible amount) |
| Taxable income | R1 710 000 |

Remaining disallowed contribution will be as follows:

| | |
|---|---|
| Contribution made | R10 000 000 |
| Less section 10C application | Nil |
| Less section 11F deduction | R 350 000 |
| Roll over amount | R 9 650 000 (to be applied in following tax years) |

From an advice point of view, it is important to inform the client that the exemption will only start applying in the following year of assessment and only if did not rank as a deduction under s 11F and was not used in terms of the Second Schedule.

# Dots on the horizon

By Sharon Hamman, Senior Legal Adviser

## Foreign employment exemption – section 10(1)(o)

This amendment is proposed to take effect on 1 March 2020 and can have far-reaching effects for people working abroad while still a SA tax resident.

At the moment, if a SA tax resident works abroad and earns foreign employment income, that income will be exempt from income tax in SA if the following requirements are met:

- They are outside SA for at least 183 days during any 12-month period;
- Of which 60 days must be consecutive.

From next year, the exemption will be limited to a maximum amount of R1 million. So if a person earns foreign employment income below R1 million, the total income will still be exempt from income tax in SA. However, if earnings exceed R1 million, the excess amount may be subject to tax in SA.

If the income is earned in a country where no tax is levied on the income in that country – for example one of the tax exempt countries like Dubai – then the full excess amount will be subject to tax as usual. If tax is payable in that country, the double taxation agreement between SA and that country will dictate how the tax is determined and payable – to prevent the income from being taxed twice.

SA taxpayers employed in tax-exempt countries can be severely affected by this amendment.

## ANC's suggestion to manipulate retirement fund investment into government projects

With the run-up to the election all parties are sharing their manifests in the hope to gain votes. In their election manifesto the ANC once again mentioned the possibility to amend investment guidelines applicable to retirement funds, to force those funds to invest in government projects and businesses. It has caused quite a stir in the media and has many an investor worried.

The reason I am including this in this publication is to highlight the procedure that must take place before a change like this can happen. Firstly, the public, retirement funds, employers, employees, their unions, and bargaining councils will have their say and give input. The international market will also have something to say.

Then, government will have to hear all interested parties' input, take it all into account, after which the legislature will have to draft something that will once again be open for debate, comment, constant amendment, and eventual approval by government –it can only be enacted if the majority of MPs vote in favour of the amendment.

We have heard this before, always during election times, and not once has anything transpired. I cannot predict the future, but I do know that there is a long process to be followed before something like this is enacted. Let us wait and see and not worry about things that we have no control over at this point. When the time comes, we will make sure our voices are heard. Of course we will keep you informed if anything changes or as the matter develops.

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## Limiting living annuity drawdown rates when owned by retirement funds

The FSCA makes certain proposals in the Draft Conduct Standard for Living Annuities that will apply in a default annuity strategy. Concern about this draft has been raised, as the Standard proposes that income levels from living annuities be capped and reduced from current legislated levels.

As a response I would like to share the following:

- It is still in draft format and the retirement fund industry is providing comments and giving direction to the development of this Standard;
- The proposal is only aimed at living annuities that are included in a fund's annuity strategy; it is not intended to apply to living annuities in general. (So it will apply to fund owned living annuities taken out as part of their default strategy and not member owned living annuities.)
- The proposal has no bearing or impact on a living annuity that falls outside of a fund's annuity strategy. The normal legislated limits still apply as it is and there is no indication that these levels are about to change.

Let us wait and see how things develop and have faith in the retirement fund industry that they will always endeavour to do the right thing for their members.

*"Change is difficult.....Not changing is fatal".*



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