Dear Sir / Madam

CALL FOR COMMENT: GUIDE TO THE TAXATION OF LUMP SUM BENEFITS

We refer to your call for comment regarding the above-mentioned. Set out below please find SAICA’s comments, which have been provided by members of our National Tax Committee.

1. Current content

1.1 We refer to the Guide to the Taxation of Lump Sum Benefits ("the Guide") issued during March 2008, in particular Part 3 of the Guide which deals with benefits on withdrawal or resignation.

1.2 We note that the Guide states in paragraph 3.1 that the "deductions against a lump sum benefit paid on withdrawal or resignation that were available prior to 1 October 2007 remain the same". It is further stated in paragraph 3.3 that "... the taxable portion of withdrawal and resignation benefits paid on or after 1 October 2007 continue to be subject to tax at the so-called “average rate of tax”, determinable in terms of section 5(10) of the Act." We do not, with the greatest of respect, agree with these comments.

1.3 The reason for our disagreement with this statement is that paragraph 7 of the Second Schedule to the Income Tax Act, No 58 of 1962 ("the Act") in terms of which the lump sum payments were taxed at the average rate of tax has indeed been amended with effect from 1 October 2007. Prior to the amendment noted, the paragraph read as follows:

"The normal tax payable in respect of any year of assessment by any person whose income ... include an amount determined in accordance with the provisions of this Schedule, shall, ..., be determined in accordance with the provisions of section 5(10) of this Act,..."
1.4 The paragraph has been amended by the insertion of the words "of paragraph (2)(b)" and following the amendment effective from 1 October 2007 reads as follows:

"The normal tax payable in respect of any year of assessment by any person whose income ... include an amount determined in accordance with the provisions of paragraph (2)(b) of this Schedule, shall, ..., be determined in accordance with the provisions of section 5(10) of this Act, ..."

The average rate of tax can therefore only be applied to amounts determined in accordance with the provisions of paragraph 2(b) of the Second Schedule to the Act.

1.5 Paragraph 2(b) of the Second Schedule to the Act provides for the inclusion of "the aggregate of any amounts deducted from the minimum individual reserve of that person during that year in terms of section 37D(1)(d) of the Pensions Funds Act, 1956 ...". It does not deal with or refer to the provisions of paragraph 6 of the Second Schedule to the Act which deals with withdrawals as a result of resignation of a member or the winding-up of a fund.

1.6 In this regard it is noted that paragraph 2(c) of the Second Schedule to the Act deals with paragraph 6 lump sums payable by reason of a withdrawal due to resignation from a fund or the winding-up of a fund (hereinafter referred to as "paragraph 6 lump sums").

1.7 Section 37D(1)(d) of the Pensions Funds Act, No 24 of 1956 ("the PF Act") referred to in paragraph 2(b) of the Second Schedule to the Act provides for the deduction from a member’s benefit or minimum individual reserve "any amount assigned from his or her pension interest to a non-member spouse or any other person in terms of a valid order made by a competent court". It does not refer in to paragraph 6 lump sums at all!

1.8 Had paragraph 7 of the Second Schedule to the Act referred to paragraph 2(c) of the Schedule, then we would agree with your comment that there was no change to the treatment of lump sums on withdrawals due to resignations or the winding-up of the funds. Based on our interpretation therefore, only amounts included in the lump sum which has been assigned to a non-member spouse or another person in terms of a court order is to be taxed at the average rate of tax.

1.9 If it was indeed SARS’s intention that paragraph 6 lump sums should be taxed at the average tax rate as provided for in section 5(10) of the Act, then paragraph 7 of the Second Schedule to the Act needs to be amended. The reference to paragraph 2(b) will have to be changed to paragraph 2(c). Paragraph 7 should then read as follows:

"The normal tax payable in respect of any year of assessment by any person whose income ... include an amount determined in accordance with the provisions of paragraph 2(c) of this Schedule, shall, ..., be determined in accordance with the provisions of section 5(10) of this Act, ...".

1.10 If it was SARS's intention that any amount assigned from his or her pension interest to a non-member spouse or any other person in terms of a valid order made
by a competent court in terms of section 37D(1)(d) of the PF Act should also be 
taxed at the average rate of tax as provided for in section 5(10) of the Act, then 
paragraph 7 should read as follows:

"The normal tax payable in respect of any year of assessment by any person whose 
income ... include an amount determined in accordance with the provisions of 
paragraph 2(b) and 2(c) of this Schedule, shall, ..., be determined in accordance 
with the provisions of section 5(10) of this Act, ...".

1.11 Paragraph 4.5 of the Guide states that, "Where the trustees cannot satisfy 
themselves that a member or former member has not commuted before, the rules of 
the fund may permit the commutation of the remaining total value of the annuity for 
a lump sum on condition that the total value on the date of commutation does not 
exceed R50 000." It is not clear whether this limitation will apply to each annuity 
contract in isolation, where an annuitant has more then one annuity, or whether all 
the annuity contracts must be accumulated and if the total does not exceed 
R50 000, then commutation can take place. This position must be clarified.

1.12 Paragraph 5.1.2 - Tax status of surplus apportionments to active members. This 
paragraph is not clear as it implies that an employees’ surplus is kept separate in a 
members’ fund. It is suggested that the guide mentions that the surplus is added to 
the members accumulation account in the fund and is then subject to the normal tax 
rules associated with retirement fund benefits.

1.13 Paragraph 5.4 - Divorce orders, maintenance orders and housing loans. This entire 
area should be expanded with specific examples. Divorces are a frequent reality 
and must be addressed in the guide more comprehensively. The situation of a 
subsequent retirement in the future after a previous divorce should be illustrated by 
means of an example.

1.14 Annexure A: Examples. The guide still does not extend far enough to give actual 
calculations of the tax payable. The first example merely states that “the tax 
payable will be determined by reference to the scale of rates listed in 7.1 above”. It 
is suggested that the actual calculation is disclosed. The second example suffers 
from the same omission. It is again suggested that the calculation be shown.

1.15 Annexure B: frequently asked questions. In paragraph (5)(ii) the last line of that 
paragraph should read: "A retirement benefit from a provident fund may be 
commuted by way of a lump sum." (replace “is commonly paid”).

2. Major shortcoming of current guide

2.1 A major shortcoming of the current guide is that it fails to deal with the situation 
where employees who are withdrawing or resigning from a retirement rendered 
services outside of the Republic of South Africa ("SA").

2.2 While a new tax regime has been implemented in relation to lump sum amounts 
derived by a taxpayer on retirement from a retirement fund (pension, provident or 
retirement annuity fund), the question of whether the full amount falls to be taxed 
in the hands of the recipient depends on his or her tax resident status at the time of 
accrual of the lump sum.
2.3 Based on the examples used in the Guide, if a retiree is tax resident in SA at the time he or she derives the lump sum, the full amount of the lump sum falls to be taxed in his or her hands. However, the Guide does not deal with the situation where the tax resident retiree rendered services outside SA. While the law is not absolutely clear on this point, should the lump sum relate to a period that the person rendered services outside SA, then, based on our interpretation of the Act, the lump sum should be apportioned as between the period of service rendered outside SA and the total period of service rendered (proviso to paragraph (e) of the definition of “gross income”, read with section 9(1)(g) of the Act). Only that portion of the lump sum that relates to services rendered in SA will be subject to tax in SA in accordance with the new regime.

2.4 The Guide does not deal with the situation where a non-resident retiree derives a lump sum. Based on our interpretation of the Act, where a non-resident retiree derives a lump sum, only so much of the lump sum as can be said to have been derived from a real or deemed source in SA falls within the SA tax net (paragraph (ii), read with paragraph (e), of the definition of “gross income” in section 1 of the Act). In essence, if a retiree has rendered services in SA in two of the last ten years prior to retirement, then the full amount of the lump sum is deemed to have been derived by the retiree from a source in SA (paragraph (e) of the definition of “gross income”, read with section 9(1)(g) of the Act). However, where the lump sum relates to services rendered in and outside SA, then the lump sum must be apportioned on the basis of the ratio of services rendered in SA to total services rendered and only that portion of the lump sum as is attributable to the services rendered in SA fall to be taxed here (proviso to section 9(1)(g), read with paragraph (e) of the definition of “gross income” in section 1 of the Act). The taxable portion of the lump sum will fall to be taxed in accordance with the new regime.

2.5 The Guide further does not deal with the situation where a non-resident withdraws or resigns from a retirement fund. It would seem that should a non-resident withdraws or resigns from a retirement fund, only so much of the lump sum as can be said to be derived from a real or deemed source in SA falls to be taxed in his hands in SA. Section 9(1)(g) of the Act that provides for pensions and annuities to have been derived from a source in SA and apportionment does not apply to lump sums derived from a retirement fund. It follows that it would be open to non-residents to argue that part of the lump sum derived by them from a SA retirement fund was derived from a source outside SA and accordingly not taxable here. However, to the extent that any portion of the lump sum can be said to have been derived from a source in SA, that portion is subject to tax in the non-resident’s hands as ordinary income and at his or her marginal rates of tax. That is, the taxable portion of the lump sum is not taxable at the non-resident’s average rate of tax.

Please do not hesitate to contact me should you require further information.

Yours faithfully

M Hassan CA(SA)

PROJECT DIRECTOR: TAX

The South African Institute of Chartered Accountants