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REPUBLIC OF SOUTH AFRICA

EXPLANATORY MEMORANDUM

ON THE

TAX ON RETIREMENT FUNDS BILL,1996

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In its Third Report, the Katz Commission proposed a new approach to the taxation of retirement funds. Following the Joint Standing Committee on Finance's discussions in this regard, the Government *inter alia* accepted in principle that a retirement fund's income should be taxed as it arises rather than when paid out.

Earlier this year the Minister of Finance, therefore, proposed in his Budget Speech that as a first step in the taxation of the income of retirement funds, a tax be introduced on the gross interest and net rental income received by or accrued to all retirement funds. This Bill gives effect to the announcement of the Minister in this regard.

CLAUSE 1

Definitions

Actuarial value

Clauses 4 and 5 prescribe the formulae to be applied in the determination of the taxable amount of an untaxed policyholder fund (UPHF) and a retirement fund, respectively. Such formulae provide *inter alia* that income from assets attributable to liabilities in respect of pensioners of a retirement fund and annuities in the case of an insurer, are not subject to the tax on retirement funds. To determine such non-taxable portion of income certain ratios have been incorporated into the formulae. The ratios to be so applied have been formulated with reference to the actuarial value of assets or liabilities of funds and in this regard it was necessary to define the concept of actuarial value.

In the case of a retirement fund the actuarial value must—

- in the case of a valuator appointed in terms of the Pension Funds Act, 1956, be made by such valuator on a basis acceptable to the Financial Services Board (the Board);
- in the case of industrial funds, be made by the actuary responsible for the valuation of the assets and liabilities of such a fund;
- in the case of funds established for the benefit of employees of the State, local authorities and parastatal institutions, be made by the actuary responsible for a statutory valuation of the fund's assets and liabilities and shall be made on the basis as required in terms of the relevant statutory requirements.

Actuarial values must be based on valuations done prior to the tax period during which a taxable amount is to be determined and the relevant valuation report must be submitted to the Board by funds registered under the Pension Funds Act or the Insurance Act. The report must be so submitted before the end of the relevant tax period and the Board must find the report acceptable. All other funds must submit their actuarial valuations to the Commissioner for Inland Revenue. The valuations must be so submitted before the end of the tax period in respect of which the valuation will be applied to calculate the tax liability and the Commissioner must find the valuation acceptable in consultation with the Chief Actuary of the Board.

The actuarial value of the liabilities of an untaxed policyholder fund must be valued on a basis as required in terms of the Insurance Act.

Guaranteed annuity

In order to determine the taxable portion of the income of an insurer, a differentiation is made between a guaranteed annuity and any other annuity. Any annuity which does not share in any bonus distribution, and contractually provides for a guaranteed increase at a fixed rate over the full term of the annuity, constitutes a guaranteed annuity.

Fund

Fund means either a retirement fund or the UPHF of an insurer, as the case may be.

Interest

Interest includes—

- any amount contemplated in the definition of "interest" in section 24J(1) of the Income Tax Act, for example any discount, premium or related finance charge; and
- dividends which are deemed to be interest in terms of section 8E of the Income Tax Act.

Market value

This expression is defined as the amount which a person, having the right to freely dispose of an asset in the open market, might reasonably expect to obtain from a sale of the asset. This concept is, for example, applied in limiting the taxable amount in respect of a retirement fund, where the interest and rental-bearing assets of the fund represent more than 50% of the total assets of the fund.

Retirement fund

Retirement fund includes all pension funds, provident funds and retirement annuity funds as defined in the Income Tax Act and similar funds managed and controlled outside the Republic. Funds of the former TBVC countries which have been deemed to have been approved or established by law, are also included.

Tax period

A period of six months commencing on 1 March 1996 to 31 August 1996 and every consecutive period of six months thereafter.

Tax

Tax includes both the tax on retirement funds and any provisional tax payable in terms of this Bill.

Untaxed policyholder fund (UPHF)

An UPHF means a fund of an insurer established as contemplated in section 29(4)(a) of the Income Tax Act.

CLAUSE 2

Levy of tax and rate thereof

This clause represents the charging section and imposes a tax (called the tax on retirement funds) at the rate of 17% on the taxable amount of a retirement fund or an

UPHF of an insurer, which is collectively being referred to as a fund.

The taxable amount of a fund is calculated by—

- firstly, determining the income (being gross interest and net rental income) of a fund in terms of *clause 3*; and
- secondly, making certain adjustments to such income by applying different formulae to such income to determine the taxable amount of the relevant fund.

Section 4 prescribes the formula to be applied to determine the taxable amount of an UPHF, while section 5 prescribes the formula to be applied to determine the taxable amount of a retirement fund.

See Examples 1 and 2 of Annexure for an example in this regard.

CLAUSE 3

Determination of income of fund

This clause prescribes the formula to be applied to determine the income of a fund. In essence it is the sum of the gross amount of interest received by or accrued to a fund from a source or deemed source within the Republic, and the net rental income received by or accrued to a fund from a source or deemed source within the Republic. The income of a fund should be determined in respect of every tax period.

In determining the net rental income of a fund the following is of importance—

- rental income includes royalties and any premium or like consideration for *inter alia* the use of land, plant or machinery and certain incorporeal assets;
- only—
  - expenses actually incurred by a fund directly in the production of its rental income: and
  - an appropriate portion of any allowance calculated in respect of any asset from which the rental income arises,

  will qualify as a deduction. Furthermore, only expenditure or allowances which would have been allowed as a deduction in terms of the Income Tax Act, 1962, will qualify as a deduction;
- where the rental expenses and allowances exceed the rental income during a tax period, the excess may not be set off against the interest income of the fund during such tax period, but the excess must be carried forward to the immediately following tax period and shall be deemed to be expenditure actually incurred or an allowance calculated, in respect of such immediately following tax period.

See Examples 1 and 2 of Annexure for an example in this regard.

CLAUSE 4

Determination of taxable amount of an untaxed policyholder fund

In terms of this clause the taxable amount of an UPHF of an insurer is determined for a tax period. The calculation is done by applying a prescribed formula. Essentially it is the income of the UPHF during a tax period less—

- the income allocated by the insurer to a retirement fund in terms of section 9 during the tax period;

- the income from assets attributable to liabilities in respect of guaranteed annuities during the tax period which have been accounted for and held in a separate portfolio on 1 March 1996 in terms of a practice consistently applied by such UPHF before that date.

Once that has been established the rental and interest income of the UPHF from assets attributable to liabilities in respect of with-profit annuities and untaxed business with exempt institutions are excluded on a proportionate basis.

See Example 2 of Annexure for an example in this regard.

CLAUSE 5

Determination of taxable amount of a retirement fund

In terms of this clause the taxable amount of a retirement fund is determined for a tax period.

This calculation is also done in terms of a prescribed formula, which essentially is the income of such retirement fund as determined in terms of section 3 in respect of a tax period, plus the income which has been allocated to the fund by an insurer in terms of section 9 during the tax period.

Once that has been established the interest and rental income from assets attributable to liabilities in respect of pensioners are excluded on a proportionate basis.

Where, however, the market value of all the interest and rental-bearing assets of a retirement fund is greater than 50% of the market value of all assets of such fund, the taxable amount of the fund is limited by applying a prescribed ratio.

Such ratio is given by 50% of the market value of all assets of the retirement fund, to the market value of all interest- and rental-bearing assets of such fund.

See Example 1 of Annexure for an example in this regard.

CLAUSE 6

Payment of the tax on retirement funds

The tax on retirement funds is payable to the Commissioner by a fund within three months after the end of each tax period of such fund. Payment is made on declaration in terms of a return prescribed by the Commissioner.

CLAUSE 7

Payment of provisional tax

Every fund must make two provisional tax payments in respect of every tax period in respect of its liability for the tax on retirement funds.

The first provisional tax payment in respect of a tax period is equal to 50% of the actual amount of the tax on retirement funds payable for the immediately preceding tax period. The last date of payment for the first provisional tax payment falling between—

- 1 March and 31 August, is the end of May;
- 1 September and 28/29 February, is the end of November.

A first provisional tax payment is not required for the tax period 1 March 1996 to 31 August 1996.

The second provisional tax payment must be an amount equal to 90% of the actual tax on retirement funds payable during the relevant tax period, reduced by the first provisional tax payment. The second provisional tax payment must be made within 25 days after the end of every tax period.

All provisional tax payments—

- made in respect of a fund's tax period, may be set-off by the fund against its liability for the tax on retirement funds;
- are made on declaration in terms of a return prescribed by the Commissioner.

CLAUSE 8

Person liable for tax

The person liable for the tax is the insurer (in the case of an UPHF) or the retirement fund, as the case may be.

The persons actually responsible for the duties to be performed in terms of this Bill are either the principal officer, liquidator, public officer or other appointed officer, as the case may be.

CLAUSE 9

Allocation by insurer of income to retirement fund

In terms of this clause an insurer may, where a retirement fund participates in the UPHF of the insurer, allocate income received by or accrued to the insurer during a tax period, to the retirement fund during the tax period.

The income so allocated must be excluded from the UPHF's taxable amount for the tax period during which the income was so allocated. The retirement fund on the other hand must include the income in its taxable amount for the tax period during which the allocation was made.

CLAUSE 10

Notification of income allocated

This clause provides that the insurer must advise both the retirement fund and the Commissioner of the allocation. The retirement fund must be advised within 14 days after the end of the relevant tax period and the Commissioner within three months after the end of the relevant tax period, during which the allocation was made.

Subclause (3) regulates the situation where an insurer fails to comply with the provisions of this clause.

CLAUSE 11

Interest on late payment of tax

This clause provides for the payment of interest at the prescribed rate, where any provisional tax or the tax on retirement funds has not been paid timeously. Interest on late payments is calculated on a daily basis on the outstanding amount, from, in so far as it relates to the payment of—

- the tax on retirement funds, from the end of the three month period contemplated in *clause 6* of the Bill;
- a first provisional tax payment, from the last day of the relevant month contemplated in *clause 7(3)* of the Bill; or

- a second provisional tax payment, from the end of the relevant period contemplated in *clause 7(5)* of the Bill.

CLAUSE 12

Penalty for failure to pay tax when due

The proposed clause makes provision for the imposition of, in addition to interest payable in terms of *clause 11*, a penalty equal to 10% in respect of any tax not paid or underpaid. The Commissioner may, however, having regard to the circumstances of the case, remit the penalty partially or in full.

CLAUSE 13

Assessment by Commissioner

This clause empowers the Commissioner, where he is satisfied that the tax has not been paid or has been underpaid, to make a reasonable estimate of the tax payable and to issue a notice of assessment in that regard.

CLAUSE 14

Accrual and incurral of interest

This clause provides that the provisions of section 24J of the Income Tax Act, 1962 (which section governs the accrual and incurral of interest), will apply for the purposes of this Bill.

It furthermore provides for an election in relation to the date from which section 24J should apply. A fund, therefore, has the option to revalue an instrument at market value on 1 March 1996 and to apply section 24J from that date onwards or to apply section 24J from the date of acquisition of the instrument.

APPLICATION OF SECTION 24J

Example 1

A pension fund acquired government stock on 1 January 1996 for an amount of R892 405. The stock carries a coupon of 11,5% per annum payable six monthly and matures on 30 May 2000 at a nominal value of R1 000 000.

(a) The pension fund elects to apply the provisions of section 24J from the date of acquisition of the stock.

Cash flow	
Date	**R**
1 January 1996	(892 405)
30 May 1996	57 500
30 November 1996	57 500
30 May 1997	57 500
30 November 1997	57 500
30 May 1998	57 500
30 November 1998	57 500
30 May 1999	57 500
30 November 1999	57 500
30 May 2000	1 057 500
	625 095

The yield to maturity assuming a monthly accrual period is therefore 1,23082%.

The accrual of interest by the retirement fund for the tax period ending 31 August 1996 will be:

= R34 185 + R33 314

= R67 499

Value on 1 March 1996

= R892 405 x $(1{,}0123082)^2$

= R914 508

1 March until 30 May

= R914 508 x $(1{,}0123082)^3$ – R914 508

= R948 693 – R914 508

= R34 185

31 May until 31 August

= (R948 693 – R57 500) x $(1{,}0123082)^3$ – R891 193

= (R891 193 x $1{,}0123082)^3$ – R891 193

= R33 314

(b) The pension fund elects to revalue the stock as at 1 March 1996 and applies section 24J from that date. On 1 March 1996 the market value of the stock is R881 336 which corresponds with a monthly yield to maturity rate of 1,325%.

The accrual of interest by the retirement fund for the tax period ending 31 August 1996 will be:

= R35 499 + R34 613

= R70 112

Value on 1 March 1996

= R881 336

1 March until 30 May

= R881 336 x $(1{,}01325)^3$ – R881 336

= R916 835 – R881 336

= R35 499

31 May until 31 August

= (R916 835 – R57 500) x $(1{,}01325)^3$ – R859 335

= (R859 335 x $1{,}01325)^3$ – R859 335

= R34 613

Example 2

A pension fund acquired government stock on 10 June 1996 for an amount of R886 735. The stock carries a coupon of 11,5% per annum payable six monthly and matures on 30 May 2000 at a nominal value of R1 000 000.

The pension fund is entitled in terms of section 14 to apply a monthly accrual period. This will have the effect that interest will be accrued for the full month of June although the instruments were not held throughout the month.

The accrual of interest by the pension fund for the tax period ending 31 August 1996 will be:

<u>1 June until 31 August</u>

$= R886\ 735 \times (1{,}0124376)^3 - R886\ 735$

$= R920\ 235 - R886\ 735$

$= \underline{\underline{R33\ 500}}$

CLAUSE 15

Discretion of Commissioner

Any decision of the Commissioner in the exercise of his discretion under this Bill shall be subject to objection and appeal.

CLAUSE 16

Applicability of the Income Tax Act

This clause makes the provisions contained in the Income Tax Act with regard to—

(a) the administration thereof as contained in Chapter I of the Income Tax Act;

(b) the production of documents and evidence on oath;

(c) penalty on default;

(d) additional tax in event of default or omission;

(e) assessments;

(f) objections and appeals;

(g) the recovery of tax;

(h) the refund of tax; and

(i) transactions, operations or schemes for purposes of avoiding or postponing liability for or reducing the amount of taxes on income.

mutatis mutandis applicable for the purposes of this Bill.

CLAUSE 17

Short title

This clause provides the short title of the Bill.

ANNEXURE

Example 1

Calculation of the tax payable by RET pension fund for its first tax period ending 31 August 1996.

Information applicable to first tax period—

		R
I =	Gross interest received or accrued	120 000
R =	Gross rental received or accrued	120 000
E =	Direct rental expenditure actually incurred	60 000
H =	Amounts allocated to fund by an insurer	240 000
K =	Actuarial value of pensioner liabilities on 30/6/1994	1 500 000
L =	Actuarial value of assets on 30/6/1994	2 800 000
N =	Market value of all assets on 30/6/1995	3 600 000
P =	Market value of interest and rental-bearing assets on 30/6/95	2 000 000

Section 3

A = Income

= I + (R − E)

= R120 000 + (R120 000 − R60 000)

= R180 000

Section 5(1)

T = Taxable amount

= (A + H) x (1 − (K ÷ L))

= (R180 000 + R240 000) x (1 − (R1 500 000 ÷ R2 800 000))

= R420 000 x 0,46

= R195 000

Section 5(2)

M = Limited taxable amount

= N ÷ (2 x P) x T

= R3 600 000 ÷ (2 x R2 000 000) x R195 000

= R175 500

Section 2

Tax = R175 500 x 0,17

= R29 835

Example 2

Calculation of the tax payable by INS untaxed policyholder fund for its first tax period ending 31 August 1996.

Information applicable to first tax period—

		R
I =	Gross interest received or accrued	500 000
R =	Gross rental received or accrued	100 000
E =	Direct rental expenditure actually incurred	20 000
B =	Amounts allocated by insurer to retirement funds	300 000
C =	Income in respect of guaranteed annuities	150 000
D =	Actuarial value of liabilities on 29/2/1996 excluding liabilities in respect of B and C	2 500 000
F =	D – (actuarial value of liabilities in respect of tax exempt institutions and profit-sharing annuities)	1 500 000

Section 3

A = Income

= I + (R – E)

= R500 000 + (R100 000 – R20 000)

= R580 000

Section 4

T = Taxable amount

= (((A – (B + C)) x F) ÷ D)

= (((R580 000 – (R300 000 + R150 000)) x R1 500 000) ÷ R2 500 000)

= R130 000 x R1 500 000 ÷ R2 500 000

= R78 000

Section 2

Tax = R78 000 x 0,17

= R13 260