

Pension Interest at Divorce: A guide to the treatment of pension interest at divorce with reference to the history, the changes made to legislation, and the expected future outcome as based upon the current outstanding issues to be addressed by the legislature and the Minister of Finance.

by
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DECLARATION

I, Johannes Lodewicus du Preez, hereby declare that this assignment is my own original work, sources used have been accurately acknowledged and that this document has never in the past been submitted at any academic institution for obtaining an academic qualification.

J.L. DU PREEZ

07 September 2010

Pension Interest at Divorce: A guide to the tax treatment of pension interest at divorce with reference to the history, the changes made to legislation, and the expected future outcome as based upon the current outstanding issues to be addressed by the legislature and the Minister of Finance.

Due to a number of legislative changes, the tax treatment of pension interest at divorce has become a complicated issue, as it is not only affected by the Income Tax Act, but also by the Pension Funds Act as well as the Divorce Act. Because these changes are still fairly new to the industry, there are still a couple of technical issues on which the industry is not clear. In practice there are many articles and writers trying to give some form of guidance regarding the technical issues of pension interest at divorce.

The study will refer to case law that affected the changes made to the Pension Funds Act, which led to the institution of the “clean-break” principle. Some of the technical issues with regard to a payment of an award made to a non-member spouse by a divorce order will be included along with a discussion on difficulties and uncertainties arising from the “clean-break” principle.

The focus of the study will then be directed towards changes made to the Income Tax Act. Specific reference will be made to the tax on an award made to a non-member spouse by a divorce order. In some cases the tax on such an award will be recovered from the member spouse. The Income Tax Act does however provide for a right of recovery, which will be discussed. The payment of the tax from the member’s individual reserve however constitutes an additional accrual according to the Income Tax Act, which leads to a tax-on-tax issue. A discussion on GN33 will be included, as GN33 addresses the tax-on-tax issue.

A chapter on preservation funds is included, as it is important to understand the working of these funds on when a non-member spouse has the option to transfer his/her pension interest to such a fund.

The study will then look at an inequitable position in which the member finds him/herself when party to a divorce order made before 13 September 2007. Due to the changes made

to the Income Tax Act, a situation arose where the member spouse loses out on all or part of his/her R300 000 tax free benefit as allowed by the Income Tax Act for withdrawals from his/her retirement funds.

The study will include considerations for financial planning. The industry is placing more and more emphasis on sound financial planning, and it is therefore important to understand the key considerations, which an advisor or a party to a divorce should consider.

The study will include a discussion on some of the outstanding issues, which the industry expects the legislature to address in the near future. As the changes to the Income Tax Act are ever changing and the discussion on pension interest at divorce is still a new topic under discussion, the industry is keeping an eye on the expected changes from the finance ministry and the legislature.

Pensioenbelang by Egskeiding: 'n Riglyn vir die belastinghantering van pensioenbelange by egskeiding met verwysing na die geskiedenis, veranderinge aan wetgewing en verwagtinge gebaseer op die uitstaande items wat deur die wetgewer en Minister van Finansies aangespreek moet word.

As gevolg van 'n aantal veranderinge in wetgewing, het die belastinghantering van pensioenbelang by egskeiding 'n ingewikkelde kwessie geword, aangesien dit nie net deur die Inkomstebelastingwet beïnvloed word nie, maar ook deur die Pensioenfondswet sowel as die Egskeidingswet. Die studie sal verwys na regspraak wat aanleiding gegee het tot die veranderinge wat in die Pensioenfondswet gemaak is en wat gelei het tot die instelling van die "skoon-breuk"-beginsel.

Sommige van die tegniese vrae wat betref die betaling van 'n toekenning aan 'n nie-lid-gade by 'n egskeidingsbevel sal ingesluit word saam met 'n bespreking van probleme en onsekerhede wat uit die "skoon-breuk"-beginsel voortspruit.

Die fokus van die studie sal dan gerig word op veranderinge wat in die Inkomstebelastingwet aangebring is. As gevolg van veranderinge in wetgewing op spesifieke datums, word 'n toekenning wat aan 'n nie-lid-gade gemaak is in terme van 'n egskeidingsbevel belas onder drie verskillende belastingregimes, afhangende van die datum van die egskeidingsbevel.

Daar sal spesifiek verwys word na die belasting op 'n toekenning aan 'n nie-lid-gade. In sommige gevalle sal die belasting op so 'n toekenning verhaal word van die lid-gade. Die Inkomstebelastingwet maak egter voorsiening vir 'n verhalingsreg wat ook bespreek sal word. Die betaling van die belasting vanuit die lid-gade se minimum individuele reserwe word egter erken as 'n addisionele toevalling in terme van die Inkomstebelastingwet wat lei tot 'n belasting-op-belasting kwessie. GN33 sal bespreek word aangesien hierdie algemene nota die kwessie aanspreek.

'n Hoofstuk oor bewaringsfondse word ingesluit, aangesien dit belangrik is om die werking van hierdie fondse te verstaan wanneer 'n nie-lid-gade die opsie het om sy/haar pensioenbelang na so 'n fonds oor te dra.

Die studie sal dan kyk na 'n onbillike posisie waarin die lid hom/haarself bevind as hy/sy party was by 'n egskeiding voor 13 September 2007. As gevolg van die veranderinge wat in die Inkomstebelastingwet aangebring is, het 'n situasie ontstaan waar die lid eggenoot 'n gedeelte van sy/haar R300 000 belastingvrye voordeel vir onttrekkings van sy/haar aftreefonds, verloor.

Die studie sal oorwegings vir finansiële beplanning insluit. Die bedryf plaas al meer klem op omvattende finansiële beplanning en dit is dus belangrik om die deurslaggewende oorwegings waarmee 'n adviseur of 'n party by 'n egskeiding moet rekening hou, te verstaan.

Ten slotte sal die studie 'n bespreking insluit van sommige uitstaande kwessies wat die industrie verwag die wetgewer in die toekoms moet aanspreek.

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INDEX

CHAPTER 1

Preface

1.1	Background and history to research	11
1.2	Exposition	12
1.3	Aim of technical report	12
1.4	Research problems	13
1.5	Research method	13
1.6	Structure of technical report	13

CHAPTER 2

History and case law that led to the amendments made to the Pension Funds Act

2.1	Introduction	16
2.2	Legislative change made to the Divorce Amendment Act (1989)	16
2.3	Enforceability of order to pay proceeds of retirement funds/annuities, leading to the amendments made to section 37D of the Pension Funds Act	18
2.4	Conclusion	24

CHAPTER 3

Sections 37D of the Pension Funds Act and the “clean-break” principle

3.1	Introduction	25
3.2	Amendments made to the Pension Funds Act	25
3.3	Two schools of thought	27
3.4	Registered Pension Funds	28
3.5	Conclusion	30

CHAPTER 4

Changes made to the Income Tax Act

4.1	Introduction	31
4.2	Amendment required to the definition of gross income according to the Income Tax Act following the ruling in Income Tax Case No 1642 (6 and 26 March 1998)	31
4.3	Section (e) of the “gross income” definition	34
4.4	Second Schedule to the Income Tax Act	35
4.5	Tax on award made to the non-member spouse	39
4.6	Right of recovery	42
4.7	Amendment made to Paragraph 6 and Formula B (Second Schedule to the Income Tax Act)	45
4.7.1	Paragraph 6 of the Second Schedule to the Income Tax Act	45
4.7.2	Formula B of the Second Schedule to the Income Tax Act	45
4.8	“Tax on tax” issue arising from amendment	48
4.9	Tax-on-tax situation when paragraph 2B is applicable	51
4.9.1	Scenario 1	52
4.9.2	Scenario 2	52
4.10	Conclusion	54

CHAPTER 5

Preservation funds

5.1	Introduction	55
5.2	Preservation provident funds and preservation pension funds	55
5.3	Transfers to a preservation fund	56
5.4	Payments from a preservation fund	57
5.5	Conclusion	58

CHAPTER 6

Inequitable position of the member

6.1	Introduction	60
6.2	Awards made in terms of a divorce order before 13 September 2007	60
6.3	Illustrations made by the IRF	63
6.4	Suggested solutions	64
6.5	Conclusions to the illustrations made by the IRF	67

CHAPTER 7

Financial planning considerations

7.1	Introduction	68
7.2	Recovering tax from the non-member spouse	68
7.3	Limitation on recovery	69
7.4	Early withdrawals from retirement funds	70
7.5	The “cash” option	71
7.6	Conclusion	72

CHAPTER 8

Outstanding issues to be addressed by the legislature

8.1	Introduction	73
8.2	Early termination and surrender penalties	73
8.3	Simple interest rate for retirement annuities	75
8.4	Conclusion	76

CHAPTER 9

Summary and conclusion

9.1	Summary of the three tax regimes	77
9.2	Conclusion	84

BIBLIOGRAPHY	86
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CHAPTER 1

Preface

1.1 Background and history to research

According to statistics the number of divorces in South Africa fluctuated between 37 098 and 31 270 per annum from 1997 until 2006. During 2006 a total of 184 860 marriages were registered.¹ This means that approximately 20% of South African marriages end in divorce. That is why the issues of pension interest at divorce are so topical at this point in time.

The settlement of divorce orders with regard to a spouse's or member's pension interest in a retirement fund has had a long and interesting history. Legislators have made various changes to the relevant legislation over time which resulted in application of these changes being complicated in certain circumstances. There have been a number of key events that resulted in changes being made to a number of acts (Divorce Act No. 70 of 1979 herein after referred to as "Divorce Act", Pension Fund Act No.11 of 2007 herein after referred to as "Pension Fund Act", and Income Tax Act No.58 of 1962 herein after referred to as "Income Tax Act"). These events are within a specific time line, and the technical report will include specific references to events and case law in 1989, 1999 and 2007.

Because of the recent changes in the retirement industry of South Africa the proposed topic is a key element of effective and sound financial planning. A divorce can have significant financial impact on both parties. It is therefore essential to understand the financial impact and effect that a divorce will have on the financial planning for the future.

To understand the issues involved, the history of this topic has to be understood to understand why certain changes have been made to legislation. The next step will be to understand the effect of both recent and expected changes.

¹ Stats SA" Who is divorcing who and when..." The Cape Argus, 2008

A key aspect of the changes made to legislation is that it resulted in three different tax regimes under which allocations of pension interests will be taxed, depending on the date of the court order issued.

1.2 Exposition

In recent history, changes have been made to the Divorce Act, the Pension Funds Act, and the Income Tax Act. The results of these changes are that there are different taxation treatments at divorce date for pension interest based on the timing of the divorce order. These different tax regimes originate from a range of changes made to different sections in the Income Tax Act, the Divorce Act and the Pension Funds Act. Failing to understand these different treatments will lead to unsound financial advice and planning. It will also lead to attorneys and lawyers creating expectancies with their clients, which are not accurate. Creating such expectancies often results in a lawyer and financial planner being held responsible for any financial loss that resulted from a professional person failing to understand the full effect and consequence of the law in respect of which they are giving professional advice. Failing to understand the law in respect of which a professional person is giving advice, is seen as negligent and the court or ombudsman will in such cases find in favour of a client.

The problem identified is therefore based on the complexity of the different tax regimes resulting from the technical differences based on the timing of the divorce order and subsequent events.

1.3 Aim of technical report

The aim of this technical report is to:

- 1) bring about an understanding of the background and history of awards made in respect of pension interest at divorce, and the case law that initiated the amendments;

- 2) review the changes made to the Pension Funds Act and the related changes to the Income Tax Act with regard to pension interest awards in terms of divorce orders and their effects;
- 3) identify the practical issues arising from the amendments made to legislation;
- 4) highlight the outstanding issues that have not yet been fully addressed by the legislature; and to
- 5) suggest possible answers or solutions to the outstanding or unaddressed issues.

1.4 Research problems

The main issue, to which this technical assignment will seek to find an answer, is the treatment of pension interest at divorce based on the three different tax regimes. The three different tax regimes is the result of amendments to the Income Tax Act and the Pension Funds Act that came into effect on different dates.

1.5 Research method

The research method for the purpose of this assignment will be the historic research method.

The technical report will include reference to case law, financial articles published in financial magazines, papers and text books.

The study will be based on the changes and expected changes to the Pension Fund Act and the Income Tax Act, which will also include the Revenue Laws Amendment Act 2008 and the Taxation Laws Amendment Bill 2009.

1.6 Structure of technical report

In **Chapter 2** the author will refer to the amendment made to the Divorce Act in 1989 which resulted in the inclusion of a member's pension interest in his/her assets at divorce. A similar amendment was however not made to the Pension Funds Act to allow for a

registered pension fund to make such a payment from the member's fund as ordered by a divorce order. The enforceability of a divorce order against a pension fund was therefore questioned in the case of Old Mutual Life Assurance Company (SA) Limited, Sanlam Life Insurance Limited and Wanda Swemmer.

In **Chapter 3** the changes made to the Pension Funds Act which were partly initiated by the Swemmer case will be discussed. The amendments made to the Pension Funds Act lead to a number of practical issues. Firstly the amended Pension Funds Act did not state whether or not the amended act will be applied to divorce orders granted before the amendment was made to the Pension Funds Act. Secondly the Pension Funds Act only applies to pension funds registered under section 4 of the Pension Funds Act. There is however pension funds in South Africa which is not registered under section 4 of the Pension Funds Act which will therefore not be affected by the amendments made to the Pension Funds Act. Chapter 3 will include possible solutions to this situation.

In **Chapter 4** the author will refer to the amendments made to the Income Tax Act as a result of the amendments made to the Pension Funds Act. This chapter will identify the practical issues which arise from the application of the amended Income Tax Act.

The initial amendments made to the Pension Funds Act did not include a person's investment in a preservation fund. Further amendments were however made to the Pension Funds Act to include a person's interest in a preservation fund and will be addressed in **Chapter 5** of this technical report.

Due to the timing of the amendments made to the Income Tax Act, a situation has arisen where the member spouse who is party to a divorce is put in an unfair or inequitable position. This situation will only be applicable in cases where a divorce order has been granted before 13 September 2007. In **Chapter 6** this situation will be discussed along with possible solutions to this position.

In **Chapter 7** the author will look at considerations for financial planning which resulted from the amendments made to the various acts while **Chapter 8** will include references to

outstanding issues which have been highlighted by the assurance industry as a result of the application of the clean-break principle.

In **Chapter 9** a summary will be given in table format so that each aspect of the different tax regimes can be compared based upon the timing of the divorce order.

CHAPTER 2

History and case law that led to the amendments made to the Pension Funds Act

2.1 Introduction

In this chapter the amendment made to the Divorce Act during 1989 is discussed and also how the amendment affected the estate of a person who is a member of a pension fund in the case of a divorce.

As a member's pension fund interest is included in his/her estate at divorce due to the amendment made to the Divorce Act, the payment from the applicable funds was an issue which had not yet been addressed by the Pension Fund Act. A dispute has arisen with regards to the enforceability of a divorce order to pay proceeds from a pension fund which then led to some of the amendments made to sections 37D of the Pension Funds Act. The issue will be discussed with reference to the case of OLD MUTUAL LIFE ASSURANCE COMPANY (SA) LIMITED, SANLAM LIFE INSURANCE LIMITED AND WANDA SWEMMER (CASE NO: 02/03).

2.2 Legislative change made to the Divorce Amendment Act (1989)

Pension interest is defined by section 1 of the Divorce Act.

"Pension interest in relation to a party to a divorce action who-

- a) is a member of a pension fund excluding a retirement annuity fund), means the benefits to which that party as such a member would have been entitled in terms of the rules of that fund if his membership of the fund would have been terminated on the date of the divorce on account of his resignation from his office;*
- b) is a member of a retirement annuity fund which was bona fide established for the purpose of providing life annuities for the members of the fund, and which is a pension fund, means the total amount of that party's contributions to the fund up to the date of the divorce, together with a total amount of annual simple interest on those contributions up to that date, calculated at the same*

rate as the rate prescribed as at that date by the Minister of Justice in terms of section 1 (2) of the Prescribed Rate of Interest Act, 1975 (Act No. 55 of 1975), for the purposes of that Act;”²

Until 1989 the pension interest from an approved pension fund did not form part of the member’s assets at divorce. During 1989 the Divorce Act was amended with a deeming provision stating that such an interest will form part of a member’s assets on divorce.³

*“2. Section 7 of the Divorce Act, 1979, is hereby amended by the addition of the following subsections: (7)(a) In the determination of the patrimonial benefits to which the parties to any divorce action may be entitled, the pension interest of a party shall, subject to sections (b) and (c), be deemed to be part of his assets”.*⁴

The amendment was a deeming provision as it was recognised that no right to benefits from a fund accrues until the member leaves or retires from the fund.⁵

It was the legislator’s intention to increase the value of the member’s estate by the value of the pension interest. It was also the intention that, at division of the assets of the marriage, any distribution of assets, which the member was obliged to make to the non-member spouse, should be paid from the member’s actual assets. An additional mechanism was created in the case where a member could not satisfy such a payment from his/her current assets. The amended legislation provided the court with the power to order a retirement fund to note such a reward made to a non-member spouse against the records of the member-spouse. The fund was then ordered to make such a payment directly to the non-member spouse, but only when the benefits accrued to the member in terms of the fund rules.⁶

² Divorce Act No 70 of 1979

³ Gordon “*Did you know*” (6/2008) 1

⁴ Government Gazette No. 11741 (1989)

⁵ Gordon “*Pension Interests on divorce – An update*” (2008) 39

⁶ Gordon “*Pension Interests on divorce – An update*” (2008) 39

The amendment made to the Divorce Act did not provide for the following aspects:

- according to the fund's rules, the accrual of benefits to a member will only be at the date that the member resigns, retires or dies, and
- the non-member spouse was not entitled to any growth on the award from court order date until date of payment.⁷

2.3 Enforceability of order to pay proceeds of retirement funds/annuities, leading to the amendments made to section 37D of the Pension Funds Act

Before the introduction of the clean-break principle, which will be discussed in Chapter 3 in this technical report, and the relevant amendments made to section 37D of the Pension Funds Act, the enforceability of orders given to registered funds to make payments in terms of a divorce order, was under dispute by various life assurance companies.⁸

One of the court cases that gave effect to the changes to section 37D of the Pension Funds Act under which pension funds could be ordered to make payments to a non-member spouse before the benefits in terms of the fund accrued to the member on retirement, in terms of a divorce order, was the case of OLD MUTUAL LIFE ASSURANCE COMPANY (SA) LIMITED, SANLAM LIFE INSURANCE LIMITED AND WANDA SWEMMER, which was heard on appeal in the Supreme Court of Appeal of South Africa.

The plaintiffs in this case were Old Mutual Life Assurance Company (SA) Limited (Old Mutual) and Sanlam Life Insurance Limited (Sanlam) who were ordered to pay the proceeds of certain retirement annuities to the respondent (the plaintiff in the divorce proceedings).⁹ The main issue in their appeal was the “correctness and enforceability of an order made by the court granting a decree of divorce”.¹⁰

⁷ Gordon “*Pension Interests on divorce – An update*” (2008) 40

⁸ Old Mutual Life Assurance Company (SA) Ltd, Sanlam Life Insurance Ltd and Wanda Swemmer, February 2004 Case no 02/03 (SCA)

⁹ (1)

¹⁰ (2)

“Wanda Swemmer (respondent) was married in community of property. The respondent’s marriage was dissolved by a divorce order by the High Court on 20 September 2001. The divorce order included the following provisions:

7.1 Eiseres verkry as haar uitsluitlike eiendom die volgende langtermyn versekeringspolis:

<i>Old Mutual</i>	<i>8661813</i>	<i>Uittredingsannuïteit</i>
<i>Old Mutual</i>	<i>9523162</i>	<i>Uittredingsannuïteit</i>
<i>Sanlam</i>	<i>9047550x0</i>	<i>Uittredingsannuïteit”</i>

“The divorce order ordered the life assurance companies involved to pay the benefits from these policies on the earliest date that these amounts are allowed to be paid out, directly to the respondent (Wanda Swemmer).”¹¹

The respondent’s application in the High Court was successful, and the appellants were ordered to pay to the respondent the proceeds of the retirement annuity policies involved, in accordance with the divorce order. The judgement by Botha J in the High Court resulted in the appeal by Sanlam and Old Mutual.¹²

The appellants brought a counter application to set aside the sections in the divorce order which ordered them to pay the benefits from the policies to the respondent. They required the sections to be amended to state that the proceeds will be paid only when the benefits accrue to the member of the funds, Dr Swemmer. They also indicated that they are of the opinion that the court order made by the trial court was incorrect as it had the effect that Dr Swemmer was deprived of more than 50 percent of his ‘pension interest’ as defined in the Divorce Act, with regard to the relevant policies.¹³

The first appellant (Old Mutual) argued that both policies belonged to the South African Retirement Annuity Fund (SARAF), for which Old Mutual was the underwriter and the

¹¹ (2)

¹² (5)

¹³ (5)

administrator. Dr Swemmer was the assured in both of these policies. The date on which the proceeds under these policies would accrue to the assured in the normal course of business would be on the agreed retirement dates. These dates were set on 1 November 2007 and 1 May 2016 respectively. Dr Swemmer was however entitled to change such retirement dates to an earlier date on which he could call up the benefits under each policy upon reaching the age of fifty five (55).¹⁴

In the case of the second appellant (Sanlam), the situation was in line with that of the first appellant. Sanlam was the underwriter and administrator of the Professional Provident Society of South Africa ('the PPS Fund'). The PPS Fund was also the legal owner of the relevant policy in which Dr Swemmer was the assured. The terms of this policy also allowed Dr Swemmer to call up the benefits (i.e. retirement benefits) of this policy upon reaching age fifty five (55).¹⁵

Dr Swemmer turned 55 years on 2 December 2001, three years before the case went to court. As allowed by the divorce order, the respondent demanded that the life assurance companies involved pay the benefits under the retirement policies directly to her. The respondent pointed out that Dr Swemmer had already reached the age of 55, which is the minimum age upon which the benefits can be called up as an early retirement benefit.¹⁶

The respondent also pointed out that the divorce order awarded to her the sole ownership of the policies in question, and that she therefore had full rights of disposal over the policies. She also argued that her rights could only be limited contractually or by statutory limitations.¹⁷

The appellants' counter application stated that the divorce order was in conflict with the provisions of sections 7(7) and 7(8) of the Divorce Act 70 of 1979, when read together with section 37A of the Pension Funds Act. The appellants therefore argued that they were

¹⁴ (3)

¹⁵ (4)

¹⁶ (4)

¹⁷ (4)

prohibited by these statutory provisions to pay the proceeds of the policies to the respondent and to give effect to the divorce order in this regard.¹⁸

Section 37A(1) of the Pension Funds Act provided as follows:

*“Save to the extent permitted by this Act, the Income Tax Act, 1962 (Act No. 58 of 1962), and the Maintenance Act, 1988 [Act No. 99 of 1998], no benefit provided for in the rules of a registered fund (including an annuity purchased or to be purchased by the said fund from an insurer for a member), or right to such benefit, or right in respect of contributions **made by or on behalf of a member**, shall, notwithstanding anything to the contrary contained in the rules of such a fund, **be capable of being reduced, transferred or otherwise ceded, or of being pledged or hypothecated, or be liable to be attached or subjected to any form of execution under a judgment or order or a court of law....and in the event of the member or beneficiary concerned attempting to transfer or otherwise cede, or to pledge or hypothecate, such benefit or right, the fund concerned may withhold or suspend payment thereof: provided that the fund may pay any such benefit in pursuance of such contributions, or part thereof, to any one or more of the dependants of the member or beneficiary or to a guardian or trustee for the benefit of such dependant or dependants during such period as it may determine.**”¹⁹*

The sections above should be read along with sections 7(7) and 7(8) of the Divorce Amendment Act 7 of 1989 since its enactment. This legislation, which had a commencement date of 1 August 1989, resulted from recommendations made by the South African Law Commission (now known as the South African Law Reform Commission since 17 January 2003) in its “Report on the investigation into the possibility of making provision for a divorced woman to share in the pension benefits of her former husband Project”, October 1986.²⁰

¹⁸ (6)

¹⁹ (8)

²⁰ (9)

Section 7(7) and section 7(8) of the Divorce Act 7 of 1989 read as follows:

“(7) (a) In the determination of the patrimonial benefits to which the parties to any divorce action may be entitled, the **pension interest of a party shall, subject to sections (b) and (c), be deemed to be part of his assets.**

(b) The amount so deemed to be part of a party’s assets, shall be reduced by any amount of his pension interest which, by virtue of sections (a), in a previous divorce –

(i) was paid over or awarded to another party; or

(ii) for the purpose of an agreement contemplated in subsection (1), was accounted in favour of another party.

(8) Notwithstanding the provisions of any other law or of the rules of any pension fund –

(a) the court granting a decree of divorce in respect of a member of such a fund, may make an order that –

(i) any part of the pension interest of that member which, by virtue of subsection (7), is due or assigned to the other party to the divorce action concerned, shall be paid by that fund to that other party when any pension benefits accrue in respect of that member;

(ii) an endorsement be made in the records of that fund that that part of the pension interest concerned is so payable to that other party;

(b) any law, which applies in relation to the reduction, assignment, transfer, cession, pledge, hypothecation or attachment of the pension benefits, or any right in respect thereof, in that fund, shall apply mutatis mutandis with regard to the right of that other party in respect of that part of the pension interest concerned.”²¹

²¹ 9-10

The statutory restrictions placed on the respective life assurance companies in this regard were therefore, as quoted above, the following:

- the Pension Funds Act places a restriction on the appellants to transfer any money from a member's fund under a judgement or order of a court of law, including a divorce order;
- the Pension Funds Act allows the fund to withhold or suspend payment where a member attempts to transfer a benefit or right to benefits with regard to the relevant fund;
- the Divorce Act deems a pension interest to form part of his/her assets at divorce according to section 7(7)(a);
- the relevant funds will only be obliged to pay the benefits (pension interest) as awarded per the divorce order to the non-member when the benefits accrue in respect of the policy, to the member of the fund, which will only be at retirement date, or if the member so chooses to call up the benefits at age 55.

According to Van Heerden, A.J.A. the narrow definition of a 'pension interest' is as follows: "it simply establishes a method of ascertaining the value of the 'interest' of the member of the pension or retirement annuity fund concerned as accumulated up to the date of the divorce".²²

The South African Law Commission issued a report in 1995, which included the following note on "pension interest".²³

"A pension interest is not a real asset that is open to division. It is the value that, on the date of divorce, is placed on the interest that a party to those proceedings has in the pension benefits that will accrue to him or her as a member of a pension fund or retirement annuity fund at a certain future date or event in accordance with the rules of the particular fund. The value of the interest is calculated according to a fixed formula and the amount determined in this manner is deemed to be an asset of the party concerned. What we are dealing with here is a notional asset that is added to all the other assets of the party

²² (13)

²³ (13)

concerned in order to determine the extent of the other party's claim to a part of the first-mentioned party's assets."

Van Heerden, A.J.A. further agreed that the divorce order was in conflict with the provisions of sections 7(7) and 7(8) of the Divorce Act along with sections 37A of the Pension Funds Act due to the fact that the benefits had not yet accrued to Dr Swemmer. Therefore the funds could not be ordered to make any payment to the respondent according to the divorce order.²⁴

The appeal was therefore upheld.

2.4 Conclusion

Since 1989 the Divorce Act includes in a person's estate his pension interest, but legislation did not provide for the funds being paid to a non-member spouse at divorce. The enforceability of a divorce order against a fund was therefore questioned.

Since the ruling in the Swemmer case, an adjustment had been made to the Pension Funds Act to allow for the funds to pay to a non-member spouse as awarded in the divorce order. The non-member spouse does therefore not have to wait until the member spouse resigns from the fund for payment from the member's pension interest.

²⁴ (18)

CHAPTER 3

Section 37D of the Pension Funds Act and the “clean-break” principle

3.1 Introduction

Members’ pension fund interest was included in their estate at divorce after an amendment to the Divorce Act in 1989. The payments from the applicable funds were an issue as the funds were statutorily restricted from making such payments. In Chapter 2 of this technical report the author referred to the Swemmer case.

In the Swemmer case the respondent was denied any payment from the applicable funds as the respective life assurance companies were statutorily restricted from making such payments. The respondent therefore had to wait until the benefits accrue to Dr Swemmer before she could receive any payment from Dr Swemmer’s retirement funds.

The industry realised that a change was required to make provision for payments to a non-member spouse from a pension fund in the case of a divorce.

3.2 Amendments made to the Pension Funds Act

The amendment to section 37D of the Pension Funds Act was as follows:

“A registered fund may:

(d) deduct from a member’s benefit or minimum individual reserve, as the case may be any –

(i) amount assigned from such benefit or individual reserve to a non-member spouse or any other person in terms of a valid order made by a competent court; and

(ii) employees tax required to be deducted or withheld in terms of the Fourth Schedule to the Income Tax Act as a result of the deduction in sub-paragraph (i);

(e) for the purposes of section 7(8)(a) of the Divorce Act, 1979 (Act No. 70 of 1979), the pension benefit referred to in that section is deemed to accrue to the member on the date of the court order:

Provided that –

- (i) Such deduction shall be affected by the pension fund named in the order upon the receipt of the order;*
- (ii) Such deduction shall have the effect of reducing the accrued benefit at the date of such deduction;*
- (iii) The non-member spouse shall have the option to elect that the assigned amount be paid directly to him or her, or that it be transferred to an approved pension fund on his or her behalf, and such transfer or payment must take place within 60 days of such election having been exercised;*
- (iv) The non-member spouse or the other person shall not acquire the rights of a member or beneficiary in relation to the pension fund; and*
- (v) The non-member spouse or other person shall be entitled to the accrual of interest on the assigned amount at fund return from the expiry of the period referred to in subsection (iii) until payment or transfer thereof, but not to any further growth.”²⁵*

The amendment above came into effect on 13 September 2007.²⁶

The effect of the amendment above is that the fund is allowed to deduct on receipt of the divorce order from a member’s benefit not only the amount allocated to the non-member spouse but also the tax resulting from withdrawals from a retirement fund.²⁷

This amendment allowed for the “clean-break principle” to be applied with regards to the pension interest. Although there is no formal definition for this principle, the principle makes provision for a divorced spouse to gain immediate access to his/her share of the benefits from the ex-spouse’s pension interest.²⁸ The non-member spouse therefore does not have to wait until the benefits accrue to the member spouse for the non-member spouse to gain access to his/her share of the pension interest.

²⁵ Pension Funds Act No 24 of 1956

²⁶ Gordon “*Pension Interests on divorce – An update*” (2008) 40

²⁷ Gordon “*Pension Interests on divorce – An update*” (2008) 40

²⁸ Du Plessis “Clean break principle on divorce” <http://jmca.co.za/south-africa/newsletter-q2-2008/clean-break-principle-on-divorce.php> (accessed 13/05/2010)

Although the amendment came into operation on 13 September 2007, the Pension Funds Act did not state whether or not the amendment applied to a divorce order granted before 13 September 2007. Due to the lack of clarity two schools of thought arose in practice with regards to whether or not the amendment applied to a divorce order granted before 13 September 2007.²⁹

3.3 Two schools of thought

For a period, there were two schools of thought regarding whether or not the amendment applied to a divorce order granted before 13 September 2007. One school of thought argued that the amendment only applied to divorce orders granted on or after 13 September 2007, meaning that the amendment is applied prospectively. The second school argued a retrospective application, meaning that the application of the amendment includes divorce orders granted before 13 September 2007.³⁰

Pension funds applied their own opinion, but controversy arose after the ruling in *JC Cockroft v Mine Employees Pension Fund*³¹. In its ruling, the Pension Fund Adjudicator (PFA) held that it was the legislature's intention to rectify the previous unfair position in which non-member spouses found themselves. The PFA therefore held that the amendment should be applied retrospectively to existing divorce orders on 13 September 2007.³²

Since the ruling in *JC Cockroft v Mine Employees Pension Fund*, a number of funds have gained legal opinions arguing the contrary.³³

At that stage National Treasury indicated that the wording of the amendment would be clarified in the near future. Until such time, most funds decided not to make payments with regard to divorce orders granted prior to 13 September 2007.³⁴

²⁹ Gordon "Pension Interests on divorce – An update" (2008) 40

³⁰ Nkoana "Divorce, retrospectivity and the Pension Funds Act"
http://www.trms.co.za/News/OtherNews/2008/07/Pg%2012_Quarterly.pdf (accessed 15/05/2010)

³¹ *JC Cockroft v Mine Employees Pension Fund* 2008 Case No: PFA/GA/23285/2008/MD

³² Gordon "Pension Interests on divorce – An update" (2008) 40

³³ Gordon "Did you know" (6/2008) 2

The *unfair position* to which the PFA referred is because the Divorce Act and Pension Funds Act previously did not make provision for a non-member spouse to benefit from the growth (interest, dividends and capital growth) in the fund from the date of the divorce order until the benefits were paid out. These allocated amounts could only be paid out when they accrue to the member in terms of the fund rules.³⁵

3.4 Registered Pension Funds

A registered pension fund is defined in section (1) of the Pension Funds Act as a fund that is registered in terms of section 4 of the Pension Funds Act.

It is therefore important to note that some pension funds are not registered funds under the Pension Funds Act, which means that the amendment to section 37D of the Pension Funds Act have no impact on these funds. This also has the implication that the “clean-break principle” will therefore have no effect with regard to divorced members of these funds.

An example of such a fund is the Government Employees Pension Fund (GEPF). The GEPF is the largest pension fund administrator in Africa and the 21st largest pension fund in the world. The fund has approximately 1 100 000 contributing members and 330 000 pension recipients. The fund has more than R700 billion assets under management.³⁶

The GEPF is not registered under the Pension Funds Act as it operates under its own Act. It is the author’s opinion, that for the GEPF to be affected by the amendments made to both the Pension Funds Act and Income Tax Act in this regard, one of the following adjustments will have to be made by the legislature:

- The Divorce Act will have to be amended. The Divorce Act currently has the following definition of a pension fund:

³⁴ Gordon “Did you know” (6/2008) 2

³⁵ Gordon “Did you know” (6/2008) 2

³⁶ <http://www.gepf.co.za/> (accessed 17/11/2008)

“means a pension fund as defined in section 1 (1) of the Pension Funds Act, 1956 (Act No. 24 of 1956), irrespective of whether or not the provisions of that Act apply to the pension fund”

As noted earlier, the GEPF is not registered under sections 4 of the Pension Funds Act. Although the Divorce Act is applicable to pension funds that are not registered under section 4 of the Pension Funds Act, the Divorce Act does not contain the provisions of section 37D of the Pension Funds Act. The Divorce Act will therefore have to be amended to incorporate the provisions of section 37D of the Pension Funds Act to have an impact on the pension interests of a non-member spouse whose spouse is a member of the GEPF.

- The GEPF will have to be registered under the Pension Funds Act and become a “registered fund”, which will mean that the fund will have to adhere to section 37D of the Pension Funds Act.

- The rules of the Government Employees Fund Law will have to change. The trustees along with the members could call for a change in the fund’s rules issued in terms of the Government Employees Pension Fund Law. The rules could be adjusted to be in line with section 37D of the Pension Funds Act. It can therefore still give protection to the non-member spouses of its members without registering under section 4 of the Pension Fund Act.

The GEPF might in future be pressured by its members and the Department of Finance to either register under section 4 of the Pension Funds Act, or to amend the Government Employees Pension Fund Law. The reason for this statement is due to the fact that the amendments made to the Pension Fund Act are made to protect a non-member spouse in a divorce scenario while the spouses of members in the GEPF are currently not enjoying these measures of protection.

3.5 Conclusion

The effect of the amendment made to section 37D of the Pension Funds Act is that a fund registered under the Pension Fund Act must on receipt of the divorce order deduct from a member's benefit not only the amount allocated to the non-member spouse but also the tax resulting from withdrawals from a retirement fund.

The application of the amendment is only applicable to funds registered under section 4 of the Pension Funds Act. Therefore foreign funds and government funds are not affected by section 37D of the Pension Funds Act.

CHAPTER 4

Changes made to the Income Tax Act

4.1 Introduction

According to paragraph (e) of the definition of “gross income” in section 1 of the Income Tax Act an accrual from a pension fund should be included in a taxpayer’s taxable income. It is also stated in the same paragraph that retirement lump sum benefits are taxed according to the Second Schedule of the Income Tax Act.

Previously retirement lump sums were taxed at an average rate according to section 5(10) of the Income Tax Act. The ministry of finance has however proposed a progressive tax system which came into effect from 1 March 2009.

The payment of the tax from the member’s fund constitutes an additional accrual for income tax purposes which leads to a tax-on-tax situation which will be discussed.

4.2 Amendment required to the definition of gross income according to the Income Tax Act following the ruling in Income Tax Case No 1642 (6 and 26 March 1998)

The taxpayer and his wife, who had been married in community of property, entered into an agreement at divorce. The agreement awarded to the ex-wife 50% interest in pension fund rights of her husband on retirement from the applicable funds. The husband (taxpayer) left the services of his employer and withdrew from the relevant funds. The fund calculated, in terms of the divorce order, 50% of the pension interest at divorce date and paid the amount directly to the ex-wife. The Commissioner for Inland Revenue had included the ex-wife’s portion, which had been paid directly to her by the fund, in the taxpayer’s gross income. The sole issue to be determined by the court was whether the amount paid to the taxpayer’s ex-wife had been “received by” or had “accrued to” the husband in the relevant year of assessment.³⁷

³⁷ Income Tax Case No 1642 [1998] 60 SATC 541 (542)

The taxpayer and member of the fund argued that the amount paid to his ex-wife did not constitute “gross income” in his hands as defined in section (e) of the definition of gross income in section 1 of the Income Tax Act 58 of 1962.

The Income Tax Act provided the following:

The definition of “gross income” according to section 1 of the Income Tax Act reads as follows-

“‘gross income’ in relation to any year or period of assessment, means, in the case of any person, the total amount, in cash or otherwise, received by or accrued to or in favour of such person during such year or period of assessment from a source within or deemed to be within the Republic, excluding receipts or accruals of a capital nature, but including, without in any way limiting the scope of this definition, such amounts (whether of a capital nature or not) so received or accrued as described below, namely-

(e) any amount determined in accordance with the provisions of the Second Schedule in respect of lump sum benefits received by or accrued to such person from –

(i) Any fund which has in respect of the current or previous year of assessment been approved by the Commissioner, whether under this Act or any previous Income Tax Act, as a pension fund, provident fund or retirement annuity fund; or.... If such person was a member of such fund during any such year.....”³⁸

Paragraph 2 of the Second Schedule of the Income Tax Act provided –

“2. Subject to the provisions of paragraph 2A, the amount to be included in the gross income of any person in terms of paragraph (e) of the definition of ‘gross income’ in section 1 of this Act shall be the aggregate of the amounts received by or accrued to such person by way of lump sum benefits during any year of assessment from any pension funds, provident funds or retirement annuity funds, less the deductions permitted under the provisions of this Schedule.”³⁹

³⁸ Income Tax Act No. 58 of 1962

³⁹ Income Tax Act No. 58 of 1962

The court held as follows – ⁴⁰

- (i) That it was clear that the legislature envisaged in section 7(8) of the Divorce Act 70 of 1979 that when the member of a pension fund becomes entitled to his pension benefit, the fund concerned shall pay the amount due to the ‘other party’, being the non-member; the wording of section 7(8) makes it clear that the time when the other party must be paid is the time when the pension benefits accrue ‘in respect of’ as opposed to ‘accrued to’ the member.
- (ii) That the parties acquired separate estates upon their divorce and only as from that date did appellant’s ex-wife’s estate become the owner of a 50% share of the pension interest at the date of the divorce.
- (iii) That appellant’s entitlement to the benefits under the pension scheme came into existence when his membership of the C Pension Fund was terminated and it was upon that termination of his membership that a ‘money value’ could be attached to his rights and, as at that date, appellant no longer had any entitlement whatsoever to the 50% interest held by his ex-wife.
- (iv) That once a divorce order has been granted in terms whereof an interest in a pension fund has been awarded to another, that order has the effect of divesting his estate of any right that he may have had in respect of that portion of his pension interest so that it could no longer be deemed to be part of his or her assets
- (v) That accordingly, as from the date of divorce, appellant’s ex-wife became the owner of the pension interest and, that being so, it was untenable to argue that the benefits first accrued to the appellant and were then paid to his wife.
- (vi) That, accordingly, the amount of R7 151.74 accrued to appellant’s ex-wife.

The result was that the appeal was allowed and the Commissioner for Inland Revenue was directed to reduce the taxpayer’s gross income for the year of assessment.⁴¹

⁴⁰ Income Tax Case No 1642 [1998] 60 SATC 541 (544)

⁴¹ Income Tax Case No 1642 [1998] 60 SATC 541 (544)

The court said it was clear that, according to section 7(8) of the Divorce Act, that the time when the non-member spouse should be paid, is the time when the pension benefits accrue ‘in respect of’, as opposed to ‘accrued to’, the member. It was therefore evident that the meaning of ‘accrue’ had to be established within the present context.⁴²

The court then concluded in its ruling that an amount will only accrue once a person can claim a right that he can turn into money. From the date of divorce, the appellant’s ex-wife became the owner of a 50% share of the pension interest, and that the appellant’s entitlement under the pension fund only came into existence when his membership from the fund was terminated.⁴³

An amendment to paragraph (e) of the definition of gross income in section 1 of the Income Tax Act was therefore required to provide for the taxation of allocations made from pension funds in respect of a divorce order.

The result of the amendment was that any allocation or payment made to a non-member spouse from the member spouse’s pension interest would be included in the member’s gross income prior to the member having terminated his/her membership of the fund.

4.3 Section (e) of the “gross income” definition

Following the ruling in Income Tax Case 1642 an amendment was made to paragraph (e) of the definition of gross income in section 1 of the Income Tax Act.

Paragraph (e) of the definition of gross income in section 1 of the Income Tax Act:

“gross income, in relation to any year or period of assessment, means –

(e) any retirement fund lump sum benefit and any other amount determined in accordance with the provisions of the Second Schedule (other than any amount included under section (eA)).....

⁴² (547)

⁴³ (548)

(eA)(bb) ... Provided that where a court order granting a decree of divorce in respect of such member has made an order that any part of such amount shall be paid to the former spouse of such member, as provided for in section 7(8) of the Divorce Act, 1979, such part shall for the purposes of this section be deemed to be an amount converted for the benefit or ultimate benefit of such member;

*[Sub-para. (bb) substituted by s. 10(1)(i) of Act 53 of 1999 and amended by s. 17(1)(b) of Act 60 of 2001]*⁴⁴

According to paragraph (e) of the definition of gross income in section 1 of the Income Tax Act a lump sum benefit received by or accrued to a person because of his membership to a pension fund is included in the gross income of the taxpayer. An amount which is payable to the member's former spouse by means of a court order as provided for in section 7(8) of the Divorce Act is furthermore deemed to be included in the member's gross income.

4.4 Second Schedule to the Income Tax Act

Since the amendment made to paragraph (e) of the definition of gross income in 1999, awards made in terms of section 7(8) of the Divorce Act were taxed in terms of paragraph 2B of the Second Schedule of the Income Tax Act. Such an award is taxed in the hands of the member spouse when the pension interest accrued in respect of the member. Section 7(8) of the Divorce Act was problematic as the pension interest would only accrue when the member left the fund, which could be as late as when the member retires from the fund. A deeming provision was therefore included in paragraph 2B of the Second Schedule of the Income Tax Act.

Paragraph 2B of the Second Schedule to the Income Tax Act:

“2B For the purposes of paragraphs 2 and 2A, where a court has made an order that any part of the pension interest of a member of a pension fund, provident fund or retirement annuity fund shall be paid to the former spouse of that member, as provided for in the Divorce Act, 1979 (Act No. 70 of 1979), the amount of that part is, to the extent that that

⁴⁴ Income Tax Act No. 58 of 1962

amount is not deemed to have been received by or to have accrued to a person other than the member in terms of paragraph (2b), deemed to be an amount that accrues to that member on the date on which the pension interest, of which that amount forms part, accrues to that member: provided that so much of any tax payable as is due to the inclusion in the income of such person of any amount in accordance with the provision of this paragraph, may be recovered by such person from the former spouse to whom or in whose favour the part in question is paid or becomes payable.”⁴⁵

Paragraph 2B of the Second Schedule to the Income Tax Act was inserted into the Income Tax Act in 1999⁴⁶, and had the effect that an award made to a non-member spouse in terms of a divorce order, was taxed in the hands of the member spouse since 1999 when the award was paid or became payable to the non-member spouse.

Note that paragraph 2B is also applied to divorce orders made against non-registered funds, for example the GEPF which was discussed in Chapter 3.

As discussed in Chapter 3 of this technical report, the amendments made to the Pension Funds Act which came into operation on 13 September 2007, allowed for payments to be made from the pension funds of the member before the member retires from the pension funds.

A further amendment to the Second Schedule was therefore required to no longer tax the benefits allocated to the non-member spouse in the hands of the member spouse, but in the hands of the non-member spouse (refer to the following paragraph).

Paragraph 2(b) of the Second Schedule of The Income Tax Act included in the taxable income of a taxpayer all lump sum benefits as a withdrawal benefit. Included in paragraph 2(b) is an award made to a non-member spouse in terms of a divorce order, which is taxed in the hands of the non-member (according to the amendment in the following paragraphs made to the Second Schedule to the Income Tax Act).

⁴⁵ Income Tax Act No. 58 of 1962

⁴⁶ Income Tax Act No. 58 of 1962

“59. (1) Section 2 of the Second Schedule to the Income Tax Act, 1962, is hereby amended –

- (b) by the insertion in subparagraph (b) of the following items:*
 - (iA) the amount awarded to the person in terms of an order of divorce to the extent that the amount is payable by a pension fund, ...*
 - (iB) any amount that is transferred for the benefit of the person to any ... , which amount is deemed to have accrued to the person on the date of transfer;*
- (a) by the substitution in subsection (b) for item (ii) of the following item:*
 - (ii) (the aggregate of) any amounts, ... received by or accrued to such person during that year by way of lump sum benefits from or in consequence of membership or past membership of any pension fund ...*

(3) Subsection (1)(b), to the extent that it inserts item (iA) into section 2(b) of the Second Schedule to the Income Tax Act, 1962, comes into operation on 1 March 2009 and applies in respect of any lump sum benefit accrued on or after that date.”⁴⁷

The effect of this amendment is that awards made to a non-member spouse are taxed in the hands of the non-member spouse (as from 1 March 2009) before the member’s membership has been terminated in terms of the fund rules. The reason for this amendment is that the amount allocated may now, in terms of section 37D of the Pension Funds Act, be paid upon divorce instead of when a benefit accrues to the member.

This amendment further has the effect that paragraph 2(b) is not aligned with the amended section 37(D) of The Pension Fund Act as it deems the award to accrue on the date of payment or transfer, while section 37D of The Pension Fund Act deems the award and the tax to accrue to the member on date of divorce according to the court order.⁴⁸

Section 37D(1)(e)(iii) of the Pension Funds Act gives the non-member spouse the following option:

“(iii) The non-member spouse shall have the option to elect that the assigned amount be paid directly to him or her, or that it be transferred to an approved pension fund on his or

⁴⁷ Revenue Laws Amendment Act No. 60 of 2008

⁴⁸ Gordon “Did you know” (6/2008) 2

*her behalf, and such transfer or payment must take place within 60 days of such election having been exercised;*⁴⁹

Paragraph 2(b) of the Second Schedule to the Income Tax Act deems the accrual to be on the date that the option given by section 37D(1)(e)(iii) is exercised by the non-member spouse.⁵⁰

Sub paragraph 2 of paragraph 2 of the Second Schedule to the Income Tax Act:

"2) An amount contemplated in subparagraph (1)(b) shall be deemed to accrue to a person—

a) in the case of an amount contemplated in subparagraph (1)(b)(iA), on the date on which an election is made as contemplated in section 37D(1)(e)(iii) of the Pension Funds Act, 1956 (Act No. 24 of 1956),..."⁵¹

The difference in the date of accrual and the date of deduction will lead to a timing delay. This is seen as a positive as it will allow a fund time to process the divorce order before it is deemed to accrue for tax purposes.⁵²

Without this amended to section 2(b) of the Second Schedule to the Income Tax Act, which deems the award and the tax to accrue when the funds becomes payable, the fund would be unable to deduct the tax until the member's benefit accrues. The accrual of these benefits can be as late as the termination of the member spouse's membership from the fund.⁵³

Refer to section 4.5 of this technical report for an explanation on how the tax on the award is deducted and paid from the fund.

⁴⁹ Pension Funds Act No. 24 of 1956

⁵⁰ Revenue Laws Amendment Act No. 60 of 2008

⁵¹ Income Tax Act No. 58 of 1962

⁵² Gordon *"Did you know"* (6/2008) 4

⁵³ Gordon *"Did you know"* (6/2008) 4

4.5 Tax on award made to the non-member spouse

The Pension Fund Act makes provision for the deduction of employees' tax by the fund in terms of the Fourth Schedule to the Income Tax Act.

Section 37D of the Pension Funds Act:

"37D(d) deduct from a member's benefit or minimum individual reserve, as the case may be, any –

- (i) amount assigned from such benefit or individual reserve to a non-member spouse or any other person in terms of a valid order made by a competent court; and*
- (ii) employees' tax required to be deducted or withheld in terms of the Fourth Schedule to the Income Tax Act, 1962 (Act No. 58 of 1962), as a result of the deduction in subsection (i).*

[Para. (d) added by s. 28 of Act 11/2007 and substituted by s. 4 of Act 35/2007]."⁵⁴

The amount awarded to a non-member spouse will be taxed in the hands of the member according to paragraph 7 of the Second Schedule to the Income Tax Act in the case of a divorce order dated before 13 September 2007, as the amendments made to the Pension Funds Act came into effect on 13 September 2007 (refer to Chapter 3 of this technical report).

For awards made after 13 September 2007 but for which the non-member has not exercised the option according to section 37D(1)(e)(iii) by 28 February 2009, the non-member spouse will remain the taxpayer. This is due to the fact the accrual for tax purposes will only happen when the deduction or payment has been made from the member's fund.⁵⁵ Furthermore paragraph 2 deems the amount to accrue in the hands of the member spouse until 28 February 2009. Refer to section 4.4 of this technical report for the discussion on accrual for tax purposes.

⁵⁴ Pension Funds Act No. 24 of 1956

⁵⁵ Institute of Retirement Funds "Submissions for amendments to the Taxation Laws Amendment Bill of 2009" (2009) Annexure B

Likewise will the member spouse remain the taxpayer for an award made before 13 September 2007 for which the non-member spouse has exercised the option per section 37D(1)(e)(iii) before 1 March 2009.⁵⁶

The non-member spouse will be the taxpayer for all awards made on or after 1 March 2009.

The calculation of the tax amount will be done using section 5(10) in the Income Tax Act and R1 800 of the amount will be tax free (before 1 March 2009) as the amount is seen to be a lump sum that accrued to the member spouse during a particular year of assessment.

Note that the previous paragraph refers to paragraph 7 of the Second Schedule to the Income Tax Act. This paragraph has been repealed and therefore taxation at average tax rates no longer applies as from 1 March 2009. The repeal of paragraph 7 and the substitution of the average-tax-calculation, according to section 5(10), with a sliding scale will be discussed later in this chapter.

Before the lump sum (less the employee's tax according to the Fourth Schedule) is paid to the non-member spouse, the pension fund involved should get a directive from the South African Revenue Service (SARS). An amount equal to the calculated tax amount on the lump sum will then be deducted from the member spouse's benefit to enable the fund to pay the tax to SARS.⁵⁷

Until 1 March 2009 paragraph 7 of the Second Schedule to the Income Tax Act stated that lump sum benefits from early withdrawals are taxed according to section 5(10) of the Income Tax Act. The previous paragraph 7 of the Second Schedule to the Income Tax Act has been repealed by the Revenue Laws Amendment Act of 2008.

⁵⁶ Institute of Retirement Funds "Submissions for amendments to the Taxation Laws Amendment Bill of 2009" (2009) Annexure B

⁵⁷ Huxham & Haupt *Notes to South African Income Tax* (2008) 566

“65. (1) The Income Tax Act, 1962, is hereby amended by the repeal of paragraph 7 of the Second Schedule.”⁵⁸

The structure which was contained in the Revenue Laws Amendment Act 2009 is as follows:

- R0 – R22 500 to be taxed at 0%
- R22 501 – R600 000 – to be taxed at 18% of the amount above R22 500
- R600 001 – R900 000 – to be taxed at R103 950 + 27% of the amount above R600 000
- R900 001 and above – to be taxed at R184 950 + 36% of the amount above R900 000⁵⁹

It is important to note that these amounts are cumulative. The effect of these amounts being cumulative is that if a member is to withdraw R600 000 from one retirement fund, and there is another withdrawal of R250 000 three years later, the R250 000 will be taxed at 27%.⁶⁰

Due to the withdrawals being cumulative, a situation has arisen in which a member spouse will be treated unjustly in the scenario where a divorce order is issued before 13 September 2007, but for which the non-member has only made the selection according to section 37D(1)(e)(iii) of the Pension Fund Act, post 1 March 2009. This situation will be discussed in Chapter 6 in this technical report.

The tax table quoted above is also applicable to pension interest awards made in terms of a divorce order. Therefore, if in terms of a divorce order, a fund is ordered to pay to a non-member spouse a lump sum from the member spouse's minimum individual reserve, the rates quoted above will be applied to calculate the final tax on the early withdrawal from the pension fund.

⁵⁸ Revenue Laws Amendment Act No. 60 of 2008

⁵⁹ Duncan *“Death, Taxes and Trevor”* (2008) Money Web (1)

⁶⁰ Cameron *“Tax on retirement fund withdrawals changes again”* (2008) Personal Finance (2)

One of the effects of this adjustment is that the taxation of lump sums at early withdrawal will be treated more in line with the taxation on lump sums from retirement funds at death or retirement date. Lump sums at retirement or death received from retirement funds are currently taxed on a progressive system according to section 5(2) to the Income Tax Act. The rates used for this progressive taxation is found in paragraph 7 of Appendix 1 Part 1 to the Income Tax Act.⁶¹

- Not exceeding R300 000 – 0% of taxable income
- Exceeding R300 000 but not exceeding R600 000 – R0 plus 18% of the taxable income exceeding R300 000
- Exceeding R600 000 but not exceeding R900 000 – R54 000 plus 27% of the taxable income exceeding R600 000
- Exceeding R900 000 – R135 000 plus 36% of the taxable income exceeding R600 000⁶²

Therefore, if a non-member spouse has not yet retired, the table for early withdrawals will be applied for awards made after 1 March 2009. If the non-member spouse has indeed retired, the award will not be treated as an early withdrawal and accordingly the table contained in paragraph 7 of Appendix 1 Part 1 to the Income Tax Act will be applied.

4.6 Right of recovery

As explained in section 4.5 of this technical report, the tax on the award made to the non-member spouse is deducted and paid from the pension interest of the member spouse. The member spouse is placed in an unfair position as he/she is taxed on income which accrued to the non-member spouse.

Paragraph 2B of the Second Schedule to the Income Tax Act provides the member with a right of recovery on the tax that the member paid on behalf of the non-member spouse with regard to the award made to the non-member spouse.

⁶¹ Income Tax Act No. 58 of 1962

⁶² Income Tax Act No. 58 of 1962

“2B. ... : Provided that so much of any tax payable as is due to the inclusion in the income of such person of any amount in accordance with the provision of this section, may be recovered by such person from the former spouse to whom or in whose favour the part in question is paid or becomes payable.”⁶³

Paragraph 2(b) of the Second Schedule to the Income Tax Act provides for a similar right of recovery:

“Provided that so much of any tax payable as is due to the inclusion in the income of such person of any amount contemplated in this section pursuant to any order contemplated in section 7(8)(a) of the Divorce Act, 1979 (Act No. 70 of 1979), may, to the extent that tax is attributable to an amount contemplated in section 37D(1)(d)(i) of the Pension Funds Act, 1956 (Act No. 24 of 1956), be recovered by such person from the person to whom or in whose favour such amount is paid or payable;...”⁶⁴

The right of recovery, which is awarded to the non-member, raised three controversial issues, which are as follows:

- (1) In most cases a divorce order provides for all settlements to be full and final settlements between the parties involved. Thus, if a divorce order does not include a right of recovery, one can argue that it is contractually blocked.
- (2) The tax payable is deemed to be the liability of the member spouse, (which was the position for divorce orders granted before 01/03/2009). The member spouse is not acting as an agent (as defined in section 1 of The Income Tax Act) on behalf of the non-member spouse, and therefore there is no tax amount to recover.
- (3) It is understood that a tax statute regulates rights and responsibilities between the fiscus and a taxpayer, and it can therefore be argued that a tax statute is not empowered to regulate rights between taxpayers.⁶⁵

⁶³ Income Tax Act No. 58 of 1962

⁶⁴ Income Tax Act No. 58 of 1962

⁶⁵ Gordon *“Did you know”* (6/2008) 5

Specifically because of the first item identified above, clients should be advised to include such a full and final settlement within the settlement agreement. If such a settlement agreement is silent, the member spouse might not be able to recover the tax from the non-member spouse.

As the Divorce Act regulates the rights and responsibilities between the member and non-member spouse, it is the author's suggestion that the Divorce Act, 1979 (Act No 70 of 1979), should be amended to take into account the tax paid by the member spouse on the award made to the non-member spouse.

Alternatively section 37D of the Pension Funds Act could be amended. A proposed amendment could order the fund to calculate the tax payable and then make a deduction from the amount awarded to the non-member and allocate this amount to the member's individual reserve. The deduction will have to be made before any payment is made to the non-member spouse, as there would be no funds left for the deduction after the payment had been made to the non-member spouse or to a fund elected by the non-member spouse.

Note that the suggestion made above by the author, will only be applicable to divorce orders made before 1 March 2009. For divorce orders made on or after this date, the non-member spouse will be liable for his/her own taxes on the pension interest allocated to him/her (Refer to Chapter 4.3 in this technical report dealing with the amendments made to the Second Schedule of the Income Tax Act).

4.7 Amendment made to Paragraph 6 and Formula B (Second Schedule to the Income Tax Act)

4.7.1 Paragraph 6 of the Second Schedule to the Income Tax Act

The deductions allowed when calculating the taxable portion received from a retirement fund upon resignation or withdrawal is contained in paragraph 6 of the Second Schedule to the Income Tax Act.

Section 37D (1)(e) of the Pension Funds Act gives the non-member spouse the option to have the assigned amount transferred to an approved fund on his/her behalf. The member spouse's fund will have to make this transfer within 60 days after such an option has been exercised by the non-member spouse. The other option, which must also be given effect to within 60 days, will be to have the amount paid over directly to the non-member spouse.

Section 37D(1)(e) of the Pension Funds Act:

“37D(1)(e)

(iii) the non-member spouse shall have the option to elect that the assigned amount be paid directly to him or her, or that it be transferred to an approved pension fund on his or her behalf, and such transfer or payment must take place within 60 days of such election having been exercised;...”⁶⁶

Paragraph 6 had to be amended to allow for the transferred benefit to be tax free when a non-member spouse elects for the funds to be transferred to an approved retirement fund.

The adjustment to paragraph 6 of the Second Schedule to the Income Tax Act was amended by the Revenue Laws Amendment Act, 2008:

*“(1) Paragraph 6 of the Second Schedule of the Income Tax Act, 1962, is hereby amended -
(a) by the substitution for the words preceding subparagraph (a) of the following words:*

⁶⁶ Pension Funds Act No. 24 of 1956

“The deduction to be allowed in determining the amount required to be included in the taxpayer’s gross income for a year of assessment in terms of paragraph 2(b)(iA) and (ii) is the sum of the following amounts –“

(j) by the insertion of the following subparagraph after subparagraph (a):

(aA) any amount received by or accrued to the taxpayer as contemplated in paragraph 2(b)(iA) of this Schedule as is paid or transferred for the benefit of the taxpayer into any pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund;

(2) Subsection (1) is deemed to have come into operation on 1 March 2009 and applies in respect of an amount paid on or after that date.”⁶⁷

The introduction of section 6(aA) has the effect that the funds transferred will be transferred free of tax.

4.7.2 Formula B of the Second Schedule to the Income Tax Act

Formula B of the Second Schedule to the Income Tax Act is used to calculate the tax exempt portion of a lump sum received from a retirement fund of which the taxpayer is a member at death or retirement.

The amendment to paragraph 6 of the Second Schedule to the Income Tax Act came into operation on 1 March 2009. Therefore provision had to be made for a taxpayer who retires or withdraws funds which were previously taxed and transferred to a pension fund.

Symbol E of Formula B (according to section 1 of the Second Schedule) was amended to treat the previously taxed transfer benefit, which a non-member spouse transferred to an approved fund under the option given to the non-member spouse according to section 37D(1)(e) of the Pension Funds Act. The effect of this amendment is that such funds will be tax free on retirement or death.

⁶⁷ Revenue Laws Amendment Act No. 60 of 2008

The amended symbol E contained in paragraph 1 of the Second Schedule to the Income Tax Act and was amended by the Revenue Laws Amendment Act, 2008.

“58 1(d) by the insertion in paragraph (d) of the definition of “formula B” of the following subparagraphs:

(iA) any amount that is deemed to have accrued to the taxpayer as contemplated in paragraph 2(b)(iB);

(iB) any amount, to the extent that that amount was paid or transferred to a pension preservation fund or provident preservation fund as an unclaimed benefit as defined in section 1 of the Pension Funds Act, 1956 (Act No. 24 of 1956), and was subject to tax prior to that transfer or payment; ⁶⁸

Symbol E is therefore amended to recognise any amount previously transferred in terms of an election made under section 37D (1)(e)(iii) to be tax free upon retirement or death, and therefore recognises an award that has been paid over to an approved fund of which the non-member spouse has become a member.

The reason for this amendment was the fact that the amount received by the non-member spouse had already been taxed when the funds were transferred from the pension fund of the member spouse. Taxing this amount at withdrawal again, will have the effect of double tax being paid on the amount received by the non-member spouse.

Note that this will only be applicable for accruals before 1 March 2009 as paragraph 6 of the Second Schedule to the Income Tax Act was amended to provide for transfers to a approved retirement fund for accruals on or after 1 March 2009 as discussed in section 4.7.1 of this technical working paper.

⁶⁸ Revenue Laws Amendment Act No. 60 of 2008

4.8 “Tax on tax” issue arising from amendment

The award made to the non-member spouse will be taxed in the hands of either the member spouse or the non-member spouse for normal tax purposes depending on the date of the divorce order. Furthermore, the fund is obliged to withhold and pay tax to SARS according to the Fourth Schedule as instructed by section 37D(d) of the Pension Funds Act. Section 37D of the Pension Funds Act reads as follows:

“37D(d) ...deduct from a member’s benefit or minimum individual reserve, as the case may be, any -

- (i) amount assigned from such benefit or individual reserve to a non-member spouse or any other person in terms of a valid order made by a competent court; and*
- (ii) employees’ tax required to be deducted or withheld in terms of the Fourth Schedule to the Income Tax Act, 1962 (Act No. 58 of 1962), as a result of the deduction in subsection (i);*

[Para. (d) added by s. 28 of Act 11/2007 and substituted by s. 4 of Act 35/2007]”⁶⁹

The tax payable must also be deducted from the member’s benefit/reserve and constitutes an accrual of additional lump sum benefits according to the Income Tax Act, which will again be taxable.

This lump sum benefit accrues to the member in terms of provisions contained in paragraph 2(b) in the Second Schedule of the Income Tax Act.

2. Subject to the provisions ... the amount to be included in the gross income of any person for any year of assessment in terms of section (e) of the definition of “gross income” in section 1 of this Act shall be –

- (b) 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 Pension Funds Act, 1956, which aggregate amount shall be deemed to be a lump sum benefit received by or accrued to such person ...”⁷⁰*

⁶⁹ Pension Funds Act No. 24 of 1956

⁷⁰ Income Tax Act No. 58 of 1962

Therefore a “domino” principle arises that will have the effect that the fund has to pay tax on the amount it had to withhold to pay the original tax on the award and so on. The effect is therefore that the tax payable by the fund is more than just the tax payable on the award itself.⁷¹

SARS has issued General Note GN33. This General Note contains a formula which will be used to calculate the total tax liability to stop the domino effect created.

The calculation of the employees’ tax (PAYE), which is to be deducted from the member’s individual reserve, is not an exact calculation. The member’s effective tax rate will have an effect on the calculation according to section 5(10) (refer to next section for divorce orders after 1 March 2009). Note that the effective tax rate might be different on the date of assessment versus the date on which the tax directive was issued by SARS. The difference in the two effective tax rates will be due to the level and amount of information made available to SARS at the date of the tax directive. The member should therefore note that the final tax liability can only be determined at assessment. The amount due to SARS might be different from the amount of employees’ tax deducted, which might lead to an additional amount due to SARS or an amount refundable SARS to the member spouse.⁷²

Note that using the average tax rate according to section 5(10) will not be applicable to divorce orders made on or after 1 March 2009. Refer to Chapter 4 of this technical report for the introduction of the sliding scale for divorce orders made on or after 1 March 2009.

As noted previously, where the member is liable for the tax on the amount awarded to the spouse, the employees’ tax deducted by the fund from the member’s individual reserve constitutes an additional accrual for income tax purposes.

The additional lump sum benefit, which is in value equal to the employees’ tax paid on the amount of the court order, will require that an additional application for a tax directive should be made to SARS. Ordinarily, such a tax-on-tax effect will have the effect that the

⁷¹ Gordon “*Did you know*” (6/2008) 4

⁷² General Note GN 33, South African Revenue Service

fund administrator would have to apply for an additional tax directive for each layer of additional tax. In GN33, SARS has come up with a formula to determine the additional amount in respect of which another application for a tax directive should be made by the fund administrator to SARS.⁷³

$$X = A/C \times B$$

X = represents the amount for which an additional tax directive must be applied for

A = the tax deductible according to the first tax directive

B = 100

C = 100 minus the member's effective rate* as determined by the first tax directive

*the effective rate = PAYE according to first directive divided by the amount of the order of court

GN33 also provides the following example:

The amount payable to the non-member spouse in terms of a court order is R50 000. As determined by the tax directive received by the fund from SARS, the PAYE on this amount is R15 000. The effective rate of tax as determined by SARS in respect of the member is therefore 30% (R15 000/R50 000).

The additional amount, which has to be deducted from the member's minimum individual reserve, will cover both the R15 000 and the additional lump sum benefits caused by the tax-on-tax effect. The additional amount will be calculated as follows:

$$A = R15\ 000$$

$$B = 100$$

$$C = 100 - 30$$

$$X = R15\ 000/70 \times 100$$

$$X = R21\ 428$$

⁷³ General Note GN 33, South African Revenue Service

The fund administrator will therefore apply for an additional tax directive on the amount of R21 428. If the taxpayer's average tax rate does not change from the initial tax directive application, the tax directive received back from SARS will be for R6 428 on the R15 000.

The PAYE of R6 428 plus the initial PAYE of R15 000 will then add up to R21 428. The total amount to be deducted by the fund from the member's minimum individual reserve will therefore be R71 428 (R50 000 + R21 428).⁷⁴

Note that the example given in GN33 still applies an average tax rate while lump sum benefits are taxed according to a sliding scale from 1 March 2009.

4.9 Tax-on-tax situation when paragraph 2B is applicable

Section 2B of the Second Schedule will be applicable in situations where section 2(b) does not apply. Therefore section 2B will be applied in situations originating from a divorce order as initiated by the Divorce Act, 1979, but only to the extent that the amount is not attributable to an amount as contemplated in section 37D(1)(d)(i) of the Pension Funds Act, 1979 (refer to section 4.3 of this technical report). Section 2B will therefore be applied, but not limited to, in the following scenarios:

1. in a case where a divorce order is made against a non-registered fund, for example the GEPF (as the GEPF are not affected by the rulings of the Pension Funds Act), and
2. the election by the non-member spouse is made on or after the date when benefits accrue to the member according to the fund rules.

The question that arises is whether there will still be a tax-on-tax situation as discussed in the previous section.

⁷⁴ General Note GN 33, South African Revenue Service

Refer to the following two scenarios and the discussion on whether the tax-on-tax situation will be applied in each of these situations.

4.9.1 Scenario 1

As noted earlier, the GEPF is not a registered fund according to section 4 of the Pension Funds Act. The fund is therefore not bound by section 37D of the Pension Funds Act, which permits registered funds to deduct and pay an amount from the member's individual reserve due to a non-member spouse before any benefit accrues. Without such a deduction there is no accrual that will have the effect that no PAYE will be payable on the amount awarded until such time as a benefit accrues.

While not being bound to section 37D of the Pension Fund Act, the GEPF is also not bound by section 37D(ii) of the Pension Fund Act, which permits a registered fund to deduct PAYE tax (on a divorce award paid before a benefit accrued) and pay over to SARS according to the Fourth Schedule of the Income Tax Act. With no deduction of additional funds there will be no additional accrual as defined, to the member. With no additional accrual, there will be no further PAYE element having the effect that the domino effect, which was referred to earlier, is not created and the tax-on-tax issue is therefore not applicable to the GEPF.

4.9.2 Scenario 2

Section 37D(1)(e)(iii) gives the non-member spouse the following option:

"37D 1(e)(iii)

the non-member spouse shall have the option to elect that the assigned amount be paid directly to him or her, or that it be transferred to an approved pension fund on his or her behalf, and such transfer or payment must take place within 60 days of such election having been exercised;..."⁷⁵

⁷⁵ Pension Funds Act No. 24 of 1956

The non-member could however decide to exercise the option rendered by section 37D1(e) of the Pension Funds Act after the member's benefit accrued to him by way of termination of membership from the fund. The member's membership can be terminated by resigning, death or retirement.

In each of these cases the member's minimum benefit will be paid to him or his estate. It is the author's opinion that the tax-on-tax situation will not be applicable as the full benefit (including the divorce award) has in any event already accrued on the day that the member spouse's membership was terminated and paid to him or his estate.

A further question that arises from the section above is whether GN33 should be applied in scenarios as described above. GN33 was introduced by SARS to stop the domino effect in situations where a tax-on-tax scenario arises. GN33 states that the purpose of the practice note is to calculate the additional tax arising from the domino effect. In the scenarios sketched above, there is no domino effect created.

If GN33 was to be applied, the effect will merely be a timing of cash flow on the taxpayer as the total tax payable will still be calculated by the sliding scale introduced by Minister Trevor Manuel.

If SARS is of the opinion that GN33 should be applied, and there are no funds from which the fund can make a deduction to pay the additional PAYE, it will be up to the member to make the PAYE payment to SARS.

Alternatively the fund could pay the PAYE to SARS, and try to recover the amount paid from the member, which might be problematic as the member might no longer be a member of the fund.

Although GN33 is silent on scenarios such as these, it is the author's opinion that GN33 will not have to be applied in these circumstances as there is no tax-on-tax issue.

4.10 Conclusion

The effect of the amendment to the Second Schedule to the Income Tax Act is that the new awards made to a non-member spouse will be taxed even before the member's membership has been terminated in terms of the fund rules. The date of accrual for tax purposes is the date the deduction or payment is made from the fund.

The member will remain the taxpayer for divorce awards made before 13 September 2007. For awards made after 13 September 2007 and before 1 March 2009, the member will remain the taxpayer if the award accrues before 1 March 2009 (thus if the non-member makes selection in terms of section 37D(1)(e) of the Pension Funds Act. The non-member spouse will be the taxpayer for all awards made in terms of a divorce order on or after 1 March 2009.

Schedule 2 to the Income Tax Act does provide the member spouse with a right of recovery, but this right can be limited for a number of reasons as discussed.

Paragraph 6 of the Second Schedule to the Income Tax was amended to take into account transfers made to other retirement funds. Formula B was also amended to take into account funds withdrawn after retirement which were previously subject to tax.

A tax-on-tax scenario came into existence due to the fact that the payment of the tax from the fund constitutes an additional accrual for tax purposes. The South African Revenue Service has issued General Note 33 to deal with this situation.

CHAPTER 5

Preservation funds

5.1 Introduction

When a non-member spouse is awarded funds from a member's pension fund in terms of a divorce order, the non-member spouse can choose to preserve these funds awarded for retirement by transferring the funds to a preservation fund and not have the funds paid in cash to him/her.

In Chapter 5 of this technical report the author will refer to the instances in which a preservation fund might be used and the technicalities involved with making payments from such a preservation fund when the interest in a preservation fund is included in a member's pension interest at divorce.

5.2 Preservation provident funds and preservation pension funds

A preservation fund is a pension or provident fund that has been registered with the Registrar of Pension funds and approved by SARS as a pension or provident fund (this immediately disqualifies any transfers to a preservation fund from a foreign retirement fund as a foreign funds are not registered with the Registrar of Pension funds and are not approved by SARS). This type of fund is a fund in which employees, who have left the service of their employer by way of dismissal, retrenchment or resignation, may invest their accrued fund benefits. A preservation fund may also be utilised in a case where an employer's pension or provident fund dissolves.⁷⁶

See the section below for the definition of a preservation fund according to SARS Practice Note RF 1/98.

"By preservation pension and provident funds is understood vehicles for the preservation of retirement benefits of employees who cease to be members of an

⁷⁶ "Resigned or retrenched", <http://www.jefc.co.za/Preservation-Funds.htm> (accessed 29/06/2009)

approved pension or provident fund in which the member's employer participates [hereinafter referred to as an employer fund (other than a preservation fund)] as a result of resignation from employment, retrenchment or dismissal from employment or the winding up of such a fund.”⁷⁷

Preservation funds are governed and sanctioned by the South African Revenue Service in the form of a practice note instead of formal legislation.⁷⁸

5.3 Transfers to a preservation fund

During 2008 the Income Tax Act was amended to allow for a non-member spouse to transfer pension interest awards made in terms of a divorce order to a pension preservation fund.⁷⁹

The member spouse may also elect to transfer his/her benefits to a preservation fund. The member's full benefit in the transferring fund must be transferred to the preservation fund, except where the benefits have been reduced as a result of:

1. the provisions of section 37D of the Pension Funds Act, or
2. the member transfers a portion to a retirement annuity fund, or
3. the payment of a portion to a non-member in terms of a divorce order, or in terms of a maintenance order.⁸⁰

The transfer to a preservation fund by the member spouse are prohibited if the gross benefits have been reduced for a reason other than the reasons mentioned in the previous section.⁸¹

⁷⁷ "SARS Practice Note RF 1/98" http://libcorpben.co.za/legal/sars/rfl_98.html (accessed 10/11/2008)

⁷⁸ Gordon "Did you know" (8/2008) 3

⁷⁹ Gordon "Did you know" (8/2008) 3

⁸⁰ "Resigned or retrenched", <http://www.jefc.co.za/Preservation-Funds.htm> (accessed 29/06/2009)

⁸¹ "Resigned or retrenched", <http://www.jefc.co.za/Preservation-Funds.htm> (accessed 29/06/2009)

5.4 Payments from a preservation fund

Prior to 1 November 2008 pension interest was not recorded in respect of preservation funds. Pension interest with regard to a pension fund is defined in the Divorce Act as benefits to which the member would have been entitled in terms of the rules of the fund if his membership of the fund would have been terminated on the date divorce due to his resignation.⁸²

Due to the amendment to the Pension Funds Act it is now stated that, despite the definition of pension interest in section 1(1) of the Divorce Act, the portion of a member's pension interest in the case of a member of a preservation fund that is assigned to a non-member spouse, refers to the equivalent portion of the benefits to which that member would have been entitled in terms of the rules of the fund if his or her membership terminated on the date on which the decree of divorce was granted.⁸³

Section 37D(6) of the Pension Funds Act reads as follows:

“37D (6) Despite sections (b) of the definition of “pension interest” in section 1 (1) of the Divorce Act, 1979, the portion of the pension interest of a member of a pension preservation fund or provident preservation fund (as defined in the Income Tax Act, 1962), that is assigned to a non-member spouse, refers to the equivalent portion of the benefits to which that member would have been entitled to in terms of the rules of the fund if his or her membership of the fund terminated on the date on which the decree was granted.

[S. 37D inserted by s. 14 of Act No. 94 of 1977 and amended by s. 4 (b) of Act No. 65 of 2001. Sub-s. (6) added by s. 16 (c) of Act No. 22 of 2008.]⁸⁴

It is therefore now possible to obtain a court order as contemplated in section 7(8) of the Divorce Act, against a preservation fund when the member spouse has a pension interest

⁸² Bronn “Divorce orders granted against retirement funds” Legal Matters Glacier by Sanlam (11 December 2008) Volume 7: 2

⁸³ Bronn “Divorce orders granted against retirement funds” Legal Matters Glacier by Sanlam (11 December 2008) Volume 7: 2

⁸⁴ Pension Funds Act No. 24 of 1956

in a preservation fund of which part is allocated to the non-member spouse. Before the amendments to the Pension Fund Act, this was not possible as the pension interest was only linked to a resignation benefit, which is not applicable in a preservation fund.⁸⁵

Paragraph 5 of practice note RF1/98 allows for only one withdrawal benefit to be paid by a preservation fund and the investment in the fund will be regarded as paid up after the withdrawal. It is stated in paragraph 5 that any amount deducted from the benefit (excluding a transfer to a retirement annuity fund), also including deductions made in terms of section 37D of the Pension Funds Act, will be regarded as the member's first and final withdrawal.⁸⁶ An amendment was however issued during 2008 in the form of addendum D to RF 1/98.

Addendum D to RF 1/98 was issued by SARS on 08 March 2008. The amendment made was as follows:

“Deductions from a member's minimum individual reserve as defined for purposes of section 37D of the Pension Funds Act are not regarded as the member's first and final withdrawal benefit from the preservation fund.”⁸⁷

The effect of this amendment is that deductions from a member's individual reserve in the form of divorce orders or maintenance orders will not be seen as a first and final withdrawal benefit. The member will therefore still be allowed to make an one-off withdrawal from the preservation fund in the future.

5.5 Conclusion

A member's interest in a pension preservation fund and a provident preservation fund is now included in the member's pension interest at divorce. The payment from a preservation fund is allowed and is not seen as the member's first and final withdrawal from the fund.

⁸⁵ Swanepoel “Changes to the Pension Funds Act” Legal Focus (30/09/2008) Number 99: 3

⁸⁶ “SARS Practice Note RF 1/98” http://libcorpben.co.za/legal/sars/rfl_98.html (accessed 10/11/2008)

⁸⁷ “Addendum D to Retirement Fund Practice Note RF 1/98” http://libcorpben.co.za/legal/sars/rfl_98a.html (accessed 10/11/2008)

The non-member is also allowed to transfer his/her portion of the member's pension interest to a preservation fund.

CHAPTER 6

Inequitable position of the member

6.1 Introduction

Due to the changes made to the Income Tax Act with regard to the application of the new tax tables rather than an average tax rate (as discussed in Chapter 4 of this technical report), the definition of accrual dates for tax purposes and the change in taxpayer from the member to the non-member, a situation arose in which the member spouse is put in an unfair position.

In a submission made by the Legal and Technical Committee of the Institute of Retirement Funds (IRF) to the South African Revenue Service, reference is made to this situation where the member spouse suffers prejudice as a result of an action or situation over which he or she has no control.

6.2 Awards made in terms of a divorce order before 13 September 2007

In a situation where a divorce award was made before 13 September 2007, the date of the accrual for tax purposes will be determined by the date on which the non-member spouse elected to put in a claim against the fund (according to the option granted by section 37D(1)(e) of the Pension Funds Act).⁸⁸

The member of the pension fund remains to be the taxpayer for divorce orders made before 13 September 2007 as discussed in Chapter 4 of this technical report.

Should the date of the election be **before or on 28 February 2009**, the member will pay tax on the award made to the non-member spouse at the member's average tax rate according to section 5(10) of the Income Tax Act.⁸⁹

⁸⁸ Institute of Retirement Funds "Submissions for amendments to the Taxation Laws Amendment Bill of 2009" (2009) Annexure B: 1

⁸⁹ Institute of Retirement Funds "Submissions for amendments to the Taxation Laws Amendment Bill of 2009" (2009) Annexure B: 2

Should the non-member exercise his/her right of election **on or after 1 March 2009**, the amount will still accrue to the member spouse for income tax purposes. The member spouse will therefore be taxed according to the new withdrawal table according to paragraph 7 of Appendix 1 to the Income Tax Act as the member spouse remains the tax-paying member (for divorce orders made before 13 September 2007).⁹⁰

All retirement fund lump sum withdrawal benefits plus all retirement fund lump sum benefits that accrued on or after 1 March 2009 must be aggregated for the purposes of paragraph 7 of Appendix 1 to the Income Tax Act.⁹¹

Any amount therefore allocated to a non-member spouse from the pension interest of the member spouse will cause the member to lose out on part or all of his/her R300 000 tax free benefit as provided for by paragraph 7 of Appendix 1 to the Income Tax Act.

The member could therefore pay tax of 36% if a award of R900,000 or more has been made to the non-member spouse. The member could therefore pay additional tax of R189,000 if he withdraws R900,000 after retirement if R900,000 or more has already been allocated to the non-member spouse.

- Tax on R900,000 (no award made to non-member spouse): R135,000
- Tax on R900,000 retirement lump sum (R900,000 allocated to non-member spouse): R324,000
- Difference: R189,000⁹²

Neither the Divorce Act nor the Income Tax Act permits the tax-paying member spouse to recoup this amount from the non-member spouse.

It is the author's opinion that the delay of the claim by the non-member spouse to after 1 March 2009 may be caused by the following reasons (but not limited to):

⁹⁰ Institute of Retirement Funds "Submissions for amendments to the Taxation Laws Amendment Bill of 2009" (2009) Annexure B: 2

⁹¹ Institute of Retirement Funds "Submissions for amendments to the Taxation Laws Amendment Bill of 2009" (2009) Annexure B: 2

⁹² Calculated by using the tax tables according to paragraph 7 of Appendix 1 to the Income Tax Act No. 58 of 1962

- 1) The non-member spouse is ignorant of new developments in tax law and regulations, or
- 2) the non-member spouse is ignorant of his/her rights in terms of a divorce order, or
- 3) the non-member spouse is not aware of the member's membership to a retirement fund, or
- 4) the non-member spouse's advisor/attorney is unaware of the rights, given by the Pension Funds Act of the non-member spouse, or
- 5) in the scenario where a non-member spouse is aware of this situation, the non-member spouse might act with ill intent towards a member spouse and intentionally delay his/her claim against the fund to on or after 1 March 2009.

When calculating the tax liability upon retirement, the accumulated withdrawals made before retirement will also be added to the lump sum upon retirement date. It is the author's opinion that the legislator intentionally drafted the Act as such, as a disincentive for early withdrawals from funds saved for retirement.

The IRF noted in its submission that a divorce award is not a voluntary act of early withdrawal, but that the member's fund is obliged by law (section 37D of the Pension Funds Act) to pay the award in terms of the divorce order to the non-member spouse before retirement of the member spouse. The payment to the non-member spouse is taxed in the hands of the member but it should not prejudice the member's bona fide retirement provisions by reducing his/her more generous tax concessions at retirement.⁹³

The IRF further noted that the majority of divorce awards issued before 13 September 2007 fall within the category of claims made on or after 1 March 2009 because most non-member spouses have not yet enforced their right to claim. Therefore there will be a large number of member spouses whose retirement provision will be negatively affected if the legislator does not amend the current Act.⁹⁴

⁹³ Institute of Retirement Funds "Submissions for amendments to the Taxation Laws Amendment Bill of 2009" (2009) Annexure B: 3

⁹⁴ Institute of Retirement Funds "Submissions for amendments to the Taxation Laws Amendment Bill of 2009" (2009) Annexure B: 3

6.3 Illustrations made by the IRF

The IRF included three examples to illustrate how this situation will impact the member spouse. Find below the examples in table format. The illustrations have been adjusted for comparability.

The facts for the different scenarios are as follows:

- Mr and Mrs A were divorced with a pension interest of R2m.
- Mr A is the member of a retirement fund from which an award was made to Mrs A of R900 000.
- Mr A retired on 01 May 2009 and took R300 000 cash from his retirement fund.
- Average tax rate of member spouse for scenario 2 is 25%.
- Mrs A also had a retirement fund of her own to the value of R400 000 from which she retired on 01 May 2009 (post 1 March 2009)

Table 6.3.1 – Illustrations by the IRF

	Scenario 1	Scenario 2	Scenario 3
Divorce date	03 March 2009 (on or after 1 March 2009)	01 September 2007 (before 13 September 2007)	01 September 2007 (before 13 September 2007)
Election date by non-member spouse	10 March 2009	20 February 2009 (before 1 March 2009)	20 March 2009 (on or after 1 March 2009)
Tax by member on award	R0	R321 428 (R900 000 @ 25% + tax-on-tax of R96 428)	R288 984 (R184 950 according to table + tax-on-tax of R104 034)
Tax by non-member on award	R184 950 (according to tax table for early withdrawals from retirement)	R0	R0

	funds)		
Tax by member on cash withdrawal by member after retirement date from retirement fund (due to aggregation principle)	R0	R0	R108 000 (R300 000 x 36%) First R900 000 allocated to non-member spouse. Any amount exceeding R900 000 taxed at 36% according to paragraph 7 of Appendix 1 to the Income Tax Act.
Recover from non-member according to paragraph 2(b) of the Second Schedule	R0	(R321 428)	(R288 984)
Nett effect on member	R0	R0	R108 000

⁹⁵

6.4 Suggested solutions

The IRF proposed two suggested amendments to the Income Tax Act that will rectify the current situation.

Paragraphs 5 and 6 of the Second Schedule of the Income Tax Act could be amended to provide for a deduction.

“A deduction can be provided in both paragraphs 5 and 6 of the Second Schedule for any amount assigned to a non-member spouse and accruing to the taxpayer as the member of the fund under paragraph 2(b)(iA)(AA) or 2B of the Second Schedule.”⁹⁶

⁹⁵ Institute of Retirement Funds “Submissions for amendments to the Taxation Laws Amendment Bill of 2009” (2009) Annexure B: 5

Paragraph 5 of the Second Schedule is applied and used to calculate the tax exempt portion when benefits accrue to a member upon retirement and when benefits are deemed to have accrued immediately prior to the taxpayer's death.⁹⁷

Paragraph 5 of the Second Schedule currently reads as follows:

"5 (1) The deduction to be allowed for purposes of paragraph 2(a) shall be an amount (not exceeding the aggregate value of the lump sum benefits derived during that year in consequence of or following upon the taxpayer's retirement or death) equal to the amount determined in accordance with formula B;..."⁹⁸

Symbol E in formula B of the Second Schedule to the Income Tax Act has already been adjusted as noted earlier, but only as far as the non-member's transfer to an approved fund according to the non-member's election made according to section 37D(1)(e) of the Pension Funds Act. The only effect of the amended symbol E is that the non-member's benefit will be tax free at retirement for money transferred due to a divorce order. The adjustment does not affect the member as far as transfers have been made to a non-member who was previously taxed in the hands of the member.

An amendment could be made to symbol E of formula B to include such a deduction for the benefit of the member spouse.

Paragraph 6 of the Second Schedule to the Income Tax Act applies in the case where the member makes an early withdrawal from his/her retirement fund or resigns from a retirement fund.

Paragraph 6 has already been amended, but again only as far as it concerns the allocation made to the non-member, which was transferred to an approved fund.

Note that it is important to make this adjustment to both paragraphs 5 and 6 as paragraph 5 and 6 are applied in different scenarios.

⁹⁶ Institute of Retirement Funds "Submissions for amendments to the Taxation Laws Amendment Bill of 2009" (2009) Annexure B: 8

⁹⁷ Income Tax Act No. 58 of 1962

⁹⁸ Income Tax Act No. 58 of 1962

A further proposal made by the IRF is to amend paragraph 10(a)(i) of Appendix 1 to the Taxation Laws Amendment Bill of 2009. See the sections in bold writing below for the proposed amendments.

“10. (a)(i) If a retirement fund lump sum withdrawal benefit accrues to a person in any year of assessment commencing on or after 1 March 2009, the rate of tax referred to in section 7(1) of this Act to be levied on that person in respect of taxable income comprising the aggregate of –

(aa) ...

*(bb) retirement fund lump sum withdrawal benefits received by or accrued to that person on or after 1 March 2009 and prior to the accrual of the retirement fund lump sum withdrawal benefit contemplated in sub –item (aa), **excluding amounts which accrue in terms of sections 2(b)((iA)(AA) and sections 2B of the Second Schedule** is set out in the table below...*

(ii) The amount of tax levied in terms of item (i) must be reduced by an amount equal to the tax that would be leviable on the person in terms of that item in respect of taxable income comprising the aggregate of –

*(aa) retirement fund lump sum withdrawal benefits, received by or accrued to that person on or after 1 March 2009 and prior to the accrual of the retirement fund lump sum withdrawal benefit contemplated in sub-item (i)(aa), **excluding amounts which accrue in terms of paragraph 2(b)((iA)(AA) and paragraph 2B of the Second Schedule**;...*

(bb)...

(b)(i) If a retirement fund lump sum benefit accrues to a person in any year of assessment commencing on or after 1 March 2009, the rate of tax referred to in section 7(1) of this Act to be levied on that person in respect of taxable income comprising the aggregate of –

(aa)...

*(bb) retirement fund lump sum withdrawal benefits, received by or accrued to that person on or after 1 March 2009 and prior to the accrual of the retirement fund lump sum withdrawal benefit contemplated in sub-item (aa), **excluding amounts which accrue in terms of paragraph 2(b)((iA)(AA) and paragraph 2B of the Second Schedule**;...*

(cc) ...

(ii) The amount of tax levied in terms of item (i) must be reduced by an amount equal to the tax that would be leviable on the person in terms of that item in respect of taxable income comprising the aggregate of –

(aa) retirement fund lump sum withdrawal benefits, received by or accrued to that person on or after 1 March 2009 and prior to the accrual of the retirement fund lump sum withdrawal benefit contemplated in sub-item (aa), **excluding amounts which accrue in terms of paragraph 2(b)((iA)(AA) and paragraph 2B of the Second Schedule and**

(bb) ...⁹⁹

6.5 Conclusion to the illustrations made by the IRF

If the member is successful in recovering the tax paid (as permitted by paragraph 2(b) of the Second Schedule to the Income Tax Act) on the award made to the non-member, then the member is effectively penalised by R108 000 in the case of scenario 3. As the award to the non-member and the date on which the non-member made her (Mrs A) election was not under the member's control, it is clear that the member's (Mr A) retirement fund value was unjustly reduced by R108 000.

Should the member be unsuccessful in recovering the tax paid from the non-member spouse as provided for by paragraph 2(b) of the Second Schedule to the Income Tax Act, the impact will increase by R321 428 for scenario 2 and by R288 984 for scenario 3.

This situation caused by the amendments to the Income Tax Act is currently unresolved and is still to be addressed by the legislator.

⁹⁹ Institute of Retirement Funds "Submissions for amendments to the Taxation Laws Amendment Bill of 2009" (2009) Annexure B: 7

CHAPTER 7

Financial planning considerations

7.1 Introduction

With the current economic environment being under pressure after the recession, many writers, financial institutions and financial professionals are again putting emphasis on sound financial planning, especially with regard to planning for retirement.

The amendments made to the Pension Funds Act and the Income Tax Act, has considerable impact on a taxpayer, which needs to be taken into account when a financial planner is rendering advice to his/her clients.

The impact of the amendments will be identified and discussed in this chapter to the technical report.

7.2 Recovering tax from the non-member spouse

Paragraphs 2(b) and 2B of the Second Schedule to the Income Tax Act gives the member spouse a right of recovery for taxes paid on accruals to the member, which originate from payments made to a non-member spouse from the member's retirement fund.¹⁰⁰

In an article by Jenni Gordon, three issues were identified, which all pointed towards the difficulty the member might experience in recovering the tax from the non-member spouse.¹⁰¹

The first of these was the situation that arose from a divorce settlement, which is by law a full and final settlement, which does not provide for the recovery of the tax. Thus, if a

¹⁰⁰ Income Tax Act No. 58 of 1962

¹⁰¹ Gordon "Did you know" (6/2008) 5

divorce order does not include a “right of recovery”, one can argue that it is contractually excluded or blocked.¹⁰²

Furthermore, the article suggests that the Income Tax Act is not in a position to grant such a right of recovery to the member spouse, as the Income Tax Act only regulates the rights and responsibilities between the taxpayer and the legislator.¹⁰³

In certain scenarios (refer to Chapter 4 of this technical report) the tax is deemed to be the member’s liability. The member is therefore not paying the tax of the non-member as an agent, and therefore there is no amount to be recovered.¹⁰⁴

7.3 Limitation on recovery

It is stated in GN33 that the right of recovery will not extend to the tax paid by the member-spouse on the employees’ tax that is deducted from the member’s minimum individual reserve as provided for by paragraph 2(b)(i) of the Second Schedule to the Income Tax Act.¹⁰⁵

The impact of this provision in GN33 is that the member spouse will pay tax on behalf of the non-member spouse, which he is unable to recover from the non-member spouse. As noted earlier, the Income Tax Act can only regulate matters between a taxpayer and the legislator.

A client, the member spouse, should therefore be advised of the additional taxes paid and that a settlement contract should provide for the full recovery of the additional taxes paid as calculated by GN33.

¹⁰² Gordon “*Did you know*” (6/2008) 5

¹⁰³ Gordon “*Did you know*” (6/2008) 5

¹⁰⁴ Gordon “*Did you know*” (6/2008) 5

¹⁰⁵ General Note GN 33, South African Revenue Service

7.4 Early withdrawals from retirement funds

Taxpayers need to be aware of the consequences arising from early withdrawals from retirement funds. It might often happen that a member or non-member spouse decides to make cash withdrawals from their retirement money (for example upon resignation by the member) shortly after the divorce has been finalised.

As noted earlier, the tax free withdrawal at retirement from retirement funds will be reduced by any early withdrawals made. See below an example to illustrate the effect of early withdrawals.

Assume a member withdraws from a retirement fund in the 2009/10 tax year and withdraws an amount of R192 500 of which R22 500 is tax free. He then retires in a later tax year with a total lump sum of R960 000. He takes one-third in cash (R320 000). He has no other tax free amounts to add to the tax free lump sum, and has had no previous lump sum deductions. The tax free portion of the retirement lump sum in the subsequent tax year is as follows:

$$\begin{aligned} Z &= C + E - D \\ &= [R300\ 000 - R22\ 500 - R170\ 000] + 0 - 0 \\ &= R107\ 500 \text{ tax free} \end{aligned}$$

Therefore R212 500 [R320 000-R107 500] will be taxable according to the scale at retirement-i.e.-18%. This means R38 250 tax will be paid on the lump sum. Had the member preserved his withdrawal benefit in the 2009/10 tax year, and not taken a withdrawal, R300 000 of the retirement lump sum would have been tax free and he would have paid tax only on R20 000 at 18% which calculates to R3 600.

Clients therefore need to be made aware of the negative impact of making early withdrawals from their retirement funds, and should rather be advised to make use of a preservation fund if they resign from their current retirement funds during the course of a divorce action.

7.5 The “cash” option

Section 37D(1)(e) of the Pension Funds Act read as follows:

“For the purposes of section 7(8)(a) of the Divorce Act, 1979, the pension benefit referred to in that section and the tax referred to in sections (d)(ii) are deemed to accrue to the member on the date of the court order:

Provided that –

(i) ...

(ii) ...

(iii) the non-member spouse shall have the option to elect that the assigned amount be paid directly to him or her, or that it be transferred to an approved pension fund on his or her behalf, and such transfer or payment must take place within 60 days of such election having been exercised;

(iv) ...

(v) ...”¹⁰⁶

Section 37D(1)(e)(iii) of the Pension Funds Act gives the member an option to either take a cash payout from the pension interest, or to transfer the amount assigned to him/her to an approved fund. From the wording it seems that the non-member is not allowed to take a part of the assigned amount in cash and to transfer the rest to an approved fund, and that the provision is an “either or” provision.

A scenario could arise where the non-member spouse might not have the necessary cash resources to pay the member’s claim in terms of the right of recovery for taxes paid on the non-member’s behalf if the non-member elected to transfer the funds to an approved fund.

If a client prefers to keep his/her money in a fund, the client could be advised as follows: Elect a cash payout as allowed by section 37D(1)(e)(iii) of the Pension Funds Act. From this cash payout, the member’s claim can be settled if provided for in the final settlement

¹⁰⁶ Revenue Laws Amendment Act No. 60 of 2008

agreement. The remaining cash can then be invested in a retirement annuity fund which would give the client a tax deduction in terms of section 11(n) of the Income Tax Act.

7.6 Conclusion

From Chapter 7 it is clear that when dealing with a divorce in which there is pension interest involved, it is not only the statutory provisions of the Pension Funds Act and the Income Tax Act which should be considered. There are also a number of considerations which will have financial impacts on the parties involved, and these considerations should be taken into account along with the provisions laid down by the Pension Funds Act, Income Tax Act and the Divorce Act.

CHAPTER 8

Outstanding issues to be addressed by the legislature

8.1 Introduction

The amendments made to the Income Tax Act and the Pension Funds Act as discussed in this technical report, are all changes made from 13 September until 1 March 2009. As with most amendments made by the legislator, there will always be circumstances which the legislator could not foresee at the time that the amendments were made. There are therefore still a number of outstanding issues in practice which had not yet been addressed by the legislator.

This chapter will highlight some of the outstanding issues which the financial sector expects the legislator to address in the near future.

8.2 Early termination and surrender penalties

The clean-break principle also allows for the withdrawal from a retirement annuity fund before retirement or death for the first time.¹⁰⁷

With most retirement annuity products, a portion of the commission is paid upfront to the broker or financial advisor. The life assurance industry has said that a withdrawal from a retirement annuity in terms of the clean-break principle will constitute an early termination of a contract. Such surrenders will result in surrender penalties, which will impact the member's retirement funds. In terms of regulations before 1 January 2009, life assurance companies are entitled to deduct a maximum of up to 30 percent of the value accumulated within the retirement annuity if a member stops to pay the premiums.¹⁰⁸

¹⁰⁷ Cameron "Splitting benefits may beggar divorced fund members" Personal Finance (14 June 2008) 1

¹⁰⁸ Cameron "Splitting benefits may beggar divorced fund members" Personal Finance (14 June 2008) 2

Life assurance companies have made it clear that they will treat a clean-break withdrawal by a non-member spouse as a early termination and that they intend to levy penalties even if the member spouse does not make a withdrawal from the fund in the case of recurring and single-premium policies.¹⁰⁹

The impact of the penalties will be limited due to new legislation which came into operation on 1 January 2009. The new legislation/regulations in terms of the Long-Term Insurance Act has the effect that the upfront commissions are limited and that most of the commission will be paid on a “when-and-if” basis.¹¹⁰

It is the author’s opinion that (a) an exception should be made by the life companies for the scenario described above, or (b) that legislation should be amended to not impact the value of a member’s retirement funds negatively in situations over which a member does not have control, for example by deducting an appropriate portion of the early termination penalty from the non-member spouse’s portion.

Find below an example published in Personal Finance in an article by Bruce Cameron to illustrate the effect of surrender penalties.¹¹¹ Note that this example is using an average tax rate of 30% and not the tables as introduced in the Revenue Laws Amendment Act. Note that this example is purely for illustrative purposes due to the fact that such a calculation may have a number of different outcomes based on the date of the divorce order and based on the contents of the divorce settlement.

In this example a member of an occupational retirement fund left the fund and transferred an accumulated retirement benefit to a retirement annuity fund. Three years after transferring to the retirement annuity fund, the member was divorced. In the divorce settlement it is stated that the non-member spouse is entitled to 50% of the pension interest benefits.

¹⁰⁹ Cameron “Splitting benefits may beggar divorced fund members” Personal Finance (14 June 2008) 2

¹¹⁰ Long-Term Insurance Act No. 52 of 1998, Part 3B

¹¹¹ Cameron “Splitting benefits may beggar divorced fund members” Personal Finance (14 June 2008) 3

Calculating clean-break shares

Lump sum investment: R500 000

Investment value at divorce: R700 000

Share for non-member spouse: R350 000

Residual amount due to member spouse: R350 000

Calculating tax

Member's average tax rate: 30%

Tax on R350 000: R105 000

Effective tax on tax: R3 247

Total tax: R108 247

Residual amount due to member: R241 753

Calculating surrender penalty

Early termination charge of 14%: R98 000

Residual amount due to member: R143 753

The effect of the calculations above is that the member receives 40.5% (98 000 / 241 753) less in terms of retirement value due to the early termination penalty levied on the full R700 000 in the fund at the date of the divorce settlement being paid from the fund.

It will be up to the member to try and recover half of the termination penalty from the non-member spouse. A 50% recovery of the surrender penalty should be included in the first and final divorce settlement.

8.3 Simple interest rate for retirement annuities

The Divorce Act defines pension interest, with regard to retirement annuity funds, as contributions plus interest of 15.5% according to the "Prescribed Rate of Interest Act". This rate has not been changed for a number of years.¹¹²

¹¹²Gordon "Did you know" (12/2008) 4

The definition did not take into account actual fund return, which, in the current economic environment, can be lower than 15.5%, and even negative depending on the type of fund and the underlying assets. It is provided in section 37D(5) of the Pension Funds Act that the fund's actual return should be used if it is lower than 15.5%.¹¹³

What legislation has not provided for is a scenario where a fund performs above the 15.5%. In such cases, the non-member spouse will lose out on exceptional performance by a fund (or market conditions) which might lead to returns in excess of 15.5%. Returns exceeding 15.5% is not uncommon, especially in funds with higher risk ratings and mandates, which allows the fund managers to invest in high-risk equity investments.

8.4 Conclusion

The legislator is still to address the outstanding issues identified in this chapter. Early termination penalties are something that clients should be made aware of while the simple rate of return applied to retirement annuities can be resolved by making appropriate provision in the divorce settlement.

¹¹³ Gordon "*Did you know*" (12/2008) 8

CHAPTER 9

Summary and conclusion

9.1 Summary of the three tax regimes

The following is a summary, in table format, of the three different tax regimes under which a divorce order will be treated, based on the date of the divorce order. A table format was selected for ease of use and reference.

The information contained in this table has been taken from information already discussed in this working paper, and does therefore not contain further references to sources used, but rather to the chapter in which the specific principle was discussed.

Table 9.1 – Summary of the three tax regimes

	Divorce orders granted before 13 September 2007	Divorce orders granted on or after 13 September 2007 and before 1 March 2009	Post 1 March 2009 divorce awards
Clean-break principle ¹¹⁴	The clean-break principle was previously not applied to divorce orders granted before 13 September 2007. Section 37D was however changed with effect from 1	The clean-break principle is applied to divorce orders granted on or after 13 September 2007. Section 37D of the Pension Funds Act provides for the	The clean-break principle is applied to divorce orders granted on or after 13 September 2007. Section 37D of the Pension Funds Act provides for the

¹¹⁴ Chapter 3.2 and 3.3

	Divorce orders granted before 13 September 2007	Divorce orders granted on or after 13 September 2007 and before 1 March 2009	Post 1 March 2009 divorce awards
	<p>November 2008 to provide that a pension interest allocation to a non-member spouse in terms of a divorce granted before 13 September 2007 is deemed to have accrued to the member on 13 September 2007.</p> <p>The clean-break principle therefore now also applies to divorce orders granted before 13 September 2007.</p>	<p>immediate deduction of an amount assigned from the member's benefit or individual reserve to a non-member spouse in terms of a decree granted under section 7(8)(a) of the Divorce Act, 1979.</p>	<p>immediate deduction of an amount assigned from the member's benefit or individual reserve to a non-member spouse in terms of a decree granted under section 7(8)(a) of the Divorce Act, 1979.</p>
Liability for tax ¹¹⁵	The member spouse is liable for all tax arising from awards made to the non-member spouse.	The liability of the tax depends on the date of the election made by the non-member spouse according to section	Awards made to the non-member spouse accrue to the non-member spouse for tax purposes.

¹¹⁵ Chapter 4.4 and 4.5

	Divorce orders granted before 13 September 2007	Divorce orders granted on or after 13 September 2007 and before 1 March 2009	Post 1 March 2009 divorce awards
		<p>37D(1)(e)(iii).</p> <p>Accrual for tax purposes will only happen when deduction or payment has been made from the member's fund. If the election is made on or before 28 February 2009, the member will remain the taxpayer. If the election is made on or after 1 March 2009, the non-member spouse will be taxed on the award received.</p>	
Recoverability of tax ¹¹⁶	The recoverability by the member will depend on and be limited to any agreement	The member spouse can recover the tax paid on behalf of the non-member spouse according to	Not applicable, as the award made to the non-member spouse is taxable in the hands of the

¹¹⁶ Chapter 4.6

	Divorce orders granted before 13 September 2007	Divorce orders granted on or after 13 September 2007 and before 1 March 2009	Post 1 March 2009 divorce awards
	contained in the final settlement agreement.	paragraph 2(b) and 2B of the Second Schedule to the Income Tax Act of 1962.	non-member spouse.
Calculation of tax ¹¹⁷	The award made to the non-member spouse is taxed at the average rate of the member spouse (section 5(10) of the Income Tax Act) with a tax free portion of R1 800.	The award made to the non-member spouse is taxed at the average rate of the member spouse (section 5(10) of the Income Tax Act) with a tax free portion of R1 800. See section on awards made on or after 1 March 2009 if the election according to section 37D(1)(e)(iii) of the Pension Funds Act is made on or after 1 March 2009. GN33 deals with the	Tax is calculated at progressive table with R22 500 tax free portion for awards made before retirement and R300 000 tax free after retirement for 1/3 cash option. Amounts withdrawn from retirement funds before and after retirement are cumulative for purposes of calculating the tax according to the progressive tax

¹¹⁷ Chapter 4.5 and 4.8

	Divorce orders granted before 13 September 2007	Divorce orders granted on or after 13 September 2007 and before 1 March 2009	Post 1 March 2009 divorce awards
		tax-on-tax calculation.	table.
Transfers to another fund ¹¹⁸	The non-member can choose whether amount should be paid to him/her or transferred to another fund.	The non-member can choose whether amount should be paid to him/her or transferred to another fund.	The non-member can choose cash option or have his/her award transferred to another fund.
Tax on transfers to an approved fund ¹¹⁹	Tax is payable by the member whether or not any amount is transferred to an approved retirement fund. There is no tax incentive for a non-member spouse to transfer award to an approved retirement fund.	Tax is payable whether or not any amount is transferred to an approved retirement fund. There is no tax incentive for a non-member spouse to transfer award to another fund unless accrual was on or after 1 March 2009 (therefore if the	Transfer to an approved retirement or preservation fund is exempt from tax (paragraph 6 of the Second Schedule to the Income Tax Act).

¹¹⁸ Chapter 4.7.1

¹¹⁹ Chapter 4.7.1 and 4.7.2

	Divorce orders granted before 13 September 2007	Divorce orders granted on or after 13 September 2007 and before 1 March 2009	Post 1 March 2009 divorce awards
		election according to section 37D(1)(e)(iii) of the Pension Funds Act is made on or after 1 March 2009).	
Pension interest in preservation funds ¹²⁰	<p>Prior to 1 November 2008 pension interest was not recorded in respect of preservation funds (Divorce Act).</p> <p>Included in pension interest by section 37D(6) of the Pension Funds Act since 1 November 2008.</p>	<p>Preservation funds are included in pension interest by section 37D(6) of the Pension Funds Act since 1 November 2008.</p> <p>It is therefore possible to obtain a divorce order as contemplated in section 7(8) of the Divorce Act for divorce orders granted on or after 1 November 2008.</p>	Can record a section 7(8) divorce order for orders granted on or after 1 November 2008.

¹²⁰ Chapter 5.4

	Divorce orders granted before 13 September 2007	Divorce orders granted on or after 13 September 2007 and before 1 March 2009	Post 1 March 2009 divorce awards
Growth to non-member spouse on pension interest ¹²¹	The non-member spouse is not entitled to any growth in the applicable fund after the divorce order is granted. The non-member is therefore only entitled to the value as on date of the divorce order.	The non-member spouse is not entitled to any growth in the applicable fund after the divorce order is granted. The non-member is therefore only entitled to the value as on date of the divorce order. As from 1 November 2008, a non-member spouse will be entitled to interest at 15.5% according to the Prescribed Rate of Interest Act. Such interest will be limited to the actual fund return.	As from 1 November 2008, a non-member spouse will be entitled to interest at 15.5% according to the Prescribed Rate of Interest Act. Such interest will be limited to the actual fund return.

¹²¹ Chapter 8.3

9.2 Conclusion

It is important to establish the date of divorce as the treatment of pension interest at divorce differs based on the date of the divorce order. This can be done by obtaining a copy of the court order and the settlement agreement.

The situation for divorce orders granted before 1 March 2009 can be extremely complicated and specialist advice should be obtained.

The situation for divorce orders on or after 1 March 2009 is however less complicated as the “clean-break” principle will always be applied.

The research contained within this assignment should provide the reader with an understanding of the following:

- The happenings that led to the changes to the Pension Funds Act and the Income Tax Act with regard to the treatment of pension interest at divorce,
- the working and technicalities of the clean-break principle,
- the changes made to the Income Tax Act and the Pension Funds Act as a result of the clean-break principle,
- points for consideration when dealing with divorce orders granted at different dates due to the “three-tax” regime, and
- the outstanding points for consideration, which is not provided for by legislation, or for which spouses and advisors should be aware of when involved in a divorce and pension interest situation.

Care should be exercised when dealing with pension interest as it is still a young topic in an industry that is changing daily.

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