

GENERAL NOTE GN 37

GENERAL SUBJECT: **SECOND SCHEDULE TO THE INCOME TAX ACT, NO 58
OF 1962**

SPECIFIC ASPECT: **MAINTENANCE AWARDS**

STATUS: **OPINION**

PURPOSE: To convey the view of the South African Revenue Service regarding the tax treatment of a retirement fund maintenance order of court.

BACKGROUND: Section 37D of the Pension Funds Act, No24 of 1956 as well as the Second Schedule to the Income Tax Act, No 58 of 1962 was amended in terms of the Revenue Laws Amendment Act, No35 of 2007, to recognise the deduction from a member's minimum individual reserve of the amount of a maintenance order issued by a court.

OPINION: Order against a benefit
A maintenance order of court against the benefit of a member of a retirement fund is not taken into account in the determination of the taxable status of the member's benefit. Put differently, the taxable portion of the member's benefit (whether in the form of an annuity or lump sum or a combination of the two) is not reduced by the maintenance order. The effect of this is that the maintenance order is paid by the member from after-tax income.

Order against a minimum individual reserve

To ensure similar treatment where a maintenance order is granted against the member's minimum individual reserve in the fund (i.e. prior to a benefit becoming due in terms of the rules of the fund), paragraph 2(b)(i) of the Second Schedule to the Income Tax Act provides for the taxation of the amount of such an order in the hands of the member.

Responsibility for paying the tax when order is against the minimum individual reserve

The member is responsible for paying the tax on the portion of the minimum individual reserve that is utilised to pay the maintenance order. The fund administrator is responsible for deducting employees' tax in relation to the member's tax liability.

Recovery of employees' tax from the minimum individual reserve

The Second Schedule to the Income Tax Act does not make provision for the recovery of the tax on this amount from the non-member, but section 37(1)(d)(ii) of the Pension Funds Act permits the deduction of employees' tax from the member's minimum individual reserve. Such a payment of employees' tax is also deemed to be a lump sum benefit for purposes of the Second Schedule to the Income Tax Act and thus taxable in the hands of the member.

Determining the amount of employees' tax to deduct from the minimum individual reserve

Determining the correct amount of employees' tax (PAYE) to be deducted from a member's minimum individual

reserve is not a precise exercise. Much depends on the member's effective rate of tax, which may be different on assessment to what it was when the tax directive was issued due to the level of information that was available at that time. It should therefore be explained by the member that his or her final tax liability will only be determined on assessment and that the amount of PAYE deducted from his or her minimum individual reserve may not be correct.

Where a fund deducts the employees' tax (that is, payable on the amount paid in terms of a valid court order) from the member's minimum individual reserve, an additional lump sum benefit is deemed to accrue to the member in terms of the provisions of the Second Schedule to the Income Tax Act. This additional lump sum benefit, which is equal in value to the employees' tax paid on the amount of the court order, will require another application for a tax directive. The tax-on-tax effect that the deduction from the minimum individual reserve creates would ordinarily result in the fund administrator having to apply for a tax directive on each layer of additional tax. To alleviate this burden, the use of the following formula to determine the additional amount in respect of which another application for a tax directive must be made is accepted by SARS:

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

where

- X = represents the amount for which an additional tax directive must be applied for
- A = the tax deductible as per the first tax directive tax
- B = 100
- C = 100 minus the member's effective rate of tax* as determined by the first tax directive.

* the effective rate = PAYE as per first directive divided by the amount of

the order of court

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 that must be deducted from the member's minimum individual reserve to cover both the R15 000 and the additional lump sum benefits that are caused by the tax-on-tax effect of paying for the PAYE out of the minimum individual reserve can therefore be determined as follows:

$$\begin{aligned} A &= 15\,000 \\ B &= 100 \\ C &= 100 - 30 \end{aligned}$$

$$X = R15000 / 70 \times 100$$

$$X = R21428$$

An additional (2nd) application for a tax directive must then be obtained on the amount of R21 428. Assuming the average remained the same, the tax directive that is

received back would reflect PAYE of R6 428 on the R21 428. The PAYE of R6 428, together with the initial PAYE of R15 000, adds up to R21 428.

The total amount to be deducted by the fund from the minimum individual reserve of the member is therefore R71 428 (R50 000 + R21 428).

The IRP5 certificate of the member must be completed as follows:

Code 3902	R50 000
Code 3902	R21 428
Code 4102	R21 428

The taxable amount

The payment of a maintenance order from a member's minimum individual reserve is deemed to be a lump sum benefit for purposes of the Second Schedule to the Income Tax Act. No deduction is, however, available for off-set against the lump sum, which means that the gross amount of such a lump sum is included in the member's taxable income and is subject to the rate of tax referred to in paragraph 7 of the Second Schedule to the Income Tax Act.

ISSUED BY –

**LEGAL AND POLICY DIVISION
SOUTH AFRICAN REVENUE SERVICE**

Date: 31 October 2008