

DRAFT INTERPRETATION NOTE

DATE:

ACT : INCOME TAX ACT 58 OF 1962
SECTION : SECTION 1(1) – DEFINITIONS OF PENSION AND PROVIDENT FUNDS AND PARAGRAPH 2C OF THE SECOND SCHEDULE
SUBJECT : APPORTIONMENT OF SURPLUS AND MINIMUM BENEFIT REQUIREMENTS – PENSION FUNDS SECOND AMENDMENT ACT

Preamble

In this Note unless the context indicates otherwise –

- “**active member**” refers to a member whose membership in that fund has not terminated;
- “**actuarial surplus**” refers to the difference between the fund’s assets and liabilities;
- “**fund**” means a “pension fund” and “provident fund” as defined in section 1(1) of the Income Tax Act;¹
- “**Income Tax Act**” means the Income Tax Act 58 of 1962;
- “**paragraph**” means a paragraph of the Second Schedule to the Income Tax Act unless otherwise stated;
- “**Pension Funds Act**” means the Pension Funds Act 24 of 1956;
- “**the FSCA**” means the Financial Sector Conduct Authority as defined in section 1 of the Financial Sector Regulation Act 9 of 2017;
- “**Second Schedule**” means the Second Schedule to the Income Tax Act;
- “**section**” means a section of the Income Tax Act; and
- any other word or expression bears the meaning ascribed to it in the Income Tax Act.

All forms and tables referred to in this Note are available on the SARS website at www.sars.gov.za. Unless indicated otherwise, the latest issues of these documents should be consulted.

1. Purpose

This Note provides clarity on the tax treatment of the actuarial surplus allocations or distributions made to members, former members, existing pensioners and employers by funds under the provisions of sections 15B, 15C, 15D or 15E of the Pension Funds Act.

¹ The definitions of “pension preservation fund” and “provident preservation fund” were introduced into the Income Tax Act with effect from 1 January 2009.

General Note 29 and Addendum A thereto are hereby withdrawn.

2. Background

The definition “actuarial surplus” and sections 15A to 15K were inserted into the Pension Funds Act with effect from 7 December 2001.² These changes enabled a fund to apportion any actuarial surplus between the employers, members, former members and existing pensioners of that fund.

The first surpluses were determined at the effective date of the first statutory actuarial valuation of the fund following 7 December 2001. The first surplus determined is normally referred to as the past surplus.

Section 15B(1) of the Pension Funds Act governs the distribution of the past surplus determined at the surplus apportionment date.³ The board of trustees of the fund had to determine how the past surplus should be distributed and allocated among the employer, former members, current members and pensioners of a fund. The surplus apportionment scheme had to be approved by the Registrar of Pension Funds⁴ before any distribution or allocation could be implemented. There is a difference in the tax treatment of the past surplus distributed and allocated in terms of surplus apportionment schemes approved before 1 January 2006, and schemes approved on or after 1 January 2006.

Paragraph 2C was inserted with effect from 1 January 2006⁵ and provides that surplus distributions that accrue to a taxpayer on or after 1 January 2006, as a result of a surplus apportionment scheme approved on or after that date by the Registrar of Pension Funds, must not be included in the taxpayer’s “gross income”⁶.

Any subsequent actuarial surplus arising in a fund following the approval of the surplus apportionment scheme by the Registrar of Pension Funds is referred to as ‘future surplus’ and is apportioned under section 15C of the Pension Funds Act.

This Note explains the tax treatment of distributions in terms of an approved scheme for the two different periods as well as the tax treatment of the future surplus distributions.

3. The law

The relevant sections of the Pension Funds Act and the Income Tax Act are quoted in the **Annexure**, and are discussed in more detail below.

² Pension Funds Second Amendment Act 39 of 2001.

³ As defined in section 1 of the Pension Funds Act.

⁴ The FSCA was established with effect from 1 April 2018. All duties and functions previously performed by the Registrar of Pension Funds is, with effect from 1 April 2018, performed by the Commissioner of the FSCA.

⁵ Taxation Laws Amendment Act 8 of 2007.

⁶ As defined in section 1(1).

4. Application of the law

4.1 Tax treatment of actuarial surplus apportionment schemes approved before 1 January 2006 (section 15B surplus – past surplus)

4.1.1 Allocations to active members

Allocations to active members of the fund could only be used to enhance their fund credits. These amounts form part of the member's lump sum benefit payable on exit from the fund as a result of retirement, withdrawal or death.

4.1.2 Distributions to former members who terminated their membership before the approval of the surplus apportionment scheme

A distribution in the form of a lump sum payment to a former member of the fund is a lump sum benefit. The average rate of tax as determined under section 5(10) relative to the year of assessment in which the scheme was approved, is applicable. The accrual date is the date that the Registrar of Pension Funds approved the surplus apportionment scheme.

4.1.3 Distributions to pensioners who retired from the fund before the approval of the surplus apportionment scheme

Pension fund

Any distribution of surpluses to retired members in the form of an additional pension is subject to normal tax as a pension.⁷ If the long-term insurer or fund is not in a position to enhance the existing pension then the amount is paid as a once-off bonus and is taxed in full at the member's marginal rate of tax.

Provident fund

A distribution in the form of a lump sum payment to a retired member of a provident fund is a lump sum benefit. The average tax rate as determined under section 5(10) relative to the year of assessment in which the scheme was approved, is applicable.

4.2 Actuarial surplus apportionment schemes approved on or after 1 January 2006 (section 15B surplus)

Surplus amounts allocated to active members of the fund is taxable as and when that member becomes entitled to any lump sum benefit on exit from the fund as a result of retirement, withdrawal or death.⁸

Any lump sum benefit payable to former members or retired members of a fund as a result of the approval of a surplus apportionment scheme under section 15B of the Pension Funds Act **on or after 1 January 2006** is not included in the member's gross income and is as a result not subject to tax.⁹

⁷ Paragraph (j) of the definition of "gross income" in section 1(1).

⁸ Paragraphs 5 and 6.

⁹ Paragraph 2C.

4.3 The tax treatment of future surplus payments (section 15C of the Pension Funds Act)

Section 15C of the Pension Funds Act regulates the determination of any surplus amounts to members and former members of a fund after the “surplus apportionment date” as defined in the Pension Funds Act.¹⁰ These amounts, known as ‘future surplus amounts’ are allocated and distributed to members, former members and pensioners in accordance with the provisions of section 15D¹¹ or 15E¹² of the Pension Funds Act, depending on the rules of the fund or the decision by the fund’s board of trustees if the rules of the fund are silent in that regard.

4.3.1 Allocation to active members

Any future surplus amounts allocated to active members of a fund under section 15D(1)(a) or 15E(1)(d) of the Pension Funds Act, may only be used to enhance such a member’s share in that fund. These amounts form part of the member’s lump sum benefit payable on exit from the fund as a result of retirement, withdrawal or death.

4.3.2 Distributions to former members or existing pensioners of the fund who terminated their membership prior to the surplus apportionment

Any future surplus amounts distributed to former members or pensioners as a lump sum under section 15D(1)(b) or 15E(1)(d) of the Pension Funds Act are amounts that accrue to or are received by the former member or pensioner in consequence of past membership.¹³

Future surplus payments that were payable to or accrued to the former member or pensioner before 1 March 2009 are subject to tax at the average tax rate determined under section 5(10).

As from 1 March 2009 these lump sum benefits payable to former members or pensioners are regarded as retirement fund lump sum withdrawal benefits under the new accrual provisions¹⁴ and are subject to the tax table applicable to retirement fund lump sum withdrawal benefits.

4.3.3 Distributions to the beneficiaries of members who have died prior to the surplus apportionment

Any future surplus amounts distributed to the beneficiaries of a member who has died before the distribution of the surplus is a lump sum benefit.¹⁵

Future surplus payments that were payable to or accrued to beneficiaries as a result of the death of a member before 1 March 2009 are subject to tax at the average tax rate determined under section 5(10).

¹⁰ “Surplus apportionment date” is defined in section 1 of the Pension Funds Act.

¹¹ Section 15D of the Pension Funds Act governs the utilisation of surplus in the member surplus account.

¹² Section 15E of the Pension Funds Act governs the utilisation of surplus in the employer surplus account.

¹³ Paragraph 2(1)(b)(ii).

¹⁴ Paragraph 4(1).

¹⁵ The allowable deductions under paragraphs 5 and 6.

As from 1 March 2009 these lump sum benefits payable to former members or pensioners are regarded as retirement fund lump sum withdrawal benefits under the new accrual provisions¹⁶ and are subject to the tax table applicable to retirement fund lump sum withdrawal benefits.

Example 1 – Distribution of future surplus (section 15C) to a former member and pensioner who terminated the membership before the distribution of the surplus

Facts:

P became entitled to a withdrawal interest of R150 000 in the KL Pension Fund on 31 July 2017.

The registered rules of the KL Pension Fund provide that a future surplus can be distributed to the members of the fund. A future surplus distribution was determined and approved. P qualified for a future surplus amount of R75 000, which accrued on 30 April 2018.

Result:

The following steps must be followed in order to calculate the tax payable on the withdrawal benefit payable to P:

Step 1: Determine the total taxable income in respect of all lump sums received or accrued (including the current lump sum benefit)

	R
Current withdrawal benefit	75 000
All withdrawal benefits (on or after 1 March 2009)	150 000
All retirement benefits (on or after 1 October 2007)	0
All severance benefits (on or after 1 March 2011)	<u>0</u>
Total taxable income	<u>225 000</u>

Step 2: Apply the rate of tax applicable to withdrawal benefits to the total lump sum amount calculated in Step 1

The total taxable income of R225 000, as determined in Step 1, exceeds R25 000 but does not exceed R660 000.

	R
Taxable income (R225 000 – R25 000)	200 000
<i>Multiply:</i> Applicable tax rate in the withdrawal benefit tax table	<u>18%</u>
Tax on taxable income	<u>36 000</u>

Step 3: Determine the total taxable income of all previous lump sums received or accrued (excluding the current lump sum benefit)

	R
All withdrawal benefits (on or after 1 March 2009)	150 000
All retirement benefits (on or after 1 October 2007)	0
All severance benefits (on or after 1 March 2011)	<u>0</u>
Total of previous lump sums	<u>150 000</u>

¹⁶ Paragraph 4(1).

Step 4: Apply the rate of tax applicable to withdrawal benefits to the total lump sum amount calculated in Step 3

The total taxable income of R150 000, as determined in Step 3, exceeds R25 000 but does not exceed R660 000.

	R
Total taxable income of previous lump sum benefits	
(R150 000 – R25 000)	125 000
<i>Multiply:</i> Applicable tax rate in the withdrawal benefit tax table	<u>18%</u>
Tax on previous lump sum benefits	<u>22 500</u>

Step 5: Deduct the tax calculated in Step 4 from the tax calculated in Step 2 to determine the tax payable on the current withdrawal benefit

	R
Tax on all lump sums (Step 2)	36 000
Less: Tax on previous lump sums (Step 4)	<u>(22 500)</u>
Tax on current withdrawal benefit	<u>13 500</u>

Tax of R13 500 is payable on the lump sum benefit (withdrawal benefit) of R75 000 received as a result of the section 15C future surplus distribution.

Example 2 – Distribution of future surplus (section 15C) to an existing pensioner who retired before the distribution of the surplus

Facts:

On 31 August 2017 (date of accrual), Q's retirement interest in the MLK Pension Fund was R2 250 000. Q took one-third (R750 000) of the retirement interest in cash. Tax of R135 000 was deducted from the retirement benefit.

The registered rules of the MLK Pension Fund provide that surplus can be distributed on an annual basis to the members of the fund as at the fund's anniversary date, which is the end of August each year. Q qualified for a future surplus amount of R135 000 which accrued on 31 August 2018.

Result:

The following steps must be followed in order to calculate the tax payable on the withdrawal benefit payable to Q:

Step 1: Determine the total taxable income in respect of all lump sums received or accrued (including the current lump sum benefit)

	R
Current withdrawal benefit	135 000
All withdrawal benefits (on or after 1 March 2009)	0
All retirement benefits (on or after 1 October 2007)	750 000
All severance benefits (on or after 1 March 2011)	<u>0</u>
Total taxable income	<u>885 000</u>

Step 2: Apply the rate of tax applicable to withdrawal benefits to the total lump sum amount calculated in Step 1

The total taxable income of R885 000, as determined in Step 1, exceeds R660 000 but does not exceed R990 000.

	R
Taxable income (R885 000 – R660 000)	225 000
<i>Multiply:</i> Applicable tax rate in the withdrawal benefit tax table (27%)	60 750
Tax on R990 000	<u>114 300</u>
Tax on taxable income	<u>175 050</u>

Step 3: Determine the total taxable income of all previous lump sums received or accrued (excluding the current lump sum benefit)

	R
All withdrawal benefits (on or after 1 March 2009)	0
All retirement benefits (on or after 1 October 2007)	750 000
All severance benefits (on or after 1 March 2011)	<u>0</u>
Total of previous lump sums	<u>750 000</u>

Step 4: Apply the rate of tax applicable to withdrawal benefits to the total lump sum amount calculated in Step 3

The total taxable income of R750 000, as determined in Step 3, exceeds R660 000 but does not exceed R990 000.

	R
Total taxable income of previous lump sum benefits (R750 000 – R660 000)	90 000
<i>Multiply:</i> Applicable tax rate in the withdrawal benefit tax table (27%)	24 300
Tax on R990 000	<u>114 300</u>
Tax on taxable income	<u>138 600</u>

Step 5: Deduct the tax calculated in Step 4 from the tax calculated in Step 2 to determine the tax payable on the current withdrawal benefit

	R
Tax on all lump sums (Step 2)	175 050
Less: Tax on previous lump sums (Step 4)	<u>(138 600)</u>
Tax on current withdrawal benefit	<u>36 450</u>

Tax of R36 450 is payable on the lump sum benefit (withdrawal benefit) of R135 000 received as a result of the section 15C future surplus distribution.

4.4 Difference between the recalculation of a benefit and a surplus apportionment payment

A fund may discover that former members or existing pensioners were underpaid (for example, an error was made in the initial calculation of the lump sum or investment returns were understated) and, as a result additional, amounts have to be paid to members who were active members of the fund at a certain date. These are amounts that the former members or existing pensioners were entitled to as part of their benefit when their membership in that fund terminated. The member's benefit in the fund is merely recalculated with the original date of accrual remaining the same. The additional amount payable is not as a result of a surplus apportionment calculation in the fund. The recalculation of a benefit is not a payment of a surplus.

4.4.1 Recalculation of a benefit in respect of a member who has already terminated their membership in the fund (that is, withdrawal benefit)

The additional amount must follow the member's initial exit event and the deductions under paragraph 6 will be available against the lump sum benefit, if applicable.

4.4.2 Recalculation of a benefit in respect of a retired member

The treatment of the payment will depend on the type of fund that makes the payment.

Pension fund

If, at retirement, a member of a pension fund already received one-third of his or her retirement benefit in cash, the member will only be able to receive one-third of the additional benefit in cash. Any amount that is not commuted and exceeds one-third of the total amount may be transferred to the long-term insurer paying the monthly annuity. If the long-term insurer is not in a position to accept the lump sum benefit, the additional amount is then payable as a once-off bonus and is taxed in full at the member's marginal rate of tax.

Provident fund

A member of a provident fund will be able to receive the additional amount as a lump sum benefit.

5. Conclusion

The tax treatment of actuarial surplus allocations or distributions to a member, former member or pensioner depends on when the past or future surplus accrues.

Annexure – The law**The Pensions Funds Act, 1956****Section 15B(5)(e)**

15B(5)(e) The board shall apportion the actuarial surplus between the various classes of stakeholders whom the board has determined shall participate in the apportionment in terms of subsection (4), following which such portion as is due to the employer shall be credited to the employer surplus account: Provided that—

- (e) the board shall determine how, in the case of existing members and former members, the allocated portion of actuarial surplus shall be applied for their benefit, including the crediting of any portion to the member's surplus accounts or to the member's individual accounts, as the case may be: Provided further that the board may allocate a portion of the actuarial surplus to be used for former members to a contingency reserve account which will be used to satisfy the claims of former members—
 - (i) who have been identified in subsection 4(a) but who cannot be traced; or
 - (ii) who did not substantiate their claim during the nine-month period following the advertisement in subsection 4(a)(iii) but who do so after the end of this period; and

Section 15C of the Pension Funds Act governs the apportionment of future surplus and provides that:

(1) The rules may determine any apportionment of actuarial surplus arising in the fund after the surplus apportionment date between the member surplus account, the employer surplus account or directly for the benefit of members and former members subject to the uses specified in section 15D(1).

(2) If the rules are silent on the apportionment of actuarial surplus arising after the surplus apportionment date, any apportionment between the member surplus account, the employer surplus account or directly for the benefit of members and former members, subject to the uses specified in section 15D(1), shall be determined by the board taking into account the interests of all the stakeholders in the fund: Provided that, notwithstanding anything to the contrary in the rules, neither the employer nor the members may veto such apportionment

Income Tax 58 of 1962 – before 1 March 2009**Definition of “lump sum benefit” in paragraph 1 of the Second Schedule applicable after 1 March 1998**

“**lump sum benefit**” includes any amount determined by the commutation of an annuity or portion of an annuity and any fixed or ascertainable amount (other than an annuity) payable by or provided in consequence of membership or past membership of any fund referred to in paragraph (e) of the definition of “gross income” in section one of this Act whether in one amount or in instalments;

Paragraph 4(1) of the Second Schedule

(1) If in terms of the rules of a pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund any lump sum benefit arising out of a member's withdrawal or resignation is payable at a fixed or ascertainable future date, such benefit shall be deemed to have accrued to such member on that date or on the date of his or her death, whichever is earlier, and shall be assessed to tax in respect of the year of assessment during which such benefit is deemed to accrue as though it were a lump sum benefit derived by him or her upon his or her withdrawal or resignation from the fund or upon his or her retirement or immediately prior to his or her death, as the case may be,

Paragraph 2C of the Second Schedule inserted with effect from 1 January 2006¹⁷

Paragraph 2C applies to surplus apportionment schemes approved on or after 1 January 2006. It provides that:

2C. Any lump sum benefit, or part thereof, received by or accrued to a person subsequent to the person's retirement or death, or withdrawal or resignation from any pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund or the winding up of any such fund, and in consequence of or following upon an event that is prescribed by the Minister by notice in the *Gazette* and contemplated by the rules of any such fund or the **approval of a scheme in terms of section 15B of the Pensions Funds Act** or paragraph 5.3(1)(b) of the Schedule which amends regulation 30 of the Regulations under the Long-term Insurance Act shall not constitute gross income of that person

(Emphasis added.)

Paragraph (c)(i) of the definition of “pension fund” with effect from 1 January 2006¹⁸

- (i) that the fund is a permanent fund *bona fide* established for the purpose of providing annuities for employees on retirement date or for the dependants or nominees of deceased employees, or mainly for the said purpose and also for the purpose of providing benefits other than annuities for the persons aforesaid or **for the purpose of providing any benefit contemplated in paragraph 2C of the Second Schedule or section 15A or 15E of the Pension Funds Act;**

(Emphasis added.)

¹⁷ Taxation Laws Amendment Act 8 of 2007 (promulgated 8 August 2007).

¹⁸ Revenue Laws Amendment Act 60 of 2008 (promulgated 8 January 2009).

Paragraph (a) of the definition of “provident fund” with effect from 1 January 2006¹⁹

- (a) that the fund is a permanent fund *bona fide* established solely for the purpose of providing benefits for employees on retirement date or solely for the purpose of providing benefits for the dependants or nominees of deceased employees or deceased former employees or solely for a combination of such purposes or mainly for the said purpose and **also for the purpose of providing any benefit contemplated in paragraph 2C of the Second Schedule or section 15A or 15E of the Pension Funds Act;**

(Emphasis added.)

Income Tax Act 58 of 1962 – after 1 March 2009**Definition of “lump sum benefit” in paragraph 1 of Second Schedule**

“lump sum benefit” includes—

- (a) any amount determined in respect of the commutation of an annuity or portion of an annuity—
- (i) payable by; or
 - (ii) provided in consequence of membership or past membership of, a pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund; and
- (b) any fixed or ascertainable amount (other than an annuity)—
- (i) payable by; or
 - (ii) provided in consequence of membership or past membership of, a pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund,

whether in one amount or in instalments, but does not include any amount deemed to be income accrued to a person in terms of section 7(11);

Paragraph 4(1) of the Second Schedule with effect from 1 March 2009²⁰

(1) Notwithstanding the rules of a pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund, any lump sum benefit arising out of a member’s withdrawal or resignation shall, subject to paragraph 3, be deemed to have accrued to such member on the date he or she elects to have the benefit paid to him or her or the date on which the benefit is transferred to another pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund or on the date of his or her death, whichever is earlier, and shall be assessed to tax in respect of the year of assessment during which such benefit is deemed to accrue as though it were a lump sum benefit derived by him or her upon his or her withdrawal or resignation from the fund or upon his or her retirement or immediately prior to his or her death, as the case may be.

¹⁹ Revenue Laws Amendment Act 60 of 2008 (promulgated 8 January 2009).

²⁰ Revenue Laws Amendment Act 60 of 2008 (promulgated 8 January 2009).

Paragraph 4(1) of the Second Schedule with effect from 1 March 2010²¹

(1) Notwithstanding the rules of a pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund, any lump sum benefit shall be deemed to have accrued to such member on the earliest of the date—

- (a) on which an election is made in respect of which the benefit becomes recoverable;
- (b) on which any amount is deducted from the benefit in terms of section 37D(1)(a), (b) or (c) of the Pension Funds Act, 1956 (Act No. 24 of 1956);
- (c) on which the benefit is transferred to another pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund;
- (d) of his or her retirement; or
- (e) of his or her death,

and shall be assessed to tax in respect of the year of assessment during which such lump sum benefit is deemed to accrue.

Paragraph 4(1) of the Second Schedule with effect from 10 January 2012²²

(1) Notwithstanding the rules of a pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund, and subject to paragraphs 3 and 3A, any lump sum benefit shall be deemed to have accrued to a member of such fund on the earliest of the date—

- (a) on which an election is made in respect of which the benefit becomes recoverable;
- (b) on which any amount is deducted from the benefit in terms of section 37D(1)(a), (b) or (c) of the Pension Funds Act, 1956 (Act No. 24 of 1956);
- (c) on which the benefit is transferred to another pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund;
- (d) of his or her retirement; or
- (e) of his or her death,

and shall be assessed to tax in respect of the year of assessment during which such lump sum benefit is deemed to accrue.

Paragraph 4(1) of the Second Schedule with effect from 1 March 2012²³

(1) Notwithstanding the rules of a pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund, and subject to paragraphs 3 and 3A, any lump sum benefit shall be deemed to have accrued to a person who is a member of such fund on the earliest of the date—

- (a) on which an election is made in respect of which the benefit becomes recoverable;
- (b) on which any amount is deducted from the benefit in terms of section 37D (1)(a), (b) or (c) of the Pension Funds Act, 1956 (Act No. 24 of 1956);
- (c) on which the benefit is transferred to another pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund;
- (d) of his or her retirement; or
- (e) of his or her death,

²¹ Taxation Laws Amendment Act 7 of 2010 (promulgated 2 November 2010).

²² Taxation Laws Amendment Act 24 of 2011 (promulgated 10 January 2012).

²³ Taxation Laws Amendment Act 22 of 2012 (promulgated 1 February 2013).

and shall be assessed to tax in respect of the year of assessment during which such lump sum benefit is deemed to accrue;