Sanlam

Legal Report January 2017

Insurance | Financial Planning | Retirement | Investments | Wealth

Newsletter of Sanlam Employee Benefits: Legal

1. Taxation Laws Amendment Act, 2016 and Tax Administration Laws Amendment Act, 2016

The 2016 Taxation Laws Amendment Act and the 2016 Tax Administration Laws Amendment Act were published in the Government Gazette on 19 January 2017. The main provisions that would impact the employee benefits industry are the following:

1.1 Taxation Laws Amendment Act, 2016

1.1.1 Disallowing the foreign service exemption for a lump sum or pension from a local retirement fund

The provisions of section 10(1)(gC)(ii) of the Income Tax Act allow a South African tax resident who is employed outside South Africa(SA) to receive those retirement fund benefits that accrued while outside the country free from tax. In terms of the Amendment Act the exemption provided in section 10(1)(gC)(ii) will in future only apply to benefits from foreign retirement funds.

According to the Explanatory Memorandum to the Taxation Laws Amendment Bill the reason for the change is that SA tax residents who work outside SA can receive a tax deduction on contributions made to a SA retirement fund (local retirement fund). The deduction can either be made in the same tax year if they have other forms of taxable income or worked partially in SA within that year, or the amounts can be rolled over to be deducted in a future year of assessment. Therefore Government is of the view that upon receipt of the fund benefits the amount that accrued while the SA tax resident was employed outside SA should not be tax-free, as the industry believed to be the position up to now.

The exemption provided in section 10(1)(gC)(ii) has been amended to only apply to benefits from foreign retirement funds. The amendment comes into operation on 1 March 2017 and applies in respect of both lump sum benefits and pensions. SA tax residents already receiving a pension of which a portion was exempt from income tax (because of services rendered outside SA) will also be affected with effect from the said date.

However, benefits paid to a SA tax resident arising from benefits from a foreign retirement fund that were transferred to a local retirement fund will remain tax exempt.

1.1.2 Tax deductions in respect of fund contributions based on capital gains

The tax deduction allowed in terms of section 11(k) of the Income Tax Act in respect of retirement fund contributions is, in short, 27,5 per cent of the higher of the person's remuneration or taxable income, subject to a maximum of R350 000 per year.

Two amendments were made to section 11(k). The first one is that, in calculating taxable income in order to determine the maximum tax deduction, the taxable income before any section 18A deductions (donations to public benefit organisations) must be used.

The second amendment is that the following new paragraph has been inserted in section 11(k) and applies with effect from 1 March 2016:

"(v) any deduction in terms of this paragraph must apply for the purpose of determining the total amount of taxable income, before any deduction in terms of section 18A or the inclusion of any taxable capital gain of the person, whether derived from the carrying on of any trade or otherwise."

According to the Explanatory Memorandum to the Taxation Laws Amendment Bill the harmonisation of the tax treatment of contributions in section 11(k) allowed for a deduction against income from *"carrying on a trade"*, which unintendedly excluded passive income. The purpose of the insertion of section 11(k)(v) is to allow deductions against passive income.

Capital gains that form part of taxable income are included in the calculation of the maximum deduction, but the amount contributed in respect such capital gains may however only be deducted against taxable income other than capital gains. This means that any excess that could not be deducted in a specific tax year will be carried over to the next tax year.

1.1.3 Formal emigration required for withdrawals from retirement annuity funds

In 2015, changes were made in the Income Tax Act to allow individuals to withdraw a lump sum from their retirement annuity fund when they cease to be a tax resident or when they leave South Africa at the end of their work visa.

The definition of "retirement annuity fund" has been amended with effect from 1 March 2016 to require that a member must emigrate from the Republic and that the emigration must be recognised by the South African Reserve Bank for purposes of exchange control before the member may withdraw a lump sum from his/her retirement annuity fund.

1.1.4 Determination of the fringe benefit for defined benefit contributions

Paragraph 12D of the 7th Schedule to the Income Tax Act (which deals with the valuation of contributions made by employers to certain retirement funds) includes a formula to calculate the taxable fringe benefit for contributions to a retirement fund that has a defined benefit component.

The formula in paragraph 12D is intended to take into account the retirement funding income that the retirement fund uses to calculate the required level of contributions given the expected liabilities of the fund. However, the definition of *"retirement funding income"* has referred to *"remuneration"* as contemplated in the Fourth Schedule to the Income Tax Act, which is a different income figure. Remuneration may also differ for two individuals depending on the level of travel allowance, leading to a situation where two identical members of the same defined benefit fund would have a different fringe benefit value for the employer contribution.

The definition of *"retirement funding income"* has therefore been changed to refer to the income taken into account in determining contributions made by or on behalf of the employer. The change applies in respect of contributions made on or after 1 March 2017.

The definition of *"retirement funding income"* also referred only to employer contributions and was silent on a situation where the employer is on a contribution holiday, i.e. where the employer contributions are funded from a reserve account in the fund. These types of contributions might have been interpreted to be exempt from the formula, creating a loophole. Changes have been made in paragraph 12D to adjust the definition of *"retirement funding income"* to include the last-mentioned contributions made by the fund on behalf of the employer. These changes are deemed to apply in respect of contributions made on or after 1 March 2016.

1.2 Tax Administration Laws Amendment Act, 2016

The Amendment Act amended the Income Tax Act to effectively require tax directives in respect of all transfers of business as contemplated in section 14 of the Pension Funds Act, including even bulk transfers. Indications are that administrators will be allowed to make bulk tax directive applications in case of bulk transfers.

2. Draft retirement fund defaults regulations

National Treasury on 9 December 2016 published a second draft of the proposed regulations which make provision for certain defaults in cases where retirement fund members do not make an election. This follows a first draft that was published during 2015.

The draft regulations will be incorporated into the regulations issued in terms of the Pension Funds Act and will make provision for a default investment portfolio, as well as defaults on termination of service and retirement. Comments on the draft regulations must be submitted to Treasury by 28 February 2017.

The draft regulations require funds to make provision for the following default options (Legal Focus 114 contains more details):

Default investment portfolio

The rules of defined contribution funds must make provision for a default investment portfolio which must comply with certain prescribed requirements and in which the retirement funding contributions of a member must be invested if the member has not selected another investment portfolio.

Default preservation and portability

If members are enrolled into a retirement fund as a condition of employment, the rules of that fund must make provision for paid-up benefits. When a member leaves the service of a participating employer before retirement, such member must be made a paid-up member of the fund until the fund is instructed by the member to pay his/her benefit or transfer his/her benefit to another fund. The member must also be provided with a paid-up membership certificate.

The rules of funds must make provision to accept any amount transferred to the fund from another fund for the benefit of a member. Funds must within four months of a member joining the fund obtain a list of all paid-up membership certificates in respect of any retirement savings of that member, and request the member whether he/she wishes to transfer the retirement savings held in respect of each paid-up membership certificate into the new fund.

Members must be given access to retirement benefits counselling before any withdrawal benefit is paid to them or any transfer is made on their behalf to another retirement fund.

Default annuity

All retirement funds must have an annuity strategy which includes identifying a default annuity, which will be applicable in cases where a retiring member made no election with regard to the payment or purchase of an annuity. However the member will not automatically be defaulted into the default annuity, and will only be enrolled into it if he consents thereto.

The default annuity must comply with certain prescribed requirements including that members must be given access to retirement benefits counselling not less than three months before their retirement date.

3. Retail Distribution Review

The Financial Services Board (FSB) published a Status Update on its Retail Distribution Review (RDR) during December 2016. Comments thereon can be submitted to the FSB by 31 March 2017. Against the background of the Treating Customers Fairly approach to market conduct regulation, RDR entails a range of regulatory proposals which will be implemented in three broad phases.

The Status Update provides an overview of the status of specific regulatory instruments that will give effect to RDR Phase 1, as well as the FSB's current thinking regarding proposals that may eventually be implemented in RDR Phases 2 and 3. The proposals regarding RDR Phases 2 and 3 relate to types of advisers and types of advice; investments; risk insurance; sales execution and non-advice distribution; financial inclusion and the low income market; and consumer education.

RDR Phase 1 will, among others, entail regulatory conduct of business reforms. The consultation process on certain of these regulatory instruments has commenced by way of proposed amendments to the Regulations under the Long-term Insurance Act, 1998 ("LTIA") and the Policyholder Protection Rules ("PPR") under the LTIA. The draft amendments were published during December 2016.

The draft amended LTIA Regulations propose amendments to the provisions on binder agreements as well as the inclusion of new sections regarding matters such as:

- Special provisions on replacement risk policies
- Limitation on remuneration for outsourcing by an insurer
- General principles for determining intermediary remuneration

Draft amendments to the PPR deal with matters such as:

- Fair treatment of policyholders
- Credit insurance
- Fund policies
- Advertising, brochures or similar communications
- Provision of information to policyholders and potential policyholders
- Claims management
- Complaints management
- Termination of policies
- Monitoring obligations of insurers regarding replacement of risk policies

Comments on the draft amended LTIA Regulations and PPR can be submitted to the FSB by 22 February 2017.

Retirement funds or other clients requiring more information should not hesitate to contact their consultant.