GENERAL NOTE GN 33

GENERAL SUBJECT:	**SECOND SCHEDULE TO THE INCOME TAX ACT, N0 58 OF 1962**

SPECIFIC ASPECT: **DIVORCE AWARDS**

STATUS: **OPINION**

PURPOSE: To convey the views of the South African Revenue Service regarding the tax treatment of a retirement fund divorce 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, No 35 of 2007 with effect from 13 September 2007, to recognise the so-called "clean-break" principle.   In terms of this principle the pension interest of the member-spouse is reduced by the amount of the divorce order and becomes payable to the non-member spouse on the day prescribed by the order, as opposed to the previous dispensation where the non-member spouse's portion of the pension interest only became payable to the non-member spouse when the member-spouse became entitled to a benefit from the fund.

OPINION:

Order against a minimum individual reserve

While the deeming provision contained in section 37D(1)(e) of the Pension Funds Act is stated to be for purposes of section 7(8) of the Divorce Act, No 70 of 1979, it also seems to deem the non-member spouse's portion of the pension interest to be a "benefit" for purposes of the Pension Funds Act. This seems evident from the provisions of paragraph (e)(ii) of section 73D(1) of the Pension Funds Act, in terms of which the amount assigned under the court order is deducted from the *benefit* (as opposed to a deduction from the *minimum individual reserve*).

It is accepted, however, that the non-member spouse's portion of the pension interest is deducted from the member's minimum individual reserve as envisaged by section 37D(1)(d) of the Pension Funds Act and that, as a result, the payment falls under the provisions of paragraph 2(b)(i) of the Second Schedule.

Recovery of employees' tax from the minimum individual reserve

Section 37D(1)(d)(ii) of the Pension Funds Act allows the fund administrator to reduce the member's minimum individual reserve by the amount of employees' tax that is payable by the member on the assigned pension interest. Such a payment of employees' tax by the fund 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 in addition to the assigned pension interest itself. Paragraph 2(b)(i) of the Second Schedule to the Income Tax Act makes provision for the recovery from the non-member spouse of the tax that is attributable to the assigned pension interest. The right of recovery does not extend to the tax paid by the member-spouse on the employees' tax that was deducted from his or her minimum individual reserve.

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 x 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:

A = 15 000
B = 100
C = 100 – 30

X = R15000 / 70 x 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

<u>The taxable amount</u>

The payment of a divorce 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