South African Revenue Service

INTERPRETATION NOTE 104

DATE: 4 October 2018

ACT : INCOME TAX ACT 58 OF 1962
SECTION : SECTION 10(1)(*gC*)(ii)
SUBJECT : EXEMPTION – FOREIGN PENSIONS AND TRANSFERS

Preamble

In this Note unless the context indicates otherwise –

- **"foreign services"** means services rendered outside the Republic;
- **"insurer"** means a company that is a resident and is registered under the Long-term Insurance Act 52 of 1998 as a person carrying on long-term insurance business;
- **"local retirement fund"** means a "pension fund", "pension preservation fund", "provident fund", "provident preservation fund" or "retirement annuity fund" as defined in section 1(1);
- **"Republic"** means "Republic" as defined in section 1(1);
- **"resident"** means "resident" as defined in section 1(1);
- **"section"** means a section of the Act;
- **"the Act"** means the Income Tax Act 58 of 1962; and
- any other word or expression bears the meaning ascribed to it in the Act.

1. Purpose

This Note provides clarity on the interpretation and application of section 10(1)(*g*C)(ii) to a lump sum, pension or annuity received by or accrued to any resident from a source outside the Republic.

2. Background

Section 10(1)(*g*C)(ii) exempts from normal tax any lump sum, pension or annuity received by or accrued to any resident from a source outside the Republic as consideration for past employment outside the Republic.

This exemption does not apply to a lump sum, pension or annuity received by or accrued to any resident from a local retirement fund[1] or an insurer,[2] except to the extent that an amount (which relates to foreign services rendered) is transferred to that local retirement fund or insurer from a source outside the Republic in respect of that member.

[1] With effect from 1 March 2017.
[2] With effect from 1 March 2018.

3. The law

Section 10(1)(*g*C)

> **10. Exemptions.**—(1) There shall be exempt from normal tax—
>
> (*g*C) any—
>
> (i) amount received by or accrued to any resident under the social security system of any other country; or
>
> (ii) lump sum, pension or annuity received by or accrued to any resident from a source outside the Republic as consideration for past employment outside the Republic other than from any pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund as defined in section 1 (1) or a company that is a resident and that is registered in terms of the Long-term Insurance Act as a person carrying on long term insurance business excluding any amount transferred to that fund or that insurer from a source outside the Republic in respect of that member;

4. Application of the law

The term "past employment outside the Republic" refers to foreign services (employment). Only the portion of the lump sum, pension or annuity that relates to foreign services is exempt from normal tax. Amounts that are not related to foreign services will therefore not qualify for the exemption.

Two references are made to the term "source outside the Republic" in section 10(1)(*g*C)(ii).

4.1 Amounts received by or accrued to a resident from a foreign source

The word "source" has a longstanding meaning under South African domestic law. In *CIR v Lever Bros & Unilever Ltd*[3], the majority judgement stated –

> "…the source of receipts, received as income, is not the quarter whence they come, but the originating cause of their being received as income and that this originating cause is the work which the taxpayer does to earn them, the *quid pro quo* which he gives in return for which he receives them."

The originating cause of a lump sum, pension or annuity received by or accrued to any resident *as consideration for past employment* will be the location where those services were rendered. If services were rendered in the Republic, the source of the lump sum, pension or annuity will be the Republic. If the originating cause of a receipt is situated in more than one country, the source thereof would be in each respective country.[4] This means that an apportionment is required, based on where the services were rendered.[5]

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[3] 1946 AD 441, 14 SATC 1.

[4] *CIR v Lever Bros & Unilever Ltd* 1946 AD 441, 14 SATC 1; *COT (SR) v Shein* 1958 (3) SA 14 (FC), 22 SATC 12.

[5] This is further confirmed by application of the source principles in section 9(2)(*i*).

The first reference to the term "source outside the Republic" in section 10(1)(*g*C)(ii), is as follows:

> **10. Exemptions.**—(1) There shall be exempt from normal tax—
>
> (*g*C) any—
>
> (ii) lump sum, pension or annuity received by or accrued to any resident from a source outside the Republic as consideration for past employment outside the Republic…

(Emphasis added)

The term "source outside the Republic", for purposes of the first reference thereto in section 10(1)(*g*C)(ii), refers to the originating cause that gives rise to the lump sum, pension or annuity. This is where the services have been rendered.

The following formula (which is applied on a time-based apportionment) is used to calculate the portion of a lump sum, pension or annuity that will be exempt as a result of services rendered outside the Republic:

$$\frac{\text{Foreign services rendered}}{\text{Total services rendered}} \times \text{Total amount received or accrued}$$

Example 1 – Exemption for foreign pension received or accrued

Facts:

X is a resident of the Republic and worked for a foreign employer from 1992 to 2019. During this period, X was a member of the employer's foreign retirement fund. X retired in the 2019 year of assessment after 27 years service, and qualified for a lump sum of R1,2 million and a monthly pension of R45 000. X rendered services on behalf of the foreign employer, for 9 years in the Republic and for 18 years in the foreign country. Although X retired in the Republic, X remained a member of the foreign retirement fund. For purposes of simplification, the applicable provisions of a double tax treaty and the application of exchange rates have not been considered in this example.

Result:

X, a resident of the Republic, received a lump sum and a pension from a source outside the Republic as consideration for past employment outside the Republic. X therefore qualifies for an exemption from normal tax, which is calculated as follows:

Lump Sum

$$\frac{\text{Foreign services rendered}}{\text{Total services rendered}} \times \text{Total amount received or accrued}$$

$$= \frac{\text{18 years}}{\text{27 years}} \times \text{R1,2 million}$$

= R800 000

An amount of R800 000 qualifies for exemption from normal tax in the Republic. Of the total lump sum of R1,2 million, R400 000 will therefore be subject to tax in the Republic (R1,2 million less the R800 000 exemption).

Note that, as the lump sum was <u>not</u> received or did not accrue from a *local* retirement fund, the amount of R400 000 will not qualify for the rates of tax applicable to retirement fund lump sum benefits. The amount will be included in X's "gross income" as defined in section 1(1) and will be subject to tax by application of the rates of normal tax applicable to natural persons.

<u>Monthly pension</u>

$$\frac{\text{Foreign services rendered}}{\text{Total services rendered}} \times \text{Total amount received or accrued}$$

$$= \frac{\text{18 years}}{\text{27 years}} \times \text{R45 000}$$

= R30 000

An amount of R30 000 qualifies for exemption from normal tax in the Republic. Of the total monthly annuity of R45 000, R15 000 will therefore be subject to normal tax in the Republic (R45 000 less the exemption of R30 000).

4.2 Amounts received by or accrued to a resident from a local retirement fund or insurer

The second reference to "source outside the Republic" in section 10(1)(*g*C)(ii), is as follows:

> **10. Exemptions.**—(1) There shall be exempt from normal tax—
>
> (*g*C) any—
>
> (ii) lump sum, pension or annuity…other than from any pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund as defined in section 1 (1) or a company that is a resident and that is registered in terms of the Long-term Insurance Act as a person carrying on long term insurance business excluding any amount transferred to that fund or that insurer <u>from a source outside the Republic</u> in respect of that member;

(Emphasis added)

A lump sum, pension or annuity received by or accrued to a resident from a local retirement fund or insurer will not qualify for exemption except in cases where an amount has been transferred to that local retirement fund or insurer from a source outside the Republic. Reference is made to an <u>amount</u> transferred to a local retirement fund or insurer from a source outside the Republic. It would mean that a *specified amount*, representing the value of the benefit in the foreign fund, must be transferred to a local retirement fund or insurer from a source outside the Republic in order for the exemption to apply. What is envisaged here is a transfer of the *value* of the benefit in the foreign fund into a local retirement fund, usually by way of a **once-off transfer**. This therefore will not apply to, for example, monthly amounts paid into

a local retirement fund by a foreign employer, which would be regarded as a contribution[6] as opposed to a transfer.

In this second reference to the term "source outside the Republic", the word "source" cannot be read in relation to the originating cause, because the originating cause in respect of a lump sum, pension or annuity would be the services that were rendered. (see **4.1**) It is not the services rendered that are transferred to the local retirement fund or insurer, but rather a specified amount. In this context, "source outside the Republic" means that an amount must have been transferred from outside the Republic to a local retirement fund or insurer.

Only the portion of the amount transferred, representing the value of the benefit in the fund (that is, a once-off transfer) that relates to foreign services will, however, qualify for exemption.

The exempt portion should be calculated as follows:

Step 1

Determine the portion of the amount received or accrued that relates to the amount transferred to the local retirement fund or insurer. This can be simplified by way of the following formula:

$$\frac{\text{The amount transferred}}{\text{Total retirement interest}} \times \text{Amount received or accrued}$$

Step 2

Determine the portion of the amount transferred (calculated in step 1 above) that relates to foreign services rendered, bearing in mind that only the foreign service element will qualify for exemption. This step will only be necessary if there are both foreign services and services in the Republic. The following formula can be applied:

$$\frac{\text{Foreign services rendered}}{\text{Total services rendered}} \times \text{Amount calculated in Step 1}$$

Note that the foreign services rendered and total services rendered in the above formula will be as at the date the amount was transferred to the local retirement fund or insurer. The formulae can be applied to calculate the exempt portion of either a lump sum, pension or annuity.

[6] Contributions to a pension fund, provident fund or retirement annuity fund are deductible by the member under section 11F. Any amounts that do not qualify for deduction are carried forward to the following year of assessment under section 11F(3), for consideration as a deduction in that (or successive) year of assessment, or as a deduction against a lump sum benefit upon an exit event under paragraphs 5(1)(*a*) and 6(1)(*b*)(i) of the Second Schedule to the Act, or as an exemption against a compulsory annuity under section 10C.

Example 2 – Exemption for amounts received by or accrued to a resident from a local retirement fund (with a foreign fund transfer)

Facts:

Z, a resident of the Republic, is employed by a multinational company from 1994 to 2019. Z contributed to the employer's foreign fund from 1994 to 2014. In 2014, Z decided to remain in the Republic and chose to transfer the full value of R15 million in the foreign fund (at that stage) into the employer's local retirement fund. During the 20 years that Z was a member of the foreign fund, Z rendered 15 years' service outside the Republic and 5 years service in the Republic. Z subsequently retires in 2019. The member's fund value on retirement date is R27 million. Z takes R9 million as a lump sum and the remaining R18 million in the form of a monthly pension (amounting to R90 000 per month) from the employer's local retirement fund. For purposes of simplification, the applicable provisions of a double tax treaty and the application of exchange rates have not been considered in this example.

Result:

Lump sum

Step 1

The portion of the lump sum payable to Z which relates to the amount transferred from the foreign fund to the local retirement fund will be calculated as follows:

$$\frac{\text{The amount transferred}}{\text{Total retirement interest}} \times \text{Amount received or accrued}$$

$$= \frac{\text{R15 million}}{\text{R27 million}} \times \text{R9 million}$$

= R5 million

This means that R5 million of the lump sum is attributable to the amount transferred from the foreign fund to the local retirement fund.

Step 2

Only the portion of the amount transferred that relates to foreign services will qualify for exemption, and the following formula can be applied:

$$\frac{\text{Foreign services rendered}}{\text{Total services rendered}} \times \text{Amount calculated in Step 1}$$

$$= \frac{\text{15 years}}{\text{20 years}} \times \text{R5 million}$$

= R3 750 000

An amount of R3 750 000 qualifies for exemption from normal tax in the Republic. Of the total lump sum of R9 million, R5 250 000 will therefore be subject to tax as per the rates of tax applicable to retirement fund lump sum benefits (R9 million less the R3 750 000 exemption).

Monthly pension

Step 1

The portion of the monthly pension payable to Z that relates to the amount transferred from the foreign fund to the local retirement fund will be calculated as follows:

$$\frac{\text{The amount transferred}}{\text{Total retirement interest}} \times \text{Amount received or accrued}$$

$$= \frac{\text{R15 million}}{\text{R27 million}} \times \text{R90 000}$$

= R50 000

This means that R50 000 of the monthly pension is attributable to the amount transferred from the foreign fund to the local retirement fund.

Step 2

Only the portion of the amount transferred that relates to foreign services will qualify for exemption, and the following formula can be applied:

$$\frac{\text{Foreign services rendered}}{\text{Total services rendered}} \times \text{Amount calculated in Step 1}$$

$$= \frac{\text{15 years}}{\text{20 years}} \times \text{R50 000}$$

= R37 500

An amount of R37 500 qualifies for exemption from normal tax in the Republic. Of the total annuity of R90 000, R52 500 will therefore be subject to normal tax (R90 000 less the exemption of R37 500).

Example 3 – Exemption for amounts received by or accrued to a resident from an insurer (with a foreign fund transfer)

Facts:

Y, a resident of the Republic, is employed by a multinational company from 1999 to 2019. Y contributed to the employer's foreign fund from 1999 to 2014. In 2014, Y decided to remain in the Republic and chose to transfer the full value of R9 million in the foreign fund (at that stage) into a local retirement fund. During the 15 years that Y was a member of the foreign fund, Y rendered 10 years' service outside the Republic and 5 years service in the Republic. Y subsequently retires in 2019. The member's fund value on retirement date is R12 million. Upon retirement, the local retirement fund purchased an annuity from an insurer, and Y subsequently received an annuity of R120 000 per month. For purposes of simplification, the applicable provisions of a double tax treaty and the application of exchange rates have not been considered in this example.

Result:

Step 1

The portion of the annuity payable to Y that relates to the amount transferred from the foreign fund to the local retirement fund will be calculated as follows:

$$\frac{\text{The amount transferred}}{\text{Total retirement interest}} \times \text{Amount received or accrued}$$

$$= \frac{\text{R9 million}}{\text{R12 million}} \times \text{R120 000}$$

= R90 000

This means that R90 000 of the annuity is attributable to the amount transferred from the foreign fund to the insurer.

Step 2

Only the portion of the amount transferred that relates to foreign services will qualify for exemption, and the following formula can be applied:

$$\frac{\text{Foreign services rendered}}{\text{Total services rendered}} \times \text{Amount calculated in Step 1}$$

$$= \frac{\text{10 years}}{\text{15 years}} \times \text{R90 000}$$

= R60 000

An amount of R60 000 qualifies for exemption from normal tax in the Republic. Of the total monthly annuity of R120 000, R60 000 will therefore be subject to normal tax (R120 000 less the R60 000 exemption).

5. Conclusion

Section 10(1)(*g*C)(ii) exempts from normal tax any lump sum, pension or annuity received by or accrued to any resident from a source outside the Republic as consideration for foreign services rendered. This exemption does not apply to a lump sum, pension or annuity received by or accrued to a resident from a local retirement fund[7] or an insurer,[8] except to the extent that an amount (which relates to foreign services rendered) was transferred to that local retirement fund or insurer in respect of that member.

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7 With effect from 1 March 2017.
8 With effect from 1 March 2018.