



BASIS POINT

June 2005.

Volume 2, no. 1

The newsletter of Retirement Fund Solutions Namibia (Pty) Ltd and the Benchmark Retirement Fund.



RETIREMENT FUND SOLUTIONS
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BENCHMARK
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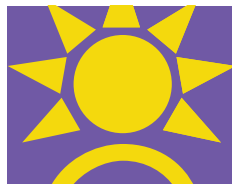
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Friedrich on Funds

Inland Revenue Practice Note 5 of 2003 Status Report

1. Background

By now, retirement funds, their trustees and indeed the retirement funds industry should have been sensitized to the requirements and implications of Inland Revenue Practice Note 5 of 2003. To recapitulate, the content of this practice note is quoted below.

“This practice note serves to clarify the taxation of death benefits derived from pension funds in instances where it solely provides for the payout of a death benefit and no annuities.

Paragraph (a) of the definition of a pension fund in section 1 of the Income Tax Act provides the following requirement, namely:

“.....that the fund is a permanent fund bona fide established for the purpose of providing annuities for employees on retirement from employment or for widows, children, dependents 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; (Underlined for emphasis).

The definition explicitly requires that:

- The fund should provide for annuities for employees on retirement or for widows, children, dependents or nominees of deceased employees; or
- The fund should provide mainly for annuities and also for the provision of a benefit other than annuities. The annuities to be paid out in terms of the rules of the

fund to the member, his or her widow/widower, dependents or nominees should therefore represent more than 50 percent of the total proceeds available to the member.

For the purposes of the definition of a pension fund, the word mainly is not defined in the Act. However, courts decided in various cases that “mainly” means more than 50 percent.

It has come to the attention of the Directorate Inland Revenue that the rules of quite a number of funds provide for a single payment (lump sum) in the event of death of the member of the fund. It is noted that Inland Revenue Directorate erroneously approved some of these funds for tax purposes.

Inland Revenue Directorate will cancel the approval of all these funds and adjust taxpayers’ assessments where contributions to the funds were allowed as a deduction for tax purposes.

However, administrators of these funds will be allowed to amend the rules of the funds in accordance with the provisions of the Act. Such amendments must take place on or before 28 February 2004.

Until the approval of these funds are cancelled or the rules are amended, and in order not to affect the members who contributed towards such funds, it has been decided to tax the lump sum death benefit paid by the funds in full on death of the member.

Administrators of funds, referred to above, should apply for tax deduction directives in all cases where lump sum death benefits are to be paid out.”



2. Subsequent Developments

In November 2003 Inland Revenue issued a circular extending the due date for submission of appropriate rule amendments from 28 February 2004 to 28 February 2005.

During the first half of 2004 a meeting was arranged with Inland Revenue by the Retirement Funds Institute (RFIN), to clarify the position of Inland Revenue and to address problems being experienced by the industry in the practical implementation of this practice note. Following this meeting RFIN established a sub committee tasked to enter into discussions with Inland Revenue with the view to find a practical way of implementing the practice note. At that stage Inland Revenue conceded to another extension of the due date for submitting appropriate rule amendments to 31 August 2005.

The consensus understanding of the sub committee was that the **practice note created a new tax regime** with regard to the taxation of death benefits that was inconsistent with the Income Tax Act. The committee agreed with the principles of the practice note though, namely that the current regime was unfair vis-à-vis provident funds and did not really promote the intention of pension funds being to provide in the needs of dependents of deceased employees. The committee therefore adopted the approach of finding a mutually acceptable solution for the interim in the spirit of cooperating with Inland Revenue in preference to adopting a confrontational approach and to assist Inland Revenue to rewrite the Income Tax Act in a way that would satisfy all stakeholders.

With this objective in mind, another meeting was held with senior officials of Inland Revenue on 18 April 2005. During these discussions it became very evident that the promoter of the practice note in the department appears to be quite clear that the practice note can be challenged if it were to be applied contrary to the stipulations of the Income Tax Act. This official took the pure stance that the practice note

simply confirms Inland Revenue's interpretation of the phrase '...or mainly for the said purpose...' as meaning that whenever a pension fund is to pay out a benefit upon the death of a member, more than 50%, or more specifically 51% of the total capital available in each and every case must be applied to provide annuities to dependents or nominees of the deceased. It was mentioned that one-third of such capital to be applied for annuities may be commuted and paid out as a tax free lump sum. It was also pointed out that the full amount may be paid out as a tax free lump sum where there was no dependent and no nominee, although one official intimated that payment to the estate of the deceased, as would be required in terms of the Pension Funds Act in such a situation, would be regarded as payment to a nominee and would thus have to be made in the form of an annuity (of which one-third could be commuted). Due to time constraints a follow up meeting was arranged for 27 April 2005.

The follow meeting on 27 April was chaired by Mr J le Roux of Inland Revenue. In his introductory remarks Mr le Roux commented that the retirement funds industry had changed significantly since the promulgation of the Income Tax Act while the Act did not keep pace with these changes. He suggested that the industry should make a presentation to Inland Revenue explaining the various products and benefit structures in use today that the meeting should attempt to identify how the industry can assist Inland Revenue to achieve its objectives. He also pointed out that there was a need to reconsider the basic premises of taxation of the retirement funds industry and invited the industry to make proposals on such ideas. One idea that has been mooted was to do away with taxation of annuities. This would require that the loss in revenue to government would have to be made good through possibly introducing a tax on retirement funds. The disadvantage of that approach would however be that it would spread the tax burden equally over the full income spectrum rather than taxing progressively on the basis of

affordability.

The technical sub committee of RFIN pointed out to Inland Revenue that there was an obvious misconception within the industry about the intention and the application of PN 5 of 2003. Accordingly the industry attempted to find a way to deal with the perceived creation of a new interim tax regime in anticipation of changes to the Income Tax Act to reflect the intention of the practice note. From that perspective the industry did not see any need for changing rule nor for any due date for submitting rule changes and that it was now incumbent upon Inland Revenue to amend the Act to reflect the new regime. The industry however, now understands that this was not the intention of the practice note. On the basis of this new perspective, the committee suggested that this should imply that all lump sums that have been taxed in the mean time need to be revisited with the view to refund any tax incorrectly deducted. This view is based on the fact that all affected pension funds had received tax approval of their respective benefit structures which often provided only for lump sum death benefits. It was pointed out that the Income Tax Act was open to interpretation in this regard and that the only option for retirement funds was to test the view of Inland Revenue by submitting their rules for tax approval and, having obtained such approval, the relevant funds accepted in good faith that their rules were in compliance of the Act. This view was opposed strongly by Inland Revenue suggesting that if a fund were to take this view, Inland Revenue would take the view that the fund's tax approval will be revoked with back dated effect and that all contributions would consequently not be allowed as a deduction. In response to a request by the committee to provide a list of funds that do not comply in the view of Inland Revenue, Inland Revenue confirmed that no such list has been drawn up yet as this would require an extensive study.

The meeting then considered a number of practical difficulties of the industry of applying the practice



note. One official of Inland Revenue suggested that the 51%:49% principle would have to be applied to each and every beneficiary individually and that no single individual should be entitled to receive more than 49% of available capital in form of a lump sum. The committee pointed out that whenever risk benefits are provided through reinsurance with an underwriter or through self-insurance, the very principle of insurance does not provide for quantifying total capital available. It would in such a situation consequently be impossible to determine the portion that has to be applied to provide an annuity. Unfortunately due to time constraints the meeting had to be terminated once again, before a mutually agreeable conclusion could be reached. Inland Revenue did however give the impressions that it now had a better understanding of the difficulties and ambiguities created by the practice note and informed the sub committee that the practice note will be redrafted and will be reissued in due course. The sub committee requested to be afforded the opportunity to comment on the revised practice note prior to its official release and suggested that each fund found to be not in compliance be given a fair time frame for submitting rule amendments, in its own right.

3. Summary

After the first meeting between RFIN technical sub committee and Inland Revenue on 18 April, it became quite apparent that the practice note and subsequent discussions with Inland Revenue at various instances created considerable confusion that actually led to the industry literally 'barking up the wrong tree' while trying to understand Inland Revenue's intentions and trying to be cooperative in achieving its perceived objectives. The discussions of 18 April have clarified the position of Inland Revenue, but it has not addressed or solved the practical problems the practice note presents to the industry.

It also became evident that the taxation of death benefits since 16 September 2003, which has been

applied haphazardly by the various tax offices, can probably be challenged on the basis that the relevant fund's rules were approved by Inland Revenue and that any lump sum death benefit should have consequently been tax free. As intimated by a senior official, Inland Revenue might respond to such challenge by revoking the tax approval and disallowing past contributions. Such action can obviously be challenged as well on the basis of the arguments put forward by RFIN sub committee. In addition the position of Inland Revenue, which is based on its interpretation of the phrase '...or mainly for the said purpose...' is questionable and can probably also be challenged.

As it was pointed out to Inland Revenue, this phrase can be applied at three different levels and will produce different results in each case. Firstly one can look at the fund as a whole and determine which portion of its total funding is or will eventually be applied to provide annuities. If this portion were to exceed 50% it could be argued that the fund complies. The second level would consider the definition of benefits as per the rules of the fund. In this case the rules would provide that in the event of a deceased member leaving dependents or nominees, annuities are to be provided to these persons. If only annuities were to be provided the situation would be clear. If the fund would however also offers a lump sum in addition to annuities it becomes a lot more complex and one would then probably consider the third level being each individual case concerned.

The third level would consider each and every case individually. One would have to quantify the total capital available for providing death benefits and ascertain that not more than half the benefit is paid as a lump sum in order to comply with the requirements of the Income Tax Act as interpreted by Inland Revenue. The issue becomes even more complex where a fund provides annuities by means of reinsurance of self-insurance where there no direct connection between the benefit and the capital required to fund such benefit.

At our meeting of 18 April it Inland Revenue intimated that it would look at the third level and would thus have to consider each and every case individually although it obviously had not inculcated the issue of reinsurance or self-insurance of risk benefits.

4. Conclusion

From the industry's point of view, there is general consensus that the Income Tax Act should follow developments rather than restricting and inhibiting these by being unnecessarily prescriptive. Demographic, cultural, social and economic changes and realities require that the industry is proactive, mobile and flexible. The manner in which benefits have been structured by funds over the past couple of years reflects such changes in needs and realities. It is therefore preferable that the income tax regime does away with the different types of funds and rather defines the manner in which each type of benefit is to be taxed. This was also the general consensus amongst the members of the committee that drafted the proposed new Retirement Funds Bill.

In the interests and on behalf of the industry and its stakeholders, RFIN should firstly consider testing Inland Revenue's interpretation of the phrase '...or mainly for the said purpose...' by reference to the level at which it is to be applied with the view to limit the number of rules that would have to be changed. Preferably this should be applied at the top level namely the funding level. RFIN should furthermore press for the removal of the different types of funds currently defined in the Income Tax Act and to introduce a tax regime that would only define how benefits are to be taxed. RFIN should furthermore consider addressing the practice of Inland Revenue to tax death benefits paid by pension funds since 16 September 2003. Finally RFIN might consider taking a mutual view that Inland Revenue cannot deal with the issue globally by way of a practice note but have to advise each fund that in its view does not comply individually and grant sufficient time for the fund to comply, considering

that all rules were approved by Inland Revenue.

From the trustees' point of view, it is important that their philosophy be revisited as regards the provision of lump sum benefits vis-à-vis annuities. The lump sum benefit clearly assumes that the beneficiary/ies will be mature enough and capable to manage the capital in a responsible manner so that their needs will be properly catered for in future. It also realizes an immediate tax liability. Providing annuities is clearly a more paternalistic approach and postpones the income tax liability.

Where lump sum benefits are preferred, their fund would have to be constituted as a provident fund.

Where the trustees take a more paternalistic approach the fund will have to be constituted as a pension fund and the rules would have to be drafted in such a manner that in all cases where the member leaves dependents or nominees, no more than one-half of the available capital may be paid out as a cash lump sum, wherever the capital can actually be quantified. Where annuities are reinsured or self-insured, the rules can be amended to provide that a maximum of 49% of any lump sum available in addition to any survivors' pens must be paid in the form of an additional annuity, and/or to provide that one-third of a self-insured or reinsured annuity may be commuted for a cash lump sum.

Alternatively, where funds currently

provide for dependents' pensions trustees can take a 'wait and see' approach and challenge Inland Revenue should it raise any objection to the benefit structure.

As regards death claims that were taxed since 16 September 2003, the trustees might consider obtaining legal advice in their own right whether or not the fund should attempt to claim the tax back from Inland Revenue on behalf of the beneficiaries. Alternatively, if RFIN obtains clarity on this on behalf of its members, trustees might prefer to take collective action if warranted.

Note: This paper reflects the personal opinions and views of the author, in his private capacity.