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Dear Mr Axelson, Mr Syminton and Ms Collins

## **APPLICATION OF SECTION 9(2)(i) AND SECTION 10(1)(gC) AND OF THE INCOME TAX ACT (NO. 58 OF 1962)**

The South African Institute of Tax Professionals ('SAIT') and the South African Institute of Chartered Accountants ('SAICA') would like to add our voice to the growing concerns expressed by industry with regard to the South African Revenue Service's ('SARS') interpretation and application of section 10(1)(gC)(ii) and section 9(2)(i) of the Income Tax Act (No. 58 of 1962) ('the Act').

All references to sections and paragraphs hereafter refer to the Act, unless otherwise indicated.

### **1 BACKGROUND**

#### **1.1. Section 9(2)(i)**

Section 9(1)(g)(ii) was the original provision in the Act that deemed pensions and annuities to be sourced in South Africa ('SA'), based on whether those services were rendered SA-in see **Annexure A** hereto.

Section 9(1)(g)(ii) was replaced by section 9(2)(i) in the Taxation Laws Act 24 of 2011. It also sources a pension or annuity in SA based on whether those services were rendered in SA- see **Annexure A** hereto.

The Explanatory Memorandum for the introduction of section 9(2)(i) stated as follows:

*4. Services, pensions/annuities and government services*

*a. Current reliance or common law*

*The source determination for services is based solely on the common law. This source determination largely focuses on the place where the services are rendered (with some minority arguments in favour of the dominant activity giving rise to those services). If services are rendered partly within and partly outside South Africa, the allocation of source is based entirely on the facts and circumstances (e.g. time and value addition). The basic common law source rules for services will remain unchanged.*

*b. Proposal for private pensions/annuities*

*The proposed rules for determining the source of private pensions or annuities derived from services will follow exactly the same principles as the source determination for service income. More specifically, the source for these annuity and pension payments will be based on the source of the underlying services giving rise to those payments.*

*Therefore, if the underlying services are rendered within South Africa, the associated annuities and pensions will be viewed as South African source. If the annuities and pensions relate to mixed services (i.e. services rendered within and without South Africa), the allocation will be based on time spent. These rules are essentially the same as pre-existing law, except for the two-out-of-ten year election.*

## **1.2. Section 9(3)**

Section 9(3) entrenches the principle in section 9(2)(i) that a pension or annuity is deemed to have accrued in respect of services rendered- see **Annexure A** hereto.:

## **1.3. Section 10(1)(gC)**

Section 10(1)(gC) of the Act was inserted by section 13(1)(d) of Act 59 of 2000 subsequent to South Africa moving from a source basis to a worldwide basis of taxation. Section 10(1)(gC)(ii) specifically stated:

“(gC) any

(ii) pension received by or accrued to any resident from a source outside the Republic, which is not deemed to be from a source in the Republic, in consideration of past employment outside the Republic”

The Explanatory Memorandum in respect of this insertion stated (emphasis ours):

*The issue of the taxation of foreign pensions has raised some controversy. Currently foreign pensions and social security payments are exempt from income tax. It is, however, international practice for a country of residence to tax foreign pensions. Many reasons have been put forward as to why foreign pensions should not be taxable once South Africa moves to a worldwide basis of taxation. It is argued that this may discourage foreigners from retiring in South Africa. Furthermore, it is argued that the income from a pension is static and that any tax imposed thereon will effectively reduce the pensioners’ income. This argument is not necessarily correct as in most instances the country of source in any event taxes the pension if it is not taxed in the country of residence.*

*Various other problems such as the deductibility of contributions to foreign pension funds and the taxation of lump sum payments from these funds will have to be addressed. Foreign funds would also have to be approved by the Commissioner based on whether the rules of the fund comply with the requirements of the Income Tax Act, 1962, and this may place a significant administrative burden on SARS.*

*From a practical point of view, it is, therefore, proposed that foreign pensions not be taxed at this stage. It must, however, be noted that this is merely an interim measure and that the issue of the taxation of foreign pensions will be revised over the next three years. This should provide sufficient time to determine how contributions to these funds and the taxation of payments from foreign funds should be dealt with and to determine what the economic impact of taxing foreign pensions may be.*

It is therefore clear that section 10(1)(gC) was a practical interim solution, not only in respect of the amounts that would be included in gross income, but also in considering the previous tax deductibility of the contributions which resulted in those pension payments, either in the form of an annuity or a lump sum. The

latter was to ensure equity for pensioners between those who did receive tax relief in respect of historical contributions and those that did not.

Section 10(1)(gC) was amended in 2001 to incorporate the deemed source rule in section 9(1)(g) which deemed the source of the pension to be where the services that created the pension was rendered, irrespective of where the annuity or pension is made or where the funds from which payment is made are situated. Section 10(1)(gC)(ii) stated:

*“(gC)*

*“(ii) pension received by or accrued to any resident from a source outside the Republic, which is not deemed to be from a source in the Republic in terms of section 9(1)(g), in consideration of past employment outside the Republic”*

Section 10(1)(gC)(ii) was further amended in 2012 and now states:

*“(gC)*

*“(ii) pension received by or accrued to any resident from a source outside the Republic as consideration for past employment outside the Republic”*

The Explanatory Memorandum in respect of this insertion stated :

*The concept of “deemed source” is no longer relevant in light of the changes made to the source rules of section 9 contained within the Taxation Laws Amendment Act, 2011.*

It is however submitted that although the concept of ‘deemed source’ was removed from section 9(2), the deeming provision of section 9(3) remains.

## **2 SARS NON-BINDING RULING**

In a written non-binding private opinion issued by SARS on 2 September 2013 to the Institute of Retirement Funds Africa, SARS sets out its various interpretations of the law pertaining to cross border pensions. This document serves as the basis for the submission, though it’s non-binding nature is noted, it seems to reflect the general approach adopted by SARS in respect of the various matters. The non-binding private opinion is attached as Annexure B to this submission.

## **3 PROBLEM STATEMENT**

We have reviewed the document from SARS and the interpretations it expresses and cannot reconcile the views expressed with the law in its current form. Our main concerns are:

- SARS' interpretation as to the source of a pension as being the source of payment (i.e. the fund) and not the originating cause (i.e. services rendered) as determined in the *Lever Bros* case and section 9(3);
- SARS' interpretation that section 9(2)(i) only applies to non-residents; and
- SARS' interpretation that section 9(2)(i) only applies to annuities not lump sums.

These concerns are set out in detail below.

## 2.1 SOURCE OF A PENSION

The ruling states in example 1 that the general source principles as described in *CIR v Lever Bros & Unilever (Pty) Ltd* 1946 AD 441 14 SATC 1 are applied. It then applies those source principles to the benefits payable by a fund situated in SA by applying the pro rata ratio of the services rendered inside and outside SA, which services resulted in the later pension amount. It is clear from SARS' application in this instance that the source of the pension under the general source principles are located where the services that created the pension are rendered and not where the fund that pays the pension is situated. We agree with such interpretation for the reasons as set out below.

The source principle heralded in *Lever Bros* at 8 (14 SATC 1) was that (emphasis ours):

*The word "source" has several possible meanings. In this section it is used figuratively, and when so used in relation to the receipt of money one possible meaning is the originating cause of the receipt of the money, another possible meaning is the quarter from which it is received. A series of decisions of this Court and of the Judicial Committee of the Privy Council upon our Income Tax Acts and upon similar Acts elsewhere have dealt with the meaning of the word "source" and the inference, which, I think, should be drawn from those decisions is that 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 work which he does may be a business which he carries on, or an enterprise which he undertakes, or an activity in which he engages and it may take the form of personal exertion, mental or physical, or it may take the form of employment of capital either by using it to earn income or by letting its use to someone else. Often the work is some combination of these.'*

In this respect we agree that the normal principle in respect of pension amounts is that the originating cause of the pension is not the *quarter from which it is received* (i.e. the place of the fund) but the originating cause which is *the work which the person did to earn the pension*.

A similar opinion that the source is dependent on the place where the services are rendered and not the place from where payment is made is also heralded in SILKE on Income Tax at 5.24 which states:

*The portion of a pension received by or accrued to a resident for services rendered outside the Republic (that is specifically deemed not to be from a source within the Republic), qualifies for exemption from tax in South Africa in terms of s 10(1)(gC)(ii).*

The interpretation that the source of annuity and pension payments is based on the source of the underlying services has further been confirmed by National Treasury in the Explanatory Memorandum to section 9(2)(i)- see 1.1. above.

However, in the same letter from SARS in example 2, SARS states that the section 10(1)(gC)(ii) exemption will not apply if the fund from which the pension is paid is in SA. This second interpretation is clarified in the letter dated 11 October 2013 whereby SARS are of the opinion that if section 10(1)(gC)(ii) is not interpreted that the requirement that the “source outside SA” refers to the place of the fund, then it is superfluous as it also requires that the employment for past consideration must also be outside SA.

SARS’s interpretation in example 2 totally disregards the judgement in *Lever Bros*, the Explanatory Memorandum and section 9(3) as to the source of income (pensions specifically) and SARS’ opinion on the superfluous nature, if any, of the legislation if the principles in *Lever Bros* are applied, and correctly so, cannot be sustained. It is submitted the reference to foreign funds having to be approved only relates to facts where that is applicable and does not in any sense qualify the whole purpose of the intended relief. In fact the legislature has specifically tried to incorporate this principle in section 9(3) by specifically deeming such amounts to be in respect of services rendered, thus confirming the common law source as the underlying services, not the residence of the paying fund. On SARS’ argument, the annuities paid to a UK resident as a consequence of a SA resident employer paying the UK employee for services rendered in the UK, would be sourced in South Africa based on the residence of the payor employer in SA. This cannot be correct.

### **Submission 2.1.1**

SARS’ interpretation of the law cannot as a matter of convenience disregard or read out of the legislation the common law position set out in *Lever Bros* case or section 9(3), which the legislature has specifically included

in the statutory provision of section 10(1)(gC). The source of the pension remains its originating cause no matter where it is received from, whether from a South African or a foreign fund.

#### **Submission 2.1.2**

The source rule as formulated in *Lever Bros* case and section 9(3) should be expressly read into section 10(1)(gC) to prevent further uncertainty, until such time as all the concerns relating to foreign sourced pensions, including the deduction of contributions has been legislatively addressed, as initially undertaken by the legislator when the relief was introduced.

#### **Submission 2.1.3**

SARS' interpretation will result in double taxation. For example, if Mr A immigrates to SA (i.e. becomes tax resident) and uses his foreign pension lump sum to buy a South African pension annuity, then SARS' interpretation would lead to the person being fully taxed in South Africa on the pension annuity, even though the person never received any tax deductions. The same would apply if Mr A encashes his pension annuity for a lump sum. The full amount according to SARS would be subject to tax in SA.

Apart from the fact that SARS has discounted the principles of the *Lever Bros* case as well as section 9(3) in example 3, in the case where the fund is foreign and the pension was in consideration for past employment outside SA it is unclear what documentation the taxpayer would have to provide to get the exemption. For example, if he worked outside of South Africa for 38 years and 5 years in South Africa, does he now have to retain documents from 43 years ago? Furthermore, with no pro rata year based apportionment in section 10(1)(gC), how would the apportionment be done as the investment returns on the first 5 years would proportionally result in such amount exceeding 5/43 years portion of the actual pension paid and *visa versa*?

#### **Submission 2.1.4**

SARS should issue guidance in the example 3 of how taxpayers should apportion the amount and what the documentary requirements are.

## **2.2 APPLICATION OF SECTION 9(2)(i) TO RESIDENTS AND NON-RESIDENTS**

The non-binding private opinion also expresses the view that section 9(2)(i) is only applicable to non-residents. It is unclear on what basis this statement is made as nowhere in section 9(2)(i) does it state that it only applies to non-residents. It merely deems an amount to be from a source in South Africa. It represents an embodiment of the common law and will, where applicable, apply to residents as well. The main difference between section 9(2)(i) and its predecessor, section 9(1)(g)(ii), was that the latter applied a more

practical test by only deeming amounts to be South African sourced if services were rendered in South Africa for 2 or more years in the last 10 years before retirement. Other than that, section 9(2)(i) remains the same with no other limitations.

### Submission 2.2.1

SARS' interpretation that section 9(2)(i) only applies to non-residents based on the fact that residents are taxed on their worldwide income is clearly incorrect. Section 9(1)(g) (which 9(2)(i) is a copy of for the most part) and section 10(1)(o), were specifically introduced as exceptions to the standard rule of worldwide basis of taxation applicable to residents. Section 9(1)(g)(ii) remained in force for 10 years after the introduction of a residence based system of taxation, and was applied by SARS to residents and non-residents alike

## 2.3 APPLICATION OF SECTION 9(2)(i) TO LUMP SUM BENEFITS

The SARS opinion also states that section 9(2)(i) only applies to annuities and not to lump sum benefits on the basis that section 9(2)(i) refers only to "pensions and annuities".

The Merriam Webster dictionary defines pension as :

*"an amount of money that a company or the government pays to a person who is old or sick and no longer works"*

but also as

*"a fixed sum paid regularly to a person"*

Though it is accepted that habitually a pension is an amount paid regularly or as annuity, it must as stated be interpreted in context in relation to all the other legislation as well.

A 'lump sum benefit' as defined in the Second Schedule to the Act includes any amount in respect of the commutation of an annuity- see **Annexure B** hereto.

In addition, in terms of paragraph 2(1) of the Second Schedule the amount of a lump sum benefit that is to be included in the gross income of a person, is subject to section 9(2)(i)- see **Annexure B** hereto. In this regard, SARS' statement that the reference in paragraph 2(1)(a) of the Second Schedule is superfluous cannot be correct. The presumption against legislation being invalid or without purpose is codified in our common law. In this respect, even subordinate legislation, such as the Second Schedule, should be

interpreted so that it is valid in respect to its references to section 9(2)(i) for the purpose as stated above, namely that all retirement amounts in paragraph 2(1)(a), lump sum benefits are subject to section 9(2)(i). It is therefore unclear on what basis SARS views the legislative reference as superfluous.

### **Submission 2.3.1**

The interpretation of section 9(2)(i) on its normal grammatical meaning and also in context to the rest of the Act, such as paragraph 2(1)(a) of the Second Schedule, does incorporate retirement lump sum benefits and correctly should do so to prevent any discrimination against provident fund members.

Yours sincerely,

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## Annexure A

### **Section 9(1)(g) (ii)**

*An amount shall be deemed to have accrued to any person from a source within the Republic if it has been received by or has accrued to or in favour of such person by virtue of-*

*(g) any pension or annuity granted to such person, wheresoever payment of that pension or annuity is made and wheresoever the funds from such payment is made are situate-*

*(ii) by any person , whether residing or carrying on business in the Republic or not, if the services in respect of which that pension or annuity was granted were performed within the Republic for at least two years during the ten years immediately preceding the date from which the pension or annuity first became due: Provided that if the pension or annuity was granted in respect of services which were rendered partly within and partly outside the Republic, only so much of such pension or annuity bears to the amount of such pension or annuity the same ratio as the period during which the services were rendered in the Republic bears to the total period during which the services were rendered, shall be deemed to be derived from a source within the Republic: Provided further than any services rendered in the territory of the former Republic of Transkei, Bophuthatswana, Venda or Ciskei shall be deemed to have been rendered within the Republic.*

### **Section 9(2)(i)**

*An amount is received or accrues to a person from a source within the Republic if that amount-*

*(i) constitutes a pension or an annuity and the services in respect of which that amount is so received or accrues were rendered within the Republic: Provided that if the amount is received or accrues in respect of services which are rendered partly within and partly outside the Republic, only so much of that amount as bears to the total of that amount the same*

*ratio as the period during which the services were rendered in the Republic bears to the total period during which the services were rendered must be regarded as having been received by or accrued to the person from a source within the Republic.*

**Section 9(3)**

*For the purposes of paragraph (i) of subsection (2), any amount granted to a person by way of pension or annuity must be deemed to have been received by or to have accrued to that person in respect of services rendered by that person;*

## Annexure B

### Second Schedule to the Income Tax Act

**'lump sum benefit'** includes-

- (a) any amount determined in respect of the commutation of an annuity of 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.
- (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 instalments, but does not include any amount deemed to be income accrued to a person in terms of section 7(11)*

#### **Paragraph 2(1)**

*Subject to section 9(2)(1)(i) and paragraphs 2A and 2C, the amount to be included in the gross income of any person in terms of paragraph (e) of the definition of "gross income" in section 1 shall be...."*