Retirement annuities and estate duty: closing the loophole

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"To eliminate the potential to avoid estate duty, government proposes that an amount equal to the non-deductible contributions to retirement funds be included in the dutiable estate when a retirement fund member passes away."

The statement above is drawn from the 2015 Budget Review and while National Treasury has no intention of scrapping the estate duty exemption that applies to retirement annuities, it would like to stop those who abuse the tax advantages of using a retirement annuity, particularly from an estate duty perspective.

So what does this effectively mean?

In order to fully understand this statement one needs to look at some of the tax changes made over the years that have affected retirement funds.

From an income tax perspective, retirement annuities have always been extremely attractive taking into consideration that one is entitled to a tax deduction of their contributions into a retirement annuity (up to 15% of their non-pensionable income), there is no tax generated inside of the fund and that there are certain tax concessions when you exit a retirement annuity. Over and above this in 2008, National Treasury exempted all retirement funds from estate duty as well as removed the upper age limit that one needed to retire from a retirement annuity and purchase a compulsory annuity. The effect of these two changes created the opportunity for those individuals in their latter stages of life to purchase a retirement annuity with large sums of cash in order to avoid estate duty.

How did this work?

Upon death up to 20% of ones assets is payable to the South African Revenue Services (SARS) for estate duty purposes with the first R3 500 000 of their estate being exempt. Essentially, if an individual passes away with R10 000 000 invested in the bank, endowment or a unit trust then potentially 20% (R2 000 000) of that asset is payable to SARS for estate duty. If the same individual was invested in an approved retirement fund like a retirement annuity then the entire fund value commuted by a beneficiary will be exempt from estate duty.

However one must consider that even though retirement annuities are exempt from estate duty, the full fund value commuted by the beneficiary is taxable in the name of the deceased estate using the retirement tax table. In our example, it is most likely that only a small part of the R10 000 000 invested qualified for a tax deduction. The majority of the amount invested would be referred to as a non-deductible contribution. Any non-deductible contribution is not taxable in terms of income tax. In essence this means that this individual was able to legitimately avoid estate duty and as well as income tax. Even if the R10 000 000 grew to R12 000 000 upon death of the member, tax would only be levied on R1 500 000 (R12 000 000 less [R500 000 tax-free and R10 000 000 non-deductible contribution] and not the full amount.

Treasury is clearly not happy with this and in the budget this year they showed their first intention to begin to manage this.

What are National Treasury's intentions?

National Treasury intends on making non-deductible contributions dutiable in terms of estate duty. This would mean that any amount contributed that did qualify for a tax deduction (15% of pensionable income for retirement annuities) will still be exempt for estate duty purposes. Only those who threw in a large amount of lump sums into a retirement annuity will feel the effects of treasury's proposed changes. Those who calculate their maximum tax deduction (15% of non-pensionable income) and decide to contribute that amount just before tax year end will continue to benefit from all the tax advantages currently provided by SARS.

So the good news for the majority of South Africans who contribute towards retirement funds is that they won't be affected and the bad news for the very small number of South Africans who contribute large amounts of lump sums into a retirement annuity is that they won't be able to use retirement annuities to avoid estate duty.

When does this become effective?

At this stage National Treasury has not given any indication as to when this will become effective and once effective, whether or not, it will be made retrospective. If it were to be made retrospective it would be very unfair to the South Africans who have legitimately contributed 'non-deductible contributions' in order to reduce their dutiable estate or even for retirement planning. The benefit of doing so is completely legitimate and those that have done so should not be penalised because treasury is now trying to close a loophole.

Employees who contributed towards a provident fund would not have qualified for a tax deduction. Therefore any contribution that an employee (not employer contribution) made would be a non-deductible contribution and it seems extremely harsh to penalise such a person who prudently and legitimately made additional contributions to their provident fund. There have already been various comments from industry that oppose making this proposed legislation change retrospective. Let's hope that when the first draft is released it will exclude non-deductible contributions made prior to the proposed effective date from estate duty. DK

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