

PAYING ESTATE DUTY ON EXCESS FUND CONTRIBUTIONS

By Diane Seccombe, National Head of Taxation at Mazars Academy

In 2015 Treasury identified a loophole in the tax legislation whereby taxpayers were making use of excessive retirement fund contributions (mostly to Retirement Annuity Funds) for estate planning purposes, to pass on wealth, tax free. Specifically to prevent this, section 3(2)(bA) was added to the Estate Duty Act (EDA) in the 2015 Taxation Amendments and applied to persons dying on or after 1 March 2016.

To understand Treasury's concern, one needs to recap a little of the Income Tax Act (ITA) treatment of retirement fund contributions. Qualifying contributions to retirement funds are deductible in terms of section 11F. Section 11F limits the maximum amount that can be deducted per year of assessment. Retirement fund contributions exceeding the maximum amount (excess contributions) are carried forward to a subsequent year of assessment where a taxpayer will attempt, subject to the limitations, to obtain a tax deduction. However, what are the consequences should a taxpayer die with a balance of excess contributions for which there has been no tax deduction?

The treatment of excess contributions at death

At the death of a taxpayer, the portion of their retirement interest in a fund that is paid out as a lump sum must be considered when calculating the final normal tax liability of the deceased. However, before any tax consequences are considered the lump sum must be reduced by the total excess contributions at that time.

So, for example: Assume at the date of death R7 million is paid out of the taxpayer's retirement fund as a lump sum to the relevant dependant or nominee. Assume further that the deceased had R600 000 in excess contributions.

The second schedule to the ITA (para 5), requires that the lump sum of R7 million first be reduced by R600 000, so that R6.4 million is the lump sum on which the normal tax liability is calculated.

R6.4 million will be taxed in terms of the relevant lump sum tax table, where, depending on qualifying lump sums received in the past, the first R500 000 may be tax free and the maximum rate of tax payable is 36%.

So, what is clear is that on the death of the fund member, excess contributions reduce the amount of any lump sum paid out by the fund before any normal tax consequences are calculated. In the above example, the lump sum subject to tax is R6.4 million and not R7 million.

Estate Duty consequences

The estate duty consequences of the lump sum must now be considered. Section 4(i) of the Estate Duty Act (EDA) makes short work of this matter as "any benefit" payable by a retirement fund as a result of the death of

the member is excluded from “property” for estate duty purposes and therefore does not fall into the estate. In the above example, the full R7 million lump sum is excluded from the estate and free from estate duty.

At this stage we quantify Treasury’s concern. An amount of R7 million has been transferred on the death of the taxpayer. R6.4 million has been subject to normal tax. The full R7 million is excluded from estate duty. So R600 000 (the excess contributions) has effectively been transferred entirely tax free. To rectify this, Treasury wanted to ensure that an amount equal to the excess contributions (R600 000) be included as “property” for estate duty purposes.

The 2015 version of section 3(2)(bA) did not successfully close the loophole as Treasury intended. The original section 3(2)(bA) expanded on the amounts that constituted “property” for estate duty purposes and that could therefore fall into the estate. Understandably the new section stated that all fund contributions that had not been deductible in terms of section 11F (excess contributions) be included in the estate. However, the new section further stated that for an excess contribution to be part of the estate, not only must the excess contribution have been disallowed as a tax deduction but the excess contribution must also have been disallowed as a deduction in terms of the second schedule. This is where things went wrong.

As explained above, the second schedule to the ITA requires that a lump sum paid out at the death of a fund member first be reduced by excessive contributions (R600 000 in the example) before the tax liability on the lump sum is determined. So because the excess contributions were being deducted off the lump sum in terms of the second schedule, the excess contributions were not meeting the two requirements of new section 3(2)(bA) of the EDA, namely that they were not tax deductible and were not taken off the lump sum in terms of the second schedule. The excess contributions were therefore not falling into the estate as intended.

Once taxpayers and those advising them realised the loophole had not been closed, the aggressive estate planning using excess fund contributions continued.

Clarifying the situation

In 2019 Treasury amended section 3(2)(bA) and backdated some of the amendments to 1 March 2016. Not for the first time Treasury relied on the argument that although the wording of the original section was insufficient to close the loophole identified from 1 March 2016, the intention had nevertheless been indicated at that time, and as such later amendments to the section would be backdated.

The amended section 3(2)(bA) leaves no room for doubt. The amended section will apply to persons who died on or after 30 October 2019. However, once the date of death is ascertained, the section looks at all retirement fund contributions from 1 March 2016.

In terms of the amended section, all retirement fund contributions that were not deductible in terms of section 11F (from 1 March 2016 to date of death) and that were allowed as a deduction against the lump sum paid out at the death of the member (in terms of para 5 of the second schedule of the ITA) will be included as “property” for estate duty purposes and be part of the estate.

In terms of the example, R600 000 will now be part of the estate for estate duty purposes if our taxpayer died on or after 30 October 2019. For normal tax purposes, R6.4 million of the lump sum will be subject to tax in terms of the lump sum table.

Glacier Financial Solutions (Pty) Ltd and Sanlam Life Insurance Ltd are licensed financial services providers