Example – Limit for rating formula

If a person's average salary over the preceding 3 years is R10 000 per annum and he receives a termination lump sum of R90 000 from his employer when he retires the taxable portion of the lump sum after deducting the s 10(1)(x) exemption, i.e. R60 000, will be subject to the rating formula but is limited to the lesser of:

(i) R60 000 (the lump sum)
(ii) R30 000 (3 x annual average salary).

Therefore only R30 000 of the lump sum will be subject to the rating formula.

Example - Section 5(10) rating calculation

The following information is given for Mr X for the year ended 29 February 2008:

Mr X retired from his employment on 31 August 2007, at the age of 58.

Salary R8 000/month		48 000
Pension contributions		(3 600)
Lump sum from employer		80 000
Lump sum from pension fund on retirement	400 000	
Less tax free portion (Second Schedule)	(300 000)	100 000
Interest income		38 000
RAF contribution (single premium)		(25 000)
Taxable capital gain		60 000

Assume that Mr X's average rate of tax ('R') for the year ended 28 February 2007 was 21%.

Tax computation (29/2/2008)

Salary	48 000
Pension contribution (s 11(k))	(3 600)
Lumpsum ex employer	80 000
s 10(1)(x) lump sum exemption	(30 000)
Pension lumpsum	100 000
Interest income	38 000
s 10(1)(i) interest exemption	(18 000)
Taxable capital gain	60 000
RAF contribution limited to:	
15% x 70 000 (**Note 1**)	(10 500)
Taxable income (including retirement fund lump sum)	R263 900
Taxable income (excluding retirement fund lump sum)	R163 900

Applying the rating formula to the taxable income excluding the retirement lump sum:

A = 22 475 (tax on 121 400 (**Note 2**))

B = 163 900 (taxable income excluding retirement fund lump sum benefit)

C = nil

D = 7 500 (**Note 3**)

L = 50 000, i.e. (80 000 - 30 000)

R = the greater of:

(i) 21% (2007 average rate per the formula)

(ii) 18% (**Note 4**)

Tax is computed as follows:

$$\left(\frac{A}{B + D - (C + L)} \times (B - L)\right) + (L \times R)$$

$$\left(\frac{22\,475}{163\,900 + 7\,500 - 50\,000} \times (163\,900 - 50\,000)\right) + (50\,000 \times 21{,}00\%)$$

= 21 087 + 10 500	R31 587
Less rebate	(7 740)
Tax payable on taxable income excluding retirement fund lump sum	R23 847
Tax payable on retirement fund lump sum (R100 000 x 18%)	R18 000

Notes:

1) The s 11(n) deduction is limited to 15% of non-retirement funding income. Income is defined as gross income less exempt income. Because the capital gain is included in taxable income it does not fall into income. The non-retirement funding income is therefore

Retirement lump sum from employer (80 000 – 30 000)	50 000
Interest (38 000 – 18 000)	20 000
	R70 000

2) A is the tax on

	B (taxable income excluding retirement lump sum)	R163 900
plus	D (see (3) below)	7 500
less	L	(50 000)
		R121 400

3) D is so much of the (15%) RAF deduction as is attributable to the inclusion in income of amounts designated as L in the formula. Therefore:

L is the lump sum per s 7A (4A) from the employer	R50 000

Therefore D is R50 000 x 15% = R7 500

4) $R = \frac{F}{B + D - (C + L + G)}$ for current year or 21% (if greater)

(F is the tax, before rebates on B + D – (C + L + G))

$$= \frac{11\,052}{163\,900 + 7\,500 - (50\,000 + 60\,000)}$$

= 18,0%, therefore use 21% as 'R'.

21.2.4 TAX IMPLICATIONS FOR THE EMPLOYER

An employer who pays a termination lump sum to a retiring employee will be allowed a tax deduction if all the requirements of s 11(a) are met. Great care should be exercised when making such payments because, depending on the reason for the payment, the amount may or may not be allowed as a deduction. This problem is well illustrated in two cases. In *W F Johnstone & Co Ltd v CIR* (1951 AD), the employer was not allowed to deduct a lump sum paid to a retiring employee on the grounds that the amount had, on the taxpayers admission, been paid to the employee because of his long and dedicated services to the company, a fact which led the court to conclude that the payment was not made in the production of income. The court felt that the amount expended could not generate income, because the employee to whom it had been paid had left the company. In *Provider v COT* (1950 SR), the taxpayer was able to satisfy the court that an amount paid to a retiring employee was paid, not because of the particular employees service, but rather as an incentive to the rest of the staff,

i.e. to create a happy and contented staff. The amount was therefore allowed as a deduction, being an expense incurred in the production of income.

Three possible situations, therefore, exist in respect of the deductibility of such lump sums:

(i) If the amount is paid in terms of a service contract, it will be allowed as a deduction.

(ii) If the amount paid acts as an incentive for current staff, it will probably be allowed as a deduction (*Provider*). For this to be so, it must be the policy of the company to pay such amounts.

(iii) If paid in respect of past services (and (i) and (ii) above do not apply) the amount will not be allowed as a deduction (*Johnstone*).

21.3 PENSION, PROVIDENT AND RETIREMENT ANNUITY FUNDS

Receipts from pension, provident and retirement annuity funds arise in one of three ways, and may take the form of either a lump sum payment, an annuity, or, most commonly, a combination of a lump sum and an annuity. The three events which give rise to receipts from such funds are:

(i) Resignation from the fund.

(ii) Retirement.

(iii) Death of the member.

Each of these events will be discussed in detail, but before doing so, it is necessary to establish what is meant by the terms pension fund, provident fund, and retirement annuity fund.

21.3.1 DEFINITIONS

Pension fund, provident fund, and retirement annuity fund are defined in section 1 of the Income Tax Act. The important things to note about these are as follows:

- A pension fund can be established by law for the employees of the state or it can be a private fund registered under the Pension Funds Act.
- The important thing about a pension fund is that, generally, the investment in the fund cannot be paid out in full when the employee retires. He or she can only take up to one-third as a lump sum, and the rest is used to pay an annuity (monthly pension) to the ex-employee.
- A provident fund is also registered under the Pension Funds Act.
- When a person retires from a provident fund, the full amount invested in the fund for the benefit of the employee can be paid out to him or her.
- A retirement annuity fund is similar to a pension fund except that a person does not have to be an employee to belong to it. On retirement only one-third can be paid out as a lump sum (unless it is below a certain amount) and the balance has to be paid out in the form of an annuity.
- All the funds have to be approved by the Commissioner for SARS.
- The definitions of 'pension fund' and 'retirement annuity fund' were amended on 8 August 2007 to provide that these funds can pay out their full value as a lump sum where two-thirds of their total value does not exceed R50 000.

Example – Full pay out

Mr X retires from employment on 01 January 2008, and becomes entitled to an annuity from a pension fund. The total amount available in the fund with which to purchase an annuity for Mr X is R75 000. As two-thirds of this amount does not exceed R50 000, the full R75 000 can be paid as a lump-sum to Mr X if he so elects.