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The tax implications on the payment of divorce benefits: the Revenue Laws Amendment Act

The Pension Funds Amendment Act ("the Amendment Act"), which was promulgated with effect from 13 September 2007, introduced the so called 'clean break' principle upon divorce by amending the Pension Funds Act. The Pension Funds Act now allows a non-member spouse to claim a portion of the member's pension interest at the date of divorce in terms of a valid divorce order granted on or after 13 September 2007, which is enforceable against the fund. This means that where a divorce order was granted on or after 13 September 2007, a non-member spouse may now claim payment of the portion of the member's pension interest which was awarded to him/her in terms of a final divorce order, at any time after the date on which the divorce is finalised.

Please refer to *On the Scales* 17 and 23 of 2007, concerning divorce orders and the clean break principle introduced in the Revenue Laws Amendment Bill, for further background to this note.

Executive Summary

- An amendment to the Pension Funds Act introduces the clean break approach in respect of valid divorce orders issued on or after 13 September 2007.
- The amendment to the Pension Funds Act and the introduction of the clean break principle now allows non-member spouses access to their share of pension interest at date of divorce, provided that the date of divorce is on or after 13 September 2007.
- The Amendment Act did not address the issue of who would be liable for tax on the payment made by the fund.
- The Revenue Laws Amendment Act ("RLAA") promulgated on 8 January 2008, addresses the issue of the payment of tax and now provides for tax to be paid on the non-member spouse's portion as and when it is due and payable to the non-member spouse. The liability for the payment of tax still remains that of the member.
- It is proposed that in future the tax liability will shift to the non-member spouse, where funds make payments to non-member spouses.

Previously the non-member spouse had to wait until the member exited the fund, before he/she could receive the portion of the pension interest awarded to him/her in a divorce order. The Pension Funds Act now allows the fund to pay pension interest due from the pension fund in terms of a divorce order to the non-member spouse immediately upon the receipt of the order enforceable against the fund. The Pension Funds Act does not make provision for when and how tax will be paid. The tax liability in respect of any payment made by the fund in respect of a divorce order remains that of the member of the fund.

Tax liability in respect of divorce order granted prior to September 2007 divorce orders.

The Pension Funds Amendment Act enacted on 13 September 2007 did not address divorce orders granted prior to 13 September 2007 and having regard to the recent Pension Funds Adjudicator ("the Adjudicator") determination in JC Cockcroft vs Mines Employees Pension Fund (where the Adjudicator determined that the Pension Funds Amendment Act is retrospective) Alexander Forbes sought legal opinion on this point. The legal opinion obtained states that the Pension Funds Amendment Act does not apply to divorce orders granted prior to 13 September 2007 that is, it is not retrospective.

Please refer to *On the Scales* 17 : *The Cockcroft* determination and divorce orders granted prior to 13 September 2007, for further background to this point.

The Pension Funds Act will once again be amended in 2008 to clarify this position and ensure that the Act is given retrospective effect in this regard.

Where Trustees of Funds have decided to follow the determination handed down by the Adjudicator, the tax liability for the payment made to the non-member spouse remains that of the member. The member remains liable for the payment of tax on the full amount payable to the non-member spouse in terms of a valid divorce order. However, the payment of tax is deferred until the member's exit from the fund. Upon retirement, resignation, retrenchment or death of the member, the fund

at first instance will settle the relevant tax liability in so far as it relates to the payment of pension interest previously made, at the member's average rate of tax as at the date of payment of the non-members' portion of pension interest. The balance, after the deduction of the tax due in respect of pension interest previously paid would be subject to tax in terms of the Second Schedule of the Income Tax Act and would be paid out to the member as his benefit due by the fund to him in terms of the fund's rules. The right to recover the tax paid on pension interest paid to the non-member spouse, conferred upon the member under the Income Tax Act remains unchanged.

Tax liability in respect of divorce order after 13 September 2007.

The Revenue Laws Amendment Act ("RLAA"), promulgated on 8 January 2008 now addresses the issue of tax on divorce and reinforces the clean break approach in its entirety. Please note that the effective date of this legislation is 13 September 2007.

The RLAA addresses how the amount payable to the non-member spouse will be taxed. The Pension Funds Act was amended and provides for the deduction of pension interest due to the non-member spouse from the member's minimum individual reserve in the fund. Furthermore, RLAA created the enabling provision to allow for the deduction or withholding of employees' tax by the administrator.

The RLAA creates a deemed accrual for tax purposes of the pension benefit to the member, at the date of divorce, so as to allow for tax to be paid over immediately when the non-member spouse's portion of pension interest is paid out by the fund. For tax purposes the accrual date is the date of the divorce order. This section of the RLAA is deemed to have come into operation as at *13 September 2007*, which coincides with the provisions relating to divorce payments in terms of the Amendment Act.

In essence the RLAA now introduces the payment of tax in respect of divorce settlements as and when payment of pension interest is made to the non-member spouse. The tax liability on the payment of the non-member spouses' pension interest which was deferred (under the old tax regime) is payable immediately following the promulgation of the RLAA. The RLAA is unclear on the tax accrual date where the date of divorce is earlier than the date of enactment of the Income Tax Act amendments. It is our understanding that the *deemed* tax accrual date for divorce orders that are dated prior to the effective date of the legislation is 13 September 2007.

Even though tax is payable as and when the pension interest to the non-member spouse is paid, the member remains liable for tax at his or her average rate, on the full amount. The right to recover the tax paid on the pension interest from the non-member spouse remains unchanged in terms of the Income Tax Act.

Proposed amendments as contained in the Taxation Laws Amendment Bill, insofar as it relates to tax on divorce

Under the current tax regime and in line with the recent enactment of the Revenue Laws Amendment Act, a divorce payment, in terms of a valid divorce order, made by a retirement fund to a non-member spouse from the member's pension benefit in the fund, is taxed in the hands of the member. In the National Budget speech of 2008 it was proposed that divorce payments made in terms of a divorce order, by retirement funds, in future will be taxed in the hands of the non-member spouse and not the member. Further, the proposed amendments will allow non-member spouses to transfer the benefits received as a result of a divorce settlement to another approved fund, including a preservation fund. This was confirmed in the **draft** Taxation Laws Amendment Act, which also now makes provision for the tax liability to be settled by non-member spouse from the pension interest awarded to him or her or to transfer his or her pension interest award to another approved fund tax free.

Should you require further information regarding the above, please contact your consultant
