DLA CLIFFE DEKKER HOFMEYR

TAX ALERT

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RETIREMENT REFORM

The National Treasury has released the first two of a series of five papers that are, in truth, discussion papers to provoke consultation with the public with the view to amend the structure of South Africa's retirement fund landscape.

In South Africa, retirement funds really stand on two legal feet: one foot is regulation through the Pension Funds Act, No 24 of 1956 (Pension Funds Act) and the Financial Services Board. The other foot is the regulation by the Commissioner of the South Africa Revenue Service through the provisions of the Income Tax Act, No 58 of 1962 (Act). Treasury is concerned about the lack of long term saving by a sufficiently large part of the public and is concerned about the complexity of the industry (and the resulting high costs) that they have felt the need to give the system an overhaul. The overhaul that they are considering now is very different from the basic tax overhaul that they gave in 2007/2008, where they standardised and simplified the taxation of the lump sum benefit.

Accordingly, the first two papers that have been released are papers B and C. Paper B is a review of retirement income markets and deals with the question of making available cost effective, standardised and easily accessible products to the public. Paper C will be dealt with in a future article.

Essentially it is the provisions of the Act that differentiate between pension funds, pension preservation funds, provident funds, provident preservation funds and retirement annuity funds. All of these definitions are found in the Act and not in the Pension Funds Act. In 'enabling a better income in retirement' the Treasury's policy wonks (I use this expression the way it is used in England and the United States, and is not meant to be in any way derogatory, but is really referring to the highly educated people at the higher echelons of Government who look carefully and understand the deeper ramification of policy choices) consider the essential distinction in modern South African retirement between retirees choosing either a conventional life annuity or a living annuity.

Conventional life annuities are issued by life insurance companies and in exchange for taking a retiree's lump sum benefit, the insurance company will promise to pay the annuitant a regular income stream guaranteed to continue for at least as long as the retiree lives. These life annuities can be purchased with a variety of different profiles, and can be programmed to increase in line with an inflation link, or to provide for a pension still for a nominated spouse after the primary holder dies. They can also be purchased with a guarantee period so that the dependants of the retiree will still receive the annuity if the annuitant dies within a short period after purchasing the annuity.

The alternative is the living annuity. The interesting aspect of the paper is how living annuities have in the last 15 years come to totally dominate the market in South Africa. This annuity is now dominated by linked investment service providers run by asset management firms under rented life licences. The living annuity is a tax protected phased withdrawal product, where the retiree tells the asset manager what assets to hold on his behalf and must then choose a draw down rate between 2,5% and 17,5% of the total assets which is paid to the retiree as income each year. To the extent that any of this capital is left when the retiree dies, the balance will revert to the beneficiaries nominated. Crucially, Treasury has highlighted that the costs involved in the living annuity are substantial, in terms of financial advice and brokerage fees; platform fees to the provider, asset management fees to the asset manager, performance fees on investments to the asset manager, and the costs such as audit fees, trustee fees, VAT and securities transfer taxes. Treasury highlights the fact that financial advisers can charge substantial fees for the financial advice in setting up these living

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annuities. This they say is why living annuities dominate the market. In contrast, they say that a financial adviser who recommends a conventional annuity is subject to a maximum commission of 1,5% of the initial purchase price, although some insurers may pay additional commissions. Treasury's concern is that financial advisers have strong incentives to recommend the living annuity rather than the conventional life annuity.

I think the Treasury's real concern is the fact that not only can the holder of a living annuity end up choosing riskier assets in the composition of his fund, but he can also increase his draw down above what might be actuarially prudent, to draw a higher income in the short term. This leaves him or her exposed to a high degree of longevity risk. Treasury's modelling indicates that there is a probability that an individual with a living annuity would face a fall in income of more than 30% in real terms at some point before death. This is why the Treasury obviously is keen that people should buy more conventional annuities because it reduces the risk of people falling back on their family or the State for support in later life. One of the key factors of why people are currently not purchasing conventional annuities is because interest rates are very low, and the life insurance company looks to hedge its liability to the retiree by purchasing long dated Government stocks in the market place.

In my view, I think the nub of what Treasury are considering is the fact that such a conventional life annuity reflects in part the amount of money the retiree can afford to spend given his or her expected longevity and the current rates of return of financial assets. The apparently low income that results from this is also based on the fact that inasmuch as the insurance company issues a guarantee for that, it needs to hold capital against it. Moreover, because the South African market has become thin, insurers that don't sell enough annuities start to face random residual risk. The greater this level of risk, the more capital required and the higher price the insurance company is charging for an annuity to generate the required return on capital. Part of Treasury's drive is that if there was more competition, or new entrants into this market it should drive annuity prices down. The return on capital used to guarantee the annuity would constitute a commensurate compensation for the level of risk. It appears that one of Treasury's real drives is to try and get a higher degree of specific rating in the South African market, so that the prospective purchaser has a degree of comfort that the insurer has priced the conventional annuity based on his actuarial risk profile, rather than lumped him in with too wide a selection of other retirees. In South Africa, rating is only done by age and sex. In the United Kingdom, annuities are rate by age and sex, but also by health status and postal code.

Higher interest rates reduce the influence of mortality on annuity prices. This is because higher interest rates lower the present value of the annuity payments and so reduce the effect of rating on price. If the insurers are not rating sufficiently, then people with lower than average life expectancies choose not to purchase these products because they correctly perceive them to represent poor value. Accordingly then people are discouraged from obtaining insurance against outliving their assets, and this simultaneously makes annuities more expensive for the rest of the market, so compounding the problem (at page 35 of the Report).

One of the options that Treasury has considered then is what they call the Default Retirement Income Trust Account. This is intended to be a hybrid product that would not offer investment choice, but would allow the trustees to invest in riskier assets because it would permit limited draw downs in the earlier years of the product, with a view to postponing or phasing in the purchase of a life annuity when the individuals are in their mid 70's, which would cut the costs of providing such longevity insurance.

Alastair Morphet

NEW PENALTY PROVISIONS UNDER THE TAX ADMINISTRATION ACT: UNDERSTATEMENT PENALTIES

In a previous article we discussed that Chapters 15, 16 and 17 of the Tax Administration Act, No 28 of 2011 (TAA) make provision for three types of penalties, namely administrative non-compliance penalties, understatement penalties and criminal offences relating to tax legislation.

In that article we specifically discussed Chapter 15 and administrative non-compliance penalties. This article focuses on Chapter 16 and understatement penalties.

The understatement penalty provisions essentially replace the 'additional tax' provisions contained in s76 of the Income Tax Act and s60 of the Value-added Tax Act.

An 'understatement' is defined in s221 of the TAA as any prejudice to SARS or the *fiscus* in respect of a tax period as a result of:

- a default in rendering a return;
- an omission from a return;
- an incorrect statement in a return; or
- where no return is required, the failure to pay the correct amount of tax.

The penalty is determined by first calculating the amount of the so-called 'shortfall'.

The shortfall is calculated as the sum of:

- The difference between the amount of tax properly chargeable and the amount of the tax calculated on the understatement.
- The difference between the amount properly refundable and the refund calculated on the understatement.
- The difference between the amount of any assessed loss or other benefit carried forward, properly calculated, and the amount of the assessed loss or other benefit calculated on the understatement, multiplied by the maximum tax rate properly applicable to the taxpayer.

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The penalty is then calculated by applying the relevant penalty percentage to the shortfall in accordance with a table. The table takes into account the behaviour of the taxpayer.

Behaviour	Standard case	If obstructive or a repeat case	Voluntary disclosure after notice of audit	Voluntary disclosure before notice of audit
Substantial understatement	25%	50%	5%	0%
Reasonable care not taken in completing return	50%	75%	25%	0%
No reasonable grounds for tax position taken	75%	100%	35%	0%
Gross negligence	100%	125%	50%	5%
Intentional tax evasion	150%	200%	75%	10%

These penalties may also be charged in respect of estimated assessments and agreed assessments.

Understatement penalties must be remitted in the case of substantial understatements where the taxpayer made full disclosure of the arrangement to SARS by the date that the return was due and the taxpayer was in possession of an opinion by a registered tax practitioner.

The opinion must have been issued by the date the return was due and must have been based on full disclosure of the facts and circumstances of the arrangement.

Where the opinion pertains to the so-called 'substance over form doctrine' or anti-avoidance provisions, the taxpayer must be able to demonstrate that all the steps or parts of the arrangement was disclosed to the tax practitioner, whether or not the taxpayer was a party to the steps or parts.

The opinion must also confirm that the taxpayer's position is more likely than not to be upheld if the matter were to proceed to court.

A substantial understatement is one where the prejudice to SARS or to the *fiscus* exceeds 5% of the amount of tax properly chargeable or refundable, or R1 million, whichever is the greater.

Where SARS refuses to remit the penalty, the decision is subject to objection and appeal.

Any non-compliance subject to an understatement penalty may not also be subject to a fixed amount administrative non-compliance penalty, but could potentially also be subject to a percentage based administrative non-compliance penalty.

In a follow-up article we will discuss Chapter 17 of the TAA, which deals with criminal offences in respect of tax legislation.

With reference to our previous article, which dealt with Chapter 15 of the TAA and administrative non-compliance penalties, the Commissioner of SARS has now published a notice in terms of s210(2) of the TAA, which lists the only non-compliance subject to a fixed amount administrative penalty to be :

Failure by a natural person to submit an income tax return as and when required under the Income Tax Act for years of assessment commencing on or after 1 March 2006 where that person has two or more outstanding income tax returns for such years of assessment.

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