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# **GUIDE ON THE TAXATION OF LUMP SUM BENEFITS**



## **GUIDE ON THE TAXATION OF LUMP SUM BENEFITS**

Another helpful guide brought to you by the South African Revenue Service.

### **Foreword**

This document is a general guide dealing with the taxation of lump sum benefits from retirement funds in South Africa. This Guide does not attempt to reflect on every scenario that could possibly exist but does attempt to provide clarity on the majority of issues that are likely to arise in practice. Where this Guide does not address a specific issue, it must be taken up with the local SARS branch office.

This document is not meant to go into the precise legal or technical detail that is often associated with tax. It should, therefore, not be used as a legal reference and is not a binding ruling. Should an advance tax ruling be required, visit the SARS website – Advance Tax Ruling (ATR) System.

This Guide is based on legislation as at 1 October 2007.

Should you require additional information, you may:

- Contact your own tax advisors/practitioners
- Contact your local SARS branch office
- Contact SARS Call Centre on 0860 12 12 18
- Visit the SARS website at <http://www.sars.gov.za>

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## **Background**

Recent changes in legislation necessitate the contextual repositioning by the Commissioner for the South African Revenue Service, of the aspects relating to the tax treatment of lump sums payable from pension, provident and retirement annuity funds.

This Guide discusses some of the more important legislative aspects relating to these benefits. The Guide does not deal with associated operational or administrative aspects.

## **PART 1 BENEFITS PAYABLE AT RETIREMENT**

### **1.1 *Pension Funds, Provident Funds and Retirement Annuity Funds***

#### **a) Typical lump sum benefits**

##### **i) Pension funds**

On retirement, a member of an approved pension fund may commute up to one-third (1/3) of the total value of his or her interest in the fund for a single payment (i.e. a lump sum). There is one exception to this rule, namely where the value of the remaining two-thirds (2/3) does not exceed a pre-determined amount, in which case the total value of the interest in the fund may be commuted for a lump sum. The latter is more fully explained in Part 4.

The remaining two-thirds (2/3) must be utilised to provide a compulsory, non-commutable life-annuity that may either be paid by the fund itself or be purchased by the fund from a registered South African long-term insurer.

##### **ii) Provident funds**

A member who retires from a provident fund is entitled to receive the full value of his or her interest in the fund by way of a lump sum.

##### **iii) Retirement Annuity funds**

On retirement, a member of an approved retirement annuity fund may commute up to one-third (1/3) of the total value of his or her interest in the fund for a lump sum. There is one exception to this rule, namely where the value of the remaining two-thirds (2/3) does not exceed a pre-determined amount R50 000, in which

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case the total value of the interest in the fund may be commuted for a lump sum. The latter is more fully explained in Part 4.

As in the case of a pension fund, the remaining two-thirds (2/3) must be utilised to provide a compulsory, non-commutable life-annuity that may either be paid by the fund itself or be purchased by the fund from a registered South African long-term insurer.

iv) **More information**

More information on the nature of lump sum benefits and the circumstances in which these benefits typically becomes payable is contained in the General Notes issued by SARS from time to time and can be assessed on the SARS website at:

<http://www.sars.gov.za/it/Retirement%20Fund%20main.htm>

b) **Taxation of lump sum benefits: Before 1 October 2007**

Prior to 1 October 2007 the tax-free portion of a lump sum payment was determined in terms of “formula A” (in the case pension funds and provident funds) and capped in terms of “formula B” as defined under the Second Schedule to the Income Tax Act, 1962 as amended (hereinafter referred to as “the Act”). In terms of these formulae, the tax-free portion of a lump sum was determined by, amongst other, the number of years of membership of the member in the fund and (in the case of pension funds and provident funds) his or her average salary over a pre-determined period, and limited to a maximum of the greater of R120 000 or R4 500 multiplied by the number of completed years of membership to the fund. The tax on the taxable portion of the lump sum was then determined in accordance with section 5(10) of the Act, at the so-called “average rate of tax”.

c) **Taxation of lump sum benefits: On or after 1 October 2007**

With effect from 1 October 2007 and in terms of the Taxation Laws Amendment Act No. 8 of 2007 (hereinafter referred to as the TLA Act):

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- i) “formula A” has been repealed; and
- ii) “formula B” is simplified.

The tax-free portion of a lump sum benefit paid by a pension fund, provident fund or retirement annuity fund is now determined by reference to one formula only, namely “formula B”, as follows:

$$Z = C + E - D$$

Where:

Z = Represents the amount to be determined

C = R300 000

E = own contributions that were not permitted as a deduction, plus (if any) a tax-free public sector portion previously transferred to the fund

D = previous deductions against lump sum benefits

The taxable portion of the lump sum (i.e. after applying “formula B”), is included in the taxpayer’s gross income in terms of paragraph (e) of the definition of “gross income” in section 1 of the Act.

This portion of the taxpayer’s “gross income” is then included directly in taxable income by ring-fencing it against other deductions, exemptions and losses. (More on this in Part 7)

The tax payable on the lump sum is determined by reference to a separate scale of rates, without taking rebates into account. (More on this in Part 8)

## **PART 2 BENEFITS PAYABLE AT DEATH**

### **2.1 Pension Funds, Provident Funds and Retirement Annuity Funds**

#### **a) Benefits**

A lump sum benefit paid upon the death of a member is deemed (for income tax purposes) to have accrued on the day prior the member's death.

#### **b) Taxation of lump sum benefits: Before 1 October 2007**

Prior to 1 October 2007 the tax-free portion of a lump sum payment was determined in terms of "formula A" (in the case of pension funds and provident funds) and capped in terms of "formula B" as defined under the Second Schedule to the Act. In terms of these formulae, the tax-free portion of a lump sum was determined by, amongst others, the number of years of membership of the member in the fund and, in the case of pension funds and provident funds, his or her average salary over a pre-determined period. The deduction was subject to a maximum of the greater of R120 000 or R4 500 multiplied by the number of completed years of membership to the fund, as well as certain other maximum and minimum amounts.

The tax on the taxable portion of the lump sum was then determined in accordance with section 5(10) of the Act at the deceased's so-called "average rate of tax".

#### **c) Taxation of lump sum benefits: On or after 1 October 2007**

With effect from 1 October 2007 and in terms of the TLA Act:

- i) "formula A" has been repealed; and
- ii) "formula B" is simplified.

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As in the case of retirement benefits, the tax-free portion of a lump sum benefit paid by a pension fund, provident fund or retirement annuity fund is now determined by reference to one formula only, namely “formula B”, as follows:

$$Z = C + E - D$$

Where:

Z = Represents the amount to be determined

C = R300 000

E = own contributions that were not permitted as a deduction, plus (if any) a tax-free public sector portion previously transferred to the fund

D = previous deductions against lump sum benefits

The taxable portion of the lump sum (i.e. after applying “formula B”), is included in the deceased taxpayer’s gross income in terms of paragraph (e) of the definition of “gross income” in section 1 of the Act.

This portion of the deceased taxpayer’s gross income is then included directly in the deceased taxpayer’s taxable income by ring-fencing it against other deductions, exemptions and losses. (More on this in Part 7)

The tax payable on the lump sum is determined by reference to a separate scale of rates, without taking rebates into account. (More on this in Part 8)

## **PART 3 BENEFITS ON WITHDRAWAL/RESIGNATION**

### **3.1 *Determining the taxable portion***

The deductions against a lump sum benefit paid on withdrawal or resignation that were available prior to 1 October 2007 remain the same. However, subsequent to 1 October 2007 account must also be taken of any tax-free public sector portion that was previously transferred to the fund (more information on this in Part 6).

### **3.2 *Determining the rate of tax***

Note that, unlike lump sum benefits on retirement and death, the taxable portion of withdrawal and resignation benefits paid on or after 1 October 2007 continue to be subject to tax at the so-called “average rate of tax”, determinable in terms of section 5(10) of the Act.

## **PART 4 COMMUTATION OF SMALL TOTAL VALUE OF ANNUITIES – PRIVATE SECTOR FUNDS**

### **4.1 *Benefits***

As discussed in Part 1, a member of a pension or a retirement annuity fund may ordinarily commute up to a maximum of one-third (1/3) of his/her retirement benefit for a lump sum.

### **4.2 *Taxation of lump sum benefits: Before 1 October 2007***

Prior to 1 October 2007 a member was entitled to commute in full an annuity for a lump sum where the total annual annuity did not exceed R1 800 (see General Note GN16 and Addendum A thereto on the SARS website).

### **4.3 *Taxation of lump sum benefits: On or after 1 October 2007***

With effect from 1 October 2007 a member may commute the remaining two-thirds of the underlying capital (i.e. the portion that would ordinarily be utilised

to provide a pension) provided that the capital amount does not exceed R50 000. Effectively, this means that a member whose total underlying capital in the fund is R75 000 or less may commute the total capital for a lump sum benefit.

#### 4.4 ***Existing annuities***

Where the trustees of a retirement fund are satisfied that a member or former member did not commute any portion of the total value of the annuity or annuities to which he or she became entitled, the rules of the fund may permit the member to commute the total value of the annuity for a lump sum on condition that the total value on the date of commutation does not exceed R75 000. Where the trustees cannot satisfy themselves that a member or former member has not commuted before, the rules of the fund may permit the commutation of the remaining total value of the annuity for a lump sum on condition that the total value on the date of commutation does not exceed R50 000.

## **PART 5 EXTRAORDINARY LUMP SUMS**

### **5.1 *Distribution of Surplus Apportionment***

#### **a) Surplus apportionments**

The provisions of section 15B of the Pension Funds Act, 1956 (Act No. 24 of 1956) regulate the distribution of a surplus apportionment to pensioners, former members and current members of retirement funds under a scheme approved by the Financial Services Board. In terms of this, active members may receive their apportionment in the form of a credit to their member accounts and former members as well as pensioners may receive the apportionment in the form of a lump sum.

#### **b) Taxation of lump sum surplus apportionments: On or after 1 October 2007**

With effect from 1 January 2006 paragraph 2C of the Second Schedule to the Act exclude surplus distributions in the form of a lump sum from gross income, effectively making the payments free of tax.

### **5.2 *“Statement of Intent” benefits***

#### **a) Benefits**

This lump sum is payable in consequence of or following upon an agreement with the long-term insurance industry signed by the Minister of Finance on 12 December 2005.

In terms of this agreement, minimum values are payable to retirement annuity fund members (or former members) that, for some reason, discontinued their contributions prematurely. The agreement was formalised in terms of the Regulations under the Long-Term Insurance Act, 1998. Regulation 5.3 (1) (b) of the Regulations under the Long-Term Insurance Act, 1998 (Act No. 52 of 1998) gives effect to this arrangement.

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A member who prematurely discontinued his or her contributions to the fund is entitled to the payment of a lump sum benefit where the member's interest in the fund is less than R7 000 which is the amount determined by the Minister in *Government Gazette* 29913, Notice No 467 of 1 June 2007.

b) **Taxation of Benefits**

With effect from 1 January 2006 paragraph 2C of the Second Schedule to the Act excludes these amounts from gross income, effectively making the payments free of tax.

## **PART 6 PRE-1 MARCH 1998 TAX- FREE LUMP SUMS PAYABLE BY PUBLIC SECTOR FUNDS**

With effect from 1 March 2006 the amount that was excluded from the provisions of the Second Schedule to the Act through the operation of “formula C” as defined in the Second Schedule upon transfer to an approved (i.e. private sector) retirement fund is added to the deduction that is available against a lump sum benefit payable on death or retirement from the private sector fund or, in the case of withdrawal or resignation benefits, creates a minimum deduction. (More on this in **Example 3**)

## **PART 7 “RETIREMENT FUND LUMP SUM BENEFIT”**

### **7.1 *The term “retirement fund lump sum benefit”***

The term “retirement fund lump sum benefit” was inserted in section 1 of the Act with effect from 1 October 2007 to differentiate benefits of this nature from other types of lump sum benefits. This differentiation was necessary to enable the simplified tax dispensation that applies to “retirement fund lump sum benefits” on or after the effective date.

Section 1 of the Act defines the term “retirement fund lump sum benefit” as the amount determined in terms of paragraph 2(a) of the Second Schedule in respect of a year of assessment, after taking into account the provisions of paragraphs 2A, 2B and 2C of that Schedule.

Effectively, therefore, “retirement fund lump sum benefits” include lump sum benefits that were derived in consequence of or following upon retirement or death, less the deduction permitted by “formula B”.

### **7.2 *Determining the tax payable***

The deduction allowed in terms of “formula B” is deducted from the lump sum payable to the member. The “retirement fund lump sum benefit” (RFLSB) is included in gross income in terms of paragraph (e) of the definition of “gross income” in section 1 of the Act. This benefit is then included, **as is**, in taxable income (i.e. the amount is ring-fenced against any deductions, exemptions and losses). The tax payable on the RFLSB is determined by reference to the new scale of rates, without any rebates being set-off against the normal tax. (More on this in Part 8)

Other lump sum benefits have not been affected by the changes and the benefits are dealt with in the same manner as they always have been.

## **PART 8 THE TAX RATES APPLICABLE TO LUMP SUM BENEFITS (2008 YEAR OF ASSESSMENT)**

### **8.1 “Retirement fund lump sum benefit”**

<b>Taxable Amount</b>	<b>Rate of Tax</b>
Not exceeding R300 000	18 per cent of the taxable income
Exceeding R300 000 but not exceeding R600 000	R54 000 plus 27 per cent of the taxable income exceeding R300 000
Exceeding R600 000	R135 000 plus 36 per cent of the taxable income exceeding R600 000

### **8.2 Other lump sum benefits**

The tax on lump sum benefits other than “retirement fund lump sum benefits” remains determinable in terms of section 5(10) of the Act.

## **PART 9 EXAMPLES**

### 9.1 *Example 1*

#### ***Retirement from a pension or provident fund***

When a member retires from a pension or provident fund, the taxable portion of the lump sum will be determined in the same way.

T is to retire from Big (Pty) Ltd on 1 December 2007 and was a member of the company's pension fund for 30 years. When he retires he will receive a lump sum from the pension fund amounting to R900 000. During his membership of the fund, all his contributions were allowed as deductions in terms of section 11(k) of the Act and he had not previously received any lump sum as a result of retirement. The tax-free portion will be computed in terms of formula B.

Formula B:  $Z = C + E - D$

In which formula –

Symbol Z represents the tax free portion of the lump sum

Symbol C represents an amount of R300 000

Symbol D represents previous deductions allowed as a result of retirement

Symbol E represents own contributions that were not permitted as a deduction plus the value of pre-1998 rights in a public sector fund (if any)

The tax-free portion of the lump sum will be determined as follows:

$$Z = R300\,000 + 0 + 0$$

$$Z = R300\,000$$

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The taxable portion of the lump sum, i.e. R600 000 (R900 000 – R300 000) will be included in gross income in terms of paragraph (e) of the definition of “gross income” in section 1 of the Act.

The taxable portion will then be included directly in taxable income by ring fencing it against other deductions, exemptions and losses.

The tax payable on the lump sum will be determined by reference to the scale of rates listed in Part 8 (8.1).

### 9.2 **Example 2**

#### ***Retirement from a Retirement Annuity Fund***

Mashudu is to retire from EFG retirement annuity fund on 1 December 2007 and is entitled to receive a lump sum of R450 000. All his contributions to EFG retirement annuity fund were allowed as a deduction in terms of section 11(n) of the Act during his 20 years of membership and he had not previously received any lump sum as a result of retirement. The tax-free portion will be computed in terms of formula B.

Formula B:  $Z = C + E - D$

In which formula –

Symbol Z represents the tax free portion of the lump sum

Symbol C represents an amount R300 000

Symbol D represents previous deductions allowed as a result of retirement

Symbol E represents own contributions that were not permitted as a deduction plus the value of pre-1998 rights in a public sector fund (if any)

The tax free portion of the lump sum will be determined as follows.

$$Z = R300\,000 + 0 + 0$$

Z= R300 000

The taxable portion of the lump sum, i.e. R150 000 (R450 000 – R300 000) will be included in gross income in terms of paragraph (e) of the definition of “gross income” in section 1 of the Act.

The taxable portion will then be included directly in taxable income by ring fencing it against other deductions, exemptions and losses.

The tax payable on the lump sum will be determined by reference to the scale of rates listed in Part 8 (8.1).

### 9.3 **Example 3**

***Retirement from a private sector fund after vested rights benefits were initially transferred from a public sector fund.***

The taxable portion of lump sum is determined in terms of formula C, which formula means –

$$A = \frac{B \times D}{C}$$

In which formula –

Symbol A: represents the amount to be determined

Symbol B: represents years of membership from 1 March 1998 until date of exit from the public sector fund

Symbol C: represents the total number of completed years of membership of the public sector fund until date of exit from the public sector fund

Symbol D: represents the lump sum payable upon exit from the public sector fund

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Mulalo has been a member of a public sector pension fund ever since she was appointed on 1 March 1978. She resigned with effect from 1 March 2006 from the public sector and her benefits were transferred to an approved private sector pension fund following her appointment in the private sector. Mulalo is to retire on 28 February 2008 after 30 years of employment and will receive a lump sum from the private sector fund of R960 000.

The taxable portion of Mulalo's lump sum will be determined as follows.

B = 8 years (years of membership from 01 March 1998 to 28 February 2006)

C = 28 years (years of membership from 01 March 1978 to 28 February 2006)

D = R960 000

$$A = \frac{8 \times 960\,000}{28}$$

$$A = R274\,286$$

Value of tax-free portion is R685 714 (R960 000 – R274 286)

The tax-free portion will be computed in terms of formula B.

Formula B:  $Z = C + E - D$

In which formula –

Symbol Z represents the amount to be determined

Symbol C represents an amount R300 000

Symbol D represents previous deductions allowed as a result of retirement

Symbol E represents own contributions that were not permitted as a deduction plus the value of pre-1998 rights in a public sector fund

The tax free portion of the lump sum will be determined as follows:

$$Z = 300\,000 + 685\,714 - 0$$

Z = R985 714 (but limited by paragraph 5 to the actual lump sum benefit of R960 000).

#### 9.4 **Example 4**

##### ***Retirement from a retirement annuity and a pension fund during the same year of assessment***

Z is 65 years of age and is employed by Oli (Pty) Ltd ever since 1 March 1962. He has been a member of his employer pension fund – Oli (Pty) Ltd pension fund from the date of appointment. In addition, he is a member of XYZ retirement annuity fund. He plans to retire from XYZ retirement annuity fund on 31 October 2007 and is to receive a lump sum benefit of R200 000. In addition, he will also be retiring from his employer pension fund on 30 November 2007 and is to receive a lump sum benefit of R1, 2 million. All his contributions to the pension and retirement annuity funds were allowed in terms of sections 11(k) and 11(n) of the Act respectively. He has not previously received any lump sum as a result of retirement.

##### **Solution** - Retirement from XYZ retirement annuity fund

Retirement fund lump sum benefit R200 000

The tax-free portion will be computed in terms of formula B

$$Z = C + E - D$$

$$Z = R300\,000 + 0 - 0$$

Z = R300 000 (but limited by paragraph 5 to the actual lump sum benefit of R200 000)

No tax is payable on the retirement fund lump sum benefit of R200 000 as it is below the allowable deduction.

**Solution-** Retirement from Oli (Pty) Ltd pension fund

Lump sum benefit R1, 2 million

The tax-free portion will be computed in terms of Formula B

$$Z = C + E - D$$

$$Z = R300\,000 + 0 - R200\,000$$

$$Z = R100\,000$$

Lump sum benefit from the pension fund: R1 200 000

Less deduction allowed R100 000

Taxable amount of the lump sum benefit: R1 100 000

## 9.5 **Example 5**

### ***Retirement from multiple of funds during different years of assessments***

Odu is 65 years old and is employed by OR (Pty) Ltd ever since 1 March 1960. He has been a member of his employer pension fund – OR (Pty) Ltd pension fund from the date of appointment. In addition he has been a member of both ABC and DEF retirement annuity funds and all his contributions were allowed as deductions in terms of sections 11(k) and 11(n) of the Act.

**Year 1:** Odu retired from ABC retirement annuity fund on 1 June 2006 after 20 years of membership and received a lump sum benefit of R60 000.

**Year 2:** He retired from DEF retirement annuity fund on 1 September 2007 after 21 years of membership and received a lump sum of R60 000.

**Year 3:** He is to retire from OR (Pty) Ltd pension fund on 1 July 2008 and is to receive a lump sum of R1million.

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**Solution Year 1:** Retirement from ABC retirement annuity fund

Retirement fund lump sum benefit R60 000

The tax-free portion of R60 000 was calculated in terms of formula B as follows during the 2006/07 year of assessment:

$$Z = C + E - D$$

C= the lump sum of R60 000 limited to the greater of –  
R120 000, or  
R90 000 (R4 500 x 20)

E= Nil

D= Nil

The lump sum of R60 000 was paid tax-free as it was lower than the allowable deduction of R120 000.

**Solution Year 2:** Retirement from DEF retirement annuity fund

Retirement fund lump sum benefit R60 000

The tax-free portion of R60 000 was calculated as follows during the 2007/08 year of assessment.

Formula B

$$Z = C + E - D$$

C= The lump sum of R60 000 limited to the greater of –  
R120 000, or  
R94 500 (R4500 x 21)

E= Nil

D= R60 000

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The lump sum of R60 000 was also paid tax-free.

**Solution Year 3: Retirement from OR (Pty) Ltd pension fund**

Retirement lump sum benefit R1million

The tax-free portion to be determined in terms of Formula B

$$Z = C + E - D$$

$$C = R300\,000$$

$$E = \text{Nil}$$

$$D = R120\,000 \text{ (previous deductions allowed, i.e. } R60\,000 + R60\,000)$$

$$Z = R300\,000 + 0 - R120\,000$$

$$Z = R180\,000$$

Retirement fund lump sum benefit R1 000 000

Less deduction to be allowed            R180 000

Taxable portion of the lump sum        R820 000

## **PART 10      CONCLUSION**

Unless otherwise stated in the Taxation Laws Amendment Act No. 8 of 2007, the legislative changes in the aforementioned Act are only applicable to the lump sums that accrue on or after 1 October 2007. All lump sums that accrue before 1 October 2007 are to be treated in terms of the provisions of the Income Tax Act, 1962 that were applicable prior to legislative changes in terms of the Taxation laws Amendment Act No. 8 of 2007.