Want to withdraw retirement funds on emigration? You may have to wait three years...

By Joon Chong and Wesley Grimm

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The National Treasury published the Draft Taxation Laws Amendment Bill, 2020 (Draft Tax Bill) for public comment. One of the more contentious proposals in the Draft Tax Bill relates to the ability of people emigrating from South Africa to access amounts in their pension preservation fund, provident preservation fund and retirement annuity fund (retirement funds) when they leave.

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In accordance with the policy decision to phase out "financial emigration" for exchange control purposes, which was announced in the 2020 Budget Speech, National Treasury and the South African Revenue Service (Sars) have proposed to amend the definitions of the terms "pension preservation fund", "provident preservation fund" and "retirement annuity fund".

South Africans emigrating for exchange control purposes are currently able to make pre-retirement lump sum withdrawals from the retirement funds if they financially emigrate for exchange control purposes in accordance with the process prescribed by the South African Reserve Bank.

3-year rule

The proposal in the Draft Tax Bill is for the payment of lump sum benefits from retirement funds to only be permissible when a member of a retirement fund ceases to be a South African resident and such member has remained non-tax resident for at least three consecutive years or longer (3-year rule). The 3-year rule will impact all persons who are members of retirement funds and require immediate access to their retirement funds upon emigration.

The effect of the 3-year rule is that members of retirement funds who emigrate will have to wait for a period of at least three years before they may access their pre-retirement lump sum benefits. This will cause financial hardship for people, who may need these funds to start a new life in the destination country.

The proposed 3-year rule also poses other practical problems, including that it does not consider the position of retirement fund members who financially emigrate shortly before it commences. Those who have started the financial emigration process but have not completed it by 1 March 2021 - the proposed commencement date of the 3-year rule - will also be prejudiced.

A further practical issue is that the 3-year rule makes retirement annuity funds more unattractive as retirement savings vehicles. The reason for this is that members of retirement annuity funds will have to wait three years to access to their retirement benefits, whereas members of pension preservation and provident preservation funds may access certain pre-retirement benefits once prior to retirement and members of pension and provident funds may make a pre-retirement lump-sum withdrawal upon termination of their employment relationships.

Arbitrary rule

The most puzzling feature of the 3-year rule is its arbitrariness. In South Africa, a person is considered to be a South African tax resident where that person is either ordinarily resident in South Africa or is deemed to be tax resident by complying with the threshold requirements of the physical presence test. The 3-year rule does not reconcile to either the ordinary resident test or the physical presence test and is, in fact, at odds with the definition of resident in the Income Tax Act, 1962 (Income Tax Act). The 3-year rule also creates a misalignment with other provisions in the Income Tax Act that give rise to immediate tax consequences when people cease being a tax resident in South Africa.

Although the 3-year rule was proposed to modernise the foreign exchange control process, it is unrefined and raises the above practical issues (amongst others) which must be urgently addressed. If the 3-year rule was intended to create a better reporting arrangement in respect of which Sars may be assured that a person is emigrating from South Africa, and has permission to live somewhere else, we recommend that enhanced administrative processes, similar to a Sars audit process, be undertaken before allowing the retirement funds to be released in whole at the relevant tax rates. This would align with the way that the existing exchange control process administered by the South African Reserve Bank functions.

The 3-year rule is not an equivalent reporting arrangement, and is prejudicial especially bearing in mind that these funds are often needed for beginning a new life in the destination country, and the volatility of the Rand which may lead to a further erosion of the value by the time the funds are received. Furthermore, in our view, the existing exchange control emigration process cannot be abolished within five months to align with the proposed commencement of the 3-year rule on 1 March 2021.

We recommend that National Treasury refrain from promulgating the 3-year rule until all the practical issues regarding its implementation have been resolved.

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