Explanatory Memorandum to the draft Taxation Laws Amendment Bill, 2007, relating to the proposed provisions in respect of lump sum benefits derived upon retirement or death

The current South African retirement fund tax system can be referred to as an **"Ett"** system. In an **Ett** system, contributions are tax exempt (the "big" **E**), build-up or growth within the retirement fund is partly taxed at a low rate (middle small **t**[1]) and retirement payouts are partly taxed (last small **t**). The current proposal deals with the partly taxed retirement payouts (last small **t**).

1. Permissible lump sum payouts by pension and provident funds upon retirement of the fund member

Current legislation

As a general rule, pension and provident funds may pay out up to 1/3rd of the retirement interest in the form of a lump sum upon retirement of the fund member. The other 2/3 rds must be converted to an annuity unless the full retirement interest will result in an annuity of R1,800 per annum or less if an annuity is purchased. In terms of Addendum A of SARS General Note 16 a retirement interest of R25,200 will produce an annuity of R1,800 per annum i.e. SARS will allow the full retirement interest to be paid out to the retirement fund member upon retirement if his interest is R25,200 or less. Should his retirement fund interest be more than R25,200, only 1/3rd may be paid out in the form of a lump sum and the remaining 2/3rds must be converted to an annuity.

Problem statement

This full withdrawal of smaller funds is allowed because administration costs (i.e. industry fees) in respect of relatively small annuities often outweigh the benefits. Even though annuities are generally preferred, individuals should not be forced to utilise annuities if the benefits will be consumed by fees.

Over the course of the past few years, the National Treasury analysed data and information regarding the various costs incurred by retirement fund providers and the fees they charged to retirement fund members. As part of the review of these charges, the costs of annuities provided to retirees were investigated and it was found that a lump sum of R50,000 should provide an annuitant with a less costly annuity. The National Treasury is by no means satisfied with the costs charged on these annuities and will continue to look at various interventions to reduce the costs of annuities, but for the time being the minimum value of compulsory annuities will be increased.

[1] It is proposed that the middle "t" be changed to an "E" with effect from 1 March 2007 with the abolishment of the tax on retirement funds.

Proposed amendment

Retirees will continue to be able to withdraw 1/3rd of their retirement interest. In addition, retirees may withdraw the remaining 2/3[rds] provided that this amount does not exceed R50 000, the equivalent of an annual annuity of approximately R4 500 per annum. This means that a person with a retirement interest of R75,000 or less, will be able to withdraw the full amount in the form of a lump sum.

Amendments to the definitions of "pension fund" and "retirement annuity fund" in section 1 of the Income Tax Act give effect to this proposal. (Clause 3(1)(f) & (g))

2. Tax treatment of lump sum payouts from retirement funds upon retirement of the fund member

Current legislation

Permissible lump sums paid upon retirement are partly tax-free and partly taxable. The tax-free amount is generally calculated in terms of two formulas (Formulas A and B) with built-in minimum amounts for members of provident funds and death benefits. These formulas take into account the following variables: for pension, provident and retirement annuity funds, the number of years that the retiree was a member of the retirement fund or years of employment and for pension and provident funds, the retiree's highest annual average salary during any five consecutive years in the service of the employer.

Should a retiree receive more than one lump sum (i.e. if he was a member of more than one retirement fund), the tax-free amount received from one fund is deducted from the tax-free amount to be paid out by other retirement fund. Contributions made by a retirement fund member to a retirement fund which did not qualify for a tax deduction prior to retirement, may be paid out tax-free by the retirement fund to the retiree (or member) upon retirement.

The remaining taxable portion of the lump sum is taxed based on an averaging formula. This averaging formula is based on the highest average annual tax rate for the tax year in which the retirement lump sum is payable or the previous tax year. All taxable amounts are subject to PAYE withholding before payout.

Problem statement

The problem with the abovementioned regime is that the formulas are complex and the tax-free amount is dependant upon information which the retirement fund or retirement fund member cannot easily access or determine. The fact that certain fixed amounts included as part of the calculations has not been adjusted for many years is also problematic. The combination of these issues prompted the need for change.

The tax payable on the taxable portion of the lump sum is also difficult to determine and the averaging formula may be used as a planning opportunity by some individuals. These individuals artificially suppress overall taxable income levels for the relevant two-year period in order to limit the average tax rate on the taxable portion of the lump sum.

Proposed amendment – Tax-free portion

The tax-free retirement lump sum will be a R300 000 once in a life-time amount for all retirees. In addition to this tax-free amount, a retiree may receive an additional portion of his retirement lump sum tax-free. This additional amount is equal to contributions to the fund that were not tax-deductible when contributed and contributions made to a public sector fund on or prior to 1 March 1998 (Clauses 47, 48(1)(a), (c) and 49).

Proposed amendment – Taxable portion

The current complexities with respect to the taxable averaging formula on retirement lump sums will be eliminated and replaced by a simplified separate rate schedule. The first R300 000 lump sum payout will be tax exempt as discussed above.

In addition, the amount from R300 001 through R600 000 will be subject to a flat 18 per cent rate. All amounts above R600 000 will be subject to a flat 36 per cent rate. The new system will apply based on the aggregate of all retirement lump sums received over the retiree's lifetime. (Clauses 48 and 49). Fund administrators have to withhold tax from these payments (Clauses 52(1)(d) and 54(1)). If tax was not withheld, the taxpayer has to pay the tax within 7 days after the end of the month in which the payment was received. (Clause 50).

3. Withholding tax on lump sum retirement payments to persons earning less than the tax threshold

Current legislation

Pension fund administrators are obliged to withhold tax from lump sum retirement and withdrawal payments to fund members. The minimum rate of tax to be withheld is 18 per cent.

Problem statement

Lump sum payments paid by retirement funds to persons earning less than the tax threshold is subject to 18 per cent tax. These persons have to then register as a taxpayer and claim back the tax withheld. In many instances these

individuals are not familiar with the process of claiming back the tax withheld and effectively suffer a tax which is not due.

Proposed amendment

Lump sum payments from retirement funds to persons earning less than the tax threshold will be exempt from withholding tax (Clause 54(1))

4. Statement of Intent benefits and surplus apportionment benefits

Current legislation

The Second Schedule to the Income Tax Act governs the tax dispensation with respect to lump sum payments by retirement funds.

Problem statement

The Minister of Finance signed an agreement with the Long-term Insurance industry on 12 December 2005. In terms of this agreement, minimum values should be attributed to retirement fund members (or former members) who discontinued their contributions prematurely. This agreement was formalized in terms of the Regulations under the Long-term Insurance Act.

Many retirement funds have surplus accounts and the Pension Funds Second Amendment Act, 39 of 2001, prescribes that these surplus amounts have to be apportioned in terms of a surplus apportionment scheme. In terms of these schemes members (or former members) may receive their appropriate portion either in the form of cash of a credit to their member accounts.

These two types of benefits payable are extraordinary payments to retirement fund members (or former members) and are not specifically covered in the Second Schedule to the Income Tax Act. These payments to former members aims to rectify unfair practices of the past although full compensation is highly unlikely and the amounts payable are, in many instances, small amounts.

Proposed amendment

It is proposed that these payments to former members be exempt from income tax (Clause 48(1)(e)).