Technical Discussion Paper E for public comment

Improving tax incentives for retirement savings

4 October 2012

National Treasury

Contents

1. Introduction

This paper is part of a series of technical discussion papers released for public comment following the overview paper *Strengthening Retirement Savings* released on 14 March 2012. The overview paper covers the 2012 Budget announcements by the Minister of Finance on promoting household savings and reforming the retirement industry.

Improving tax incentives for retirement savings is one of two papers released concurrently on the taxation of savings products. The focus of this paper is on how the tax treatment of the retirement contributions, currently split between separate dispensations for pension, provident, and retirement annuity funds could be simplified and a uniform retirement contribution model established.

The focus of the second tax paper *Incentivising non-retirement savings* is on non-retirement savings and potential tax incentive options to encourage discretionary savings. Two other papers in the series, *Enabling a better income in retirement* and *Preservation, portability and governance for retirements funds* have also been released. All the above papers are available on the National Treasury website www.treasury.gov.za.

The last paper to be released later this year will analyse the costs of retirement saving during the accumulation phase; examining costs on products like retirement annuities, pensions, and provident funds before retirement.

These papers are intended to promote public consultation on how the provision of an income in retirement can be improved, so as to assist South Africa in building a fair and sustainable retirement system.

Executive summary

Three separate tax dispensations

Government has, for a number of years, encouraged South Africans to save for their retirement through various tax incentives. There are currently three separate tax dispensations for the treatment of contributions to and benefits from retirement funds. These are for pension funds, provident funds, and retirement annuity funds. They are outlined in the Income Tax Act, No. 58 of 1962, as amended (ITA). The ITA outlines the tax treatment of contributions both from the point of view of the employer, and from the point of view of the member.

Employer taxpayers are permitted to deduct contributions to pension or provident funds of between 10 per cent and 20 per cent of the "*approved remuneration*" of employees as a business expense against tax. In the case of tax-exempt entities, there is effectively no limit on the size of the deduction. These contributions do not form part of the taxable income of employees.

Employee taxpayers may not claim a deduction on their own contributions to provident funds, but may claim a deduction on contributions up to a maximum of 7.5 per cent of "*retirement-funding employment*" income on contributions to a pension fund. Further, a deduction of up to 15 per cent of "*non-retirement-funding employment*" income may be claimed against contributions made to a retirement annuity fund.

The concepts "*approved remuneration*", "*retirement funding-employment*" income and "*non-retirement funding employment*" income are defined in either the ITA or in the rules of the employer-sponsored pension fund.

Tax regime is complex, adds to costs, may be inequitable and is open to abuse

The tax regime summarised above is very complex, and requires administrators to monitor the original dispensation under which contributions were made and restrict movement between different fund types. Further, the tax exemption has no nominal monetary cap in the case of higher-income employees, allowing them to make tax-exempt contributions way in excess of the amount required to maintain a reasonable standard of living in retirement. Tax-exempt employers are also able to assist employees in postponing tax by making large contributions to pension or provident funds rather than by paying cash income.

Budget 2012 proposal

The original proposal on changing the tax deduction in respect of contributions was made in the 2011 Budget, after which public comments and some consultation took place. A more refined proposal was then announced in the 2012 Budget. The main elements of the 2012 Budget proposal are:

- Contributions by employers to all types of retirement funds will be taxed as a fringe benefit in the hands of employees, subject to the allowances set out below.
- Employees will be permitted a deduction in respect of employer and employee contributions to all types of retirement fund, equal to 22.5% (or 27.5% for those aged 45 and above) of the greater of employment or taxable income, although annual deductions will be limited to R250 000 (R300 000 for those aged 45 and above).
- A minimum monetary deduction of R20 000 will apply to allow low-income earners to contribute in excess of the above percentage limits.
- Non-deductible contributions will be exempt from income tax if, on retirement, they are taken as either part of the lump sum or as annuity income.
- A rollover dispensation similar to the one currently applying to retirement annuity contributions will be adopted to allow flexibility for those with fluctuating incomes.
- Measures to address some of the complexities of defined benefit funds will be considered.

- Contributions towards risk benefits and administration costs will be included in the maximum percentage allowable deduction.

This document responds to the following concerns raised in response to the original 2011 Budget proposal:

Concerns raised in response to the 2011 Budget proposal

- Concern was raised about the adequacy of the 22.5% threshold. It is found that the 2012 proposed regime was adequate, especially considering the change in the income base used, and the increase of the thresholds for those over the age of 45.
- Concern was expressed that the employer would no longer have a role in providing retirement income under the new dispensation. It is found that this was unlikely to be true, particularly as the tax treatment of risk benefits paid from inside retirement funds has not changed, and since most employers regard the attraction and retention of staff as the primary justification for establishing retirement funds.
- The effect of caps on national savings and on cross subsidies within funds was raised. It is found that since relatively few individuals contribute above the proposed caps, there were unlikely to be any significant effects.

Two issues still under discussion are then outlined, notably:

Issues still under discussion; consultation invited

- The treatment of defined benefit and hybrid funds. In these funds, care needs to be taken in apportioning contributions to individual members to ensure fairness between different individuals and different cohorts of individuals. Two possible approaches, a rule-based approach and a benefits-based approach, are described.
- The exact definition of the income base to which the percentage and monetary thresholds will be applied.

Finally, in two Appendices, the proposed structure of the tax regime and a summary of the proposed legislation are outlined.

The proposed structure of the tax regime and a summary of the proposed legislation are outlined in appendices

Comments on this document are invited before 30 November 2012. Consultation and workshops will take place with specific stakeholders and interested parties before and after the above date.

2. Background

South Africa uses tax incentives to encourage people to provide for retirement.

The Minister of Finance announced in the 2012 Budget that a series of technical discussion papers will be released in 2012 on the promotion of retirement savings. An overview of the discussion papers was published on 14 May 2012 in the paper *Strengthening retirement savings*. This paper, *Improving tax incentives for retirement savings*, is part of the series.

The main function of any retirement system is to facilitate and encourage individuals to save enough towards their retirement. However, research shows that few individuals can retire with sufficient savings to carry them through their later years. A low retirement savings rate is why many countries, including South Africa, make use of tax incentives to subsidise retirement savings and encourage people to contribute towards a retirement fund.

In general, the South African retirement tax regime provides for tax deductible fund contributions, a tax deferral on growth in the fund, and a preferential tax treatment when exiting the fund. The tax incentive discussed in this paper is the tax deduction for fund contributions.

Generally, when you or your employer contributes to a retirement fund, you or the employer will be able to deduct the contribution from taxable income. This means that less tax will be payable to SARS.

Example:

Jack receives a salary of R100 000. He contributes R5 000 to a pension fund. The amount is tax deductible, and Jack only has to pay tax on R95 000.

The aim of the retirement savings tax incentive regime (tax deduction) is to encourage income earners to save for their retirement and reduce their vulnerability in old age.

From a tax policy perspective, the contract with the state for benefitting from a deduction in respect of fund contributions is that the retirement savings must be preserved and annuitised. This is based on the premise that retirement savings must grow until retirement, and that it must provide the retiree with an income upon retirement. The main aim of retirement savings is after all to ensure that a retiree can continue to have a reasonable post-retirement standard of living.

There is no policy reason why the benefit of the tax incentive, and the regulated protection against longevity risk and investment risk (through annuitisation) should be limited to pension and retirement annuity fund members. In this regard, refer to the paper *Preservation, portability and governance for retirement funds*, published on 21 September 2012.

The regime as a whole is successful, particularly due to the effect of employees being compelled to join an employer-affiliated retirement fund. However, there are certain areas where the regime can be improved upon, and in so doing leverage the tax spend to generate higher retirement savings in South Africa.

Government is concerned that the current regime is too complex and open to abuse

The barriers to a more effective tax incentive regime are the complexity of the current regime (three different tax dispensations apply), as well as the fact that the regime is open to abuse through excessive contributions by employers and high-income earning individuals.

Proposals to amend the current regime and thereby address the barriers identified were made in the 2011 Budget. The intention was to create a Uniform Retirement Contribution model as part of the retirement savings tax incentive regime in early 2012. However, submissions from the retirement industry and other stakeholders in response to the 2011 Budget proposal highlighted a number of areas of concern which required further investigation. The implementation of the proposal was delayed in order to allow these concerns to be evaluated, and a revised version of the 2011 proposal was announced in the 2012 Budget.

This paper

The paper provides the rationale for the 2012 Budget proposal and analyses policy concerns in light of the comments received in respect of the 2011 and 2012 Budget proposals. To begin with, the current retirement savings tax incentive regime will be outlined and discussed. A representation of the 2012 Budget proposal will follow. The 2012 Budget proposal will be analysed with specific reference to whether it meets the shortcomings of the current regime. Specific policy considerations will be discussed, and attention will be drawn to areas where policy development is still required.

3. Existing position – retirement fund contributions

There are currently three separate tax dispensations for the treatment of contributions to and benefits from retirement funds. These are for pension funds, provident funds, and retirement annuity funds. These are outlined in the Income Tax Act, No. 58 of 1962, as amended (ITA). The ITA outlines the tax treatment of contributions both from the point of view of the employer, and from the point of view of the member.

The employer

Except for retirement annuity contributions, employer fund contributions are currently not taxed as a fringe benefit for the employee.

The ITA encourages employers to create or join (in the case of an umbrella fund) an employer-affiliated retirement fund. The ITA allows the employer to claim a deduction of all contributions made for the benefit of an employee to an employer-affiliated retirement fund (up to a specific percentage cap), without a corresponding inclusion of the value of these contributions in the "*taxable income*"[1] of the employee. This applies regardless of whether the retirement fund is a pension fund or a provident fund. There is no effective limit for employer contributions where the employer is a tax-exempt entity.

> If your employer has its own pension or a provident fund, or contributes to an umbrella retirement fund (many employers being part of one fund), you are required to be a member of the retirement fund as a condition of employment.
>
> Currently you are not taxed on the contribution made by your employer for your benefit.

In the case of a retirement annuity fund, being a self-standing fund, there is no limit on the amount that an employer can deduct for tax purposes in respect of a contribution made to a retirement annuity fund for the benefit of an employee. However, the employer contribution is treated as income (in the form of a taxable fringe benefit) for the employee to the value of the contribution made.

> Any individual over the age of 16 (including members of pension and provident funds) can belong to a retirement annuity fund. If your employer does not have a pension or provident fund, and instead contributes on your behalf to a retirement annuity fund, you will be taxed on the amount contributed as part of your salary (although you may be able to deduct the amount from taxable income, thereby leaving you in a tax neutral position).

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[1] "taxable income" means the amount remaining after taking into account against "gross income", all exclusions and deductions.

[2] The minimum deduction allowed is 10% of "approved remuneration". Only where

The employee

In the case of employee contributions to a retirement fund, the individual may be entitled to a deduction for income tax purposes (subject to a 7.5% cap), depending on whether the fund is a pension fund, a retirement annuity fund, or a provident fund. Table 1 illustrates the fact that both the income base and the allowable percentage deduction differ between the three fund types. Further, where an employer contribution has been included as a taxable fringe benefit in the hands of the employee, such as in the case of contributions to a retirement annuity fund, the contribution will be deemed to have been made by the employee.

Deductions allowed for employee fund contributions are limited to set annual caps.

Table 1: Current multiple contribution model

Source	**% cap on deduction**	**Contribution type – base**	**Retirement fund**
Employer	Exempt entity – unlimited	"*approved remuneration*"	Pension or provident fund
	Taxable entity – usually between 10% & 20%[2]		Pension or provident fund
Employee taxpayer with employer-affiliated fund	0%	No deduction available initially, but non-deductible contributions may be deducted prior to calculating tax upon exit from the fund.	Provident fund
	7.5%	"*retirement-funding employment*"-income. Non-deductible contributions (exceeding the annual caps) may be deducted prior to calculating tax upon exit from the fund.	Pension fund
	15%	'*non-retirement-funding employment income*'. Non-deductible contributions may be deducted in each consecutive year depending on whether the caps have been reached for that year.	Retirement annuity fund
Self-employed taxpayer or employee taxpayer with no employer-affiliated fund or earning additional income	15%	'*non-retirement-funding employment income*'. Non-deductible contributions may be deducted in each consecutive year depending on whether the caps have been reached for that year.	Retirement annuity fund

[2] The minimum deduction allowed is 10% of "approved remuneration". Only where the employer's contribution exceeds 10% of the employee's remuneration may the deduction be restricted to what the Commissioner regards as reasonable. The Commissioner generally allows 20% in practice. Note however that this percentage factor is a cumulative percentage, covering contributions to both pension and provident funds and medical schemes.

The main points of the different bases can be summarised as follows:

"approved remuneration": employment income and other taxable employment benefits.

- "*approved remuneration*": In the context of the ITA, it means the total remuneration accruing to the employee in respect of his employment as the Commissioner considers to be fair and reasonable in respect of services rendered. The examination takes into account the value of the services rendered in relation to the cash and other benefits received in return.

"retirement funding employment"-income: pensionable income earned by an employee.

- *"retirement funding employment*"-income: According to the ITA, it is "remuneration" as defined in the Fourth Schedule to the ITA; excluding 50% of any public office allowance or transport allowance, any retirement fund lump sum or retirement fund lump sum withdrawal benefit; but including any travel allowance unless it is a travel reimbursement based on actual distance travelled at not more than the gazetted rate.

'non-retirement-funding employment'-income: All income earned less pensionable income earned.

- *'non-retirement-funding employment'*-income: As per the ITA, this amount is calculated by taking all the income derived by the taxpayer during the year of assessment, and deducting any *"retirement funding employment"*-income. Non-retirement funding income excludes any retirement fund lump sum or retirement fund lump sum withdrawal benefit.

In practice the values attributed to "approved remuneration" and 'retirement-funding employment"-income are often the same.

Although there are three distinct calculations, in practice the same value is often attributed to "*approved remuneration*" and "*retirement-funding employment"*-income. The rules of a retirement fund typically define '*pensionable salary*' for the purposes of contributions made by the employer and the employee, as well as (where applicable) the value of the benefit payable in the case of fund-provided risk benefits.

Where the retirement fund only has one contributing employer, the rules of the fund may define the actual determination of the '*pensionable salary*' (being "retirement-funding employment"-income), for example as only including fixed remuneration (e.g. salary or wages), and excluding variable amounts such as commissions, bonuses and overtime etc. In the case of an umbrella fund, the norm is for the rules to allow the contributing employer to determine the components included in 'pensionable salary' and its value.

Both you and your employer's contribution to a retirement fund are based on your salary. However, in most cases the percentages are not based on your full salary. Most individuals can therefore still contribute to a retirement annuity fund, and claim a deduction for tax purposes because there is a portion of their salary that is not taken into account when the employee and employer's contributions are calculated.

In practice, the split of an employee's income received from the employer is divided by the employer between "retirement funding employment"-income and 'non-retirement funding employment'-income on the income tax certificate [IRP5/IT3(a)] provided to the employee and to the South African Revenue Services (SARS).

Barriers to a more effective regime

An effective tax incentive regime which encourages retirement savings should be:

- broad-based, to encourage most South Africans to make adequate provision for their retirement;
- easy to understand;
- easy to administer, so that little is lost in administration costs;
- not open to abuse, to keep the regime fair and effective;
- equitable, so that the impact of the incentive does not advantage certain taxpayers over others; and
- measurable, so that it can be determined whether the incentive causes an impact in line with the Government's goals.

Because any tax incentive is a cost to the fiscus in the form of revenue forgone, it is critical that a tax incentive is designed to be as effective as possible. At the outset, certain barriers preventing increased retirement savings were discussed. The relationship between these shortcomings and the 2012 Budget proposal will now be examined.

The regime is too complex

It is evident when viewing Table 1 that the multiple retirement contribution model is very complex. The different bases in particular require an individual to have a broad understanding of the income tax regime before being able to accurately calculate the maximum contribution eligible for a deduction.

By simplifying the model, the regime is made more accessible to the average individual, and will require a less complex administrative process.

Further, the presence of multiple tax regimes requires administrators to monitor the original 'type' of contribution and restrict, where appropriate, movement between funds with different 'types' in order to prevent tax arbitrage. Besides adding to complexity, this prevents individuals from aggregating their retirement savings into one vehicle, and increases the cost of saving.

Tax expenditure analysis is also complicated by the multiple contribution model because the contributions are split between the employer and the employee. By treating all employer contributions to retirement funds as employee fringe benefits with a corresponding deduction, one source from which tax expenditure can be monitored is effectively being created. It must also be noted that the proposed approach is consistent with the broader policy of taxing all employer-provided benefits in the hands of employees. However, corresponding relief in the form of higher percentage deductions will be implemented for employees.

From a tax expenditure point of view, only the individual's IRP5 tax certificate will have to be monitored.

The regime is open to abuse

An annual monetary cap will limit access to the tax incentive to predetermined amounts

The value of the tax incentive is currently determined by the income earned by an individual, and the relevant marginal tax rate applicable, with no limit in the case of high-income individuals. An annual monetary cap on deductible contributions will limit access to the retirement savings tax incentive to predetermined amounts, ensuring that the tax incentive is applied more equitably.

Employees should be unaffected from a tax point of view by the tax status of their employers.

Furthermore, it is currently possible for some employers (in particular tax-exempt employers) to assist employees to postpone tax by making large retirement fund contributions instead of paying the amount due as "*remuneration*". The proposed uniform tax treatment of retirement contributions will eliminate this disparity by subjecting employees to tax on a total cost-to-company basis regardless of the tax status of their employers.

A tax incentive is a cost to the fiscus in the form of revenue (tax) forgone. It is therefore important that certain taxpayers not benefit excessively from the regime at the cost of general South Africans.

4. 2012 Budget proposal

The 2011 Budget proposal

To try and mitigate concerns raised and make the retirement savings tax incentive more effective and equitable, the 2011 Budget proposed a uniform retirement contribution model, where –

2011 Budget proposal: Fringe benefit; and Percentage and monetary caps.

- employer contributions to a retirement fund will be deemed a taxable fringe benefit in the hands of the employee;
- individuals will be allowed to deduct up to 22.5% of their "*taxable income*" for contributions to pension, and retirement annuity funds; except for individuals earning less than R53 333, who may deduct up to R12 000;
- an annual maximum deduction of R200 000 will be established to ensure greater equity; and that
- the income base on which contributions to retirement funds and other social security taxes is calculated will be streamlined.

The 2012 Budget proposal

In response to concerns raised in respect of the 2011 proposal, Government undertook to review and modify the proposal. The following was proposed in the 2012 Budget Review:

Different caps for individuals below 45 and those of 45 and above; and Measures to address the complexities around defined benefit funds.

- Contributions by employees and employers to pension, provident and retirement funds will be tax deductible by individual employees.
- Individual taxpayer deductions will be set at 22.5% and 27.5%, for those below 45 years and 45 and above respectively, of the higher of employment or taxable income.
- Annual deductions will be limited to R250 000 and R300 000 for taxpayers below 45 years and above 45 years respectively.
- A minimum monetary threshold of R20 000 will apply to allow low-income earners to contribute in excess of the prescribed percentages.
- Non-deductible contributions (in excess of the thresholds) will be exempt from income tax if, on retirement, they are taken as either part of the lump sum or as annuity income.
- Measures to address some of the complexities of defined benefit pension schemes will be considered.
- A rollover dispensation similar to the current retirement annuity contributions will be adopted to allow flexibility in contributions for those with fluctuating incomes.

The caps will include amounts contributed towards fund-provided risk benefits and administration costs.

- Contributions towards risk benefits and administration costs within retirement savings will be included in the maximum percentage allowable deduction.

It was proposed that the new tax regime should come into effect on 1 March 2014.

Table 2: 2012 Budget proposal

<table>
<tr><th>Source</th><th>Contribution type – base</th><th>% cap on deduction</th><th>Annual monetary cap</th><th>Retirement fund</th></tr>
<tr><td>Employer taxpayer</td><td>Any amount contributed by the employer to a retirement fund will be taxed as a fringe benefit and will be deemed to be employee contribution.</td><td>Unlimited fringe benefit</td><td>Unlimited fringe benefit</td><td>All retirement funds</td></tr>
<tr><td rowspan="2">All individual taxpayers</td><td rowspan="2">The higher of employment or taxable income.
Any annual non-deductible contributions can be carried forward to future years.
Any non-deductible contributions that remain upon retirement will keep its tax exempt status.</td><td>22.5% for individuals < 45 years; and 27.5% for individuals aged 45 and above
Minimum of R20 000</td><td>Maximum of R250 000 for individuals < 45 years; and R300 000 for individuals aged 45 years and above</td><td rowspan="2">All retirement funds</td></tr>
<tr><td colspan="2">The value of the contributions includes amounts paid towards risk benefits and administration costs.</td></tr>
</table>

Any proposed reforms in respect of provident funds will be discussed in another discussion paper.

Policy matters which are still to be finalised, and which will be discussed in more detail later on in the paper, include:

- Measures to address the taxation of defined benefit and hybrid schemes; and
- The base to be used in respect of taxable income and employment income.

The way forward with provident funds is discussed in the paper, *Preservation, portability and governance for retirement funds* that was released on 21 September 2012. The paper presents several options that will be discussed with key stakeholders, including NEDLAC. Draft proposals will take accrued and vested rights into account and will only be made after finalising the consultation process.

The effect of implementing a uniform retirement contribution model on provident funds is discussed later on in this document.

5. Policy considerations

Following the 2011 proposal, National Treasury received comments that highlighted certain concerns discussed below. Although the concerns were raised in response to the 2011 proposal, they remain relevant.

The caps and individual savings patterns

Background

The percentage and monetary caps must protect the fiscus against excessive use of the retirement savings tax incentive.

The percentage and monetary caps in the proposed regime aim to increase equity in the tax system and protect the fiscus against excessive use of the retirement savings tax incentive. However, the caps should not prevent most individuals from attaining a reasonable standard of living in their retirement.

Concerns were raised about the adequacy of the 22.5% threshold in the 2011 proposal. In particular, it was felt that many individuals do not save when they are young, because of other commitments (such as raising a family and saving for education), and postpone saving until later in life. This is consistent with variants of the life-cycle hypothesis, such as the 'buffer-stock savings hypothesis' and much empirical evidence on savings behaviour.

Estimates provided by the retirement industry claim that:

- If a member contributes 17.5% of income (assuming 5% for risk cover) from age 25 to 65, an income replacement ratio[3] in retirement of 55% - 70% can be expected. A specific set of assumptions[4] gives an income replacement ratio of 60%.
- If savings started at age 40, a contribution rate of 30% will be required to achieve an income replacement ratio of 60%.
- If a contribution is made every second year (simulating interrupted employment), to get to the same income replacement ratio a contribution rate of 35% will be required.

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3 An income replacement ratio/rate is the percentage of pre-retirement income that a retiree would need to receive after retirement in order to have a post-retirement standard of living equivalent to his or her pre-retirement standard of living.

4 Salary inflation of 6%, inflation 5%, real return after fees 2%, inflation-linked annuity factor at age 65 (male) equals 15.16. Although not explicitly stated, the calculation appears to assume that account balances are paid out to dependents in addition to death benefits.

Table 3: Analysis of tax statistics

Analysis of Tax Statistics, 2010*		Employee pension contributions		Retirement annuity contributions	
	Income band	Proportion of taxpayers claiming a deduction	Size of deduction, relative to value of income, for those who claim	Proportion of taxpayers claiming a deduction	Size of deduction, relative to value of income, for those who claim
C:	1 – 20 000	4%	1%	8%	3%
D:	20 001 – 30 000	9%	1%	11%	2%
E:	30 001 – 40 000	10%	1%	12%	2%
F:	40 001 – 50 000	12%	1%	13%	2%
G:	50 001 – 60 000	20%	1%	14%	1%
H:	60 001 – 70 000	41%	3%	16%	1%
I:	70 001 – 80 000	39%	3%	16%	1%
J:	80 001 – 90 000	38%	2%	17%	1%
K:	90 001 – 100 000	43%	3%	18%	1%
L:	100 001 – 110 000	47%	3%	21%	1%
M:	110 001 – 120 000	52%	3%	23%	1%
N:	120 001 – 130 000	50%	3%	25%	1%
O:	130 001 – 140 000	51%	3%	27%	1%
P:	140 001 – 150 000	58%	4%	34%	1%
Q:	150 001 – 200 000	61%	4%	38%	1%
R:	200 001 – 300 000	55%	3%	40%	1%
S:	300 001 – 400 000	49%	3%	43%	1%
T:	400 001 – 500 000	46%	2%	48%	2%
U:	500 001 – 750 000	45%	2%	53%	2%
V:	750 001 – 1 000 000	39%	2%	57%	2%
W:	1 000 001 – 2 000 000	34%	1%	57%	2%
X:	2 000 001 – 5 000 000	31%	1%	53%	1%
Y:	5 000 001 +	30%	0%	51%	1%
Total		43%	3%	29%	1%

Source: Table A2.1.1, A2.7.2, and A2.7.3 of the Tax Statistics 2011. Figures reported for the tax year 2010.* It should be noted that the table excludes employer contributions, and therefore most provident fund members. The contribution rate is also less relevant for those in defined benefit funds where the pension available is determined by the rules of the fund, not the contribution rate.

Discussion

The 22.5% percentage cap is more generous than it may appear.

A first point to note is that the general 22.5% percentage cap is more generous than it may appear. Including the employer contribution in the income base increases the amount of income against which the 22.5% allowable contribution is calculated. The monetary amount that can, therefore, be contributed increases.

For instance, if an employer currently contributes 15% of an employee's cash salary to a pension plan, and employees 7.5%, the total contribution will be 22.5% of an employee's cash salary. However, under the new proposal, the general 22.5% limit applies to an employee's total income, including the value of employer contributions.

Example:

Nomfanelo's salary is R125 000. Assume that 80% of her salary is pensionable (R100 000). Her employer contributes 15% of her pensionable salary, therefore R15 000 (15% of R100 000). Her cost to company is therefore R140 000 (R125 000 + R15 000). Nomfanelo contributes 7.5% of her pensionable salary to the retirement fund, therefore R 7 500 (7.5% of R100 000).

Nomfanelo contributes R3 750, being 15% of her non-pensionable salary (R25 000) to a retirement annuity fund.

The total contribution towards retirement funds is R26 250 (R15 000 + R7 500 + R3 750). **R26 250** represents a percentage of 21% in respect of the R125 000 base (pensionable and non-pensionable salary) used.

Under the new proposal, the base will be Nomfanelo's entire cost-to-company, this time including the R15 000 contributed by the employer because she will be taxed on that amount. The total contribution that Nomfanelo will be able to deduct is 22.5% of R140 000, therefore an amount of **R31 500**. Were Nomfanelo 45 years of age or above, she would be able to deduct a contribution of **R38 500** (27.5% of R140 000).

When determining whether the proposed general 22.5% limit is sufficient or not, it is useful to examine the replacement rate that it permits individuals to attain. It is important to note that employees only need to replace their cash income, not the value of their retirement contributions. The replacement rate generated by a particular contribution rate depends on a number of factors, most especially –

- the treatment of retirement balances of those who die before retirement: if balances are paid out to dependents in addition to risk benefits, this raises the levels of risk benefits provided and lowers the ultimate replacement rate provided by the fund. An alternative approach is to redistribute the account balances of those who die before retirement to those who are still living, lowering the level of risk benefits provided;

- the difference between the rate of return earned on the funds under management, net of investment expenses, and the rate of salary growth: the greater this difference, the greater the replacement rate;

- the age at which an individual starts saving: the earlier saving starts, the greater the attainable replacement rate and the greater the sensitivity of the replacement rate to investment returns and mortality (if account balances of those who die are used to augment the balances of those who survive);

The earlier savings starts, the greater the attainable replacement rate and the greater the sensitivity of the replacement rate to investment returns and mortality.

- the cost of buying an annuity at retirement: the greater the cost of buying an annuity (either because of low interest rates or low mortality post-retirement), the lower the replacement rate;

- the contribution behaviour of individuals: the more regularly contributions occur, the greater the ultimate replacement rate because the longer the average contribution is invested; and

- the average effective tax rate imposed on the annuity received in retirement, which is often lower than the average tax rate during the individual's working life.

The following factors will have an influence on the amount of savings that you have on retirement, relative to your cash income prior to retirement:

- what does your fund do with the retirement balances of members that die before retirement?
- what is the difference between the rate of gain/loss on your money less investment expenses and the rate at which your salary grows?
- at what age did you start saving?
- what is the cost of buying an annuity at retirement?

  how regularly did you contribute during your working life, and did you preserve if you moved employers?

For instance, analysis shows that, if Government allows a contribution of 5% of salary to cover risk benefits[5] and administration costs – roughly an industry average – leaving 17.5% to cover retirement benefits, then one can calculate the maximum attainable replacement rate as a function of the difference between the rate of return on the assets in the fund, after investment fees, and salary growth, and the age at which individuals start saving. In all cases it is assumed that the cost of buying R10 000 of annual income for life is R150 000 (so the annuity factor at retirement is 15).

Table 4: Replacement rate of cash salary at age 65 with retirement contribution of 17.5% of package, retirement balances paid out on death in addition to risk benefits costing 5% of salary

Difference net investment return and salary growth	**+0%**	**+1%**	**+2%**	**+3%**	**+4%**
Age at which contributions start					
25	59%	72%	88%	112%	141%
35	43%	52%	60%	72%	85%
45	29%	33%	38%	41%	47%
55	15%	16%	18%	19%	19%

Source: National Treasury analysis.

The analysis assumes that if individuals die before retirement, the balance in their account reverts to their dependents.

This analysis assumes that if individuals die before retirement, the balance in their account reverts to their dependents rather than being used to augment the accounts of other members of the fund.

Sample calculations are shown in the next table, which assumes that individuals die according to the no-AIDS mortality in 2008 generated by the ASSA 2008[6] mortality model, and that individuals are part of a fund which contains only people of their age, who age with them. (The conservative no-AIDS mortality assumption is used to simulate the correlation between retirement balances and mortality.)

5 Approved risk benefits constitute fund-provided insurance that cover members against death and permanent disability. Funds may insure themselves or outsource the risk to life insurers.

6 Actuarial Society of South Africa, 2011, web reference: aids.actuarialsociety.org.za/Models-3145.htm

These figures show that if the cost of risk benefits and administration expenses is limited to 5% of salaries, a replacement rate of 60% of cash salary is attainable under the proposed general 22.5% cap for someone who only starts saving at age 35, even if net investment returns are quite poor. For those who start saving for retirement later than age 45, an income replacement ratio of 70% is still virtually unattainable under these assumptions. These models represent an ideal case, because very few South Africans work consistently for 40 years, and even fewer contribute continuously to their retirement funds and preserve all their savings.

A replacement rate of 60% of cash salary is attainable under the proposed general 22.5% cap if saving starts at age 35.

Table 5: Replacement rate of cash salary at age 65 with retirement contribution of 17.5% of package, retirement balances on death used to augment retirement balance of survivors.

Difference between net investment return and salary growth	**+0%**	**+1%**	**+2%**	**+32%**	**+4%**
Age at which contributions start					
25	83%	103%	129%	163%	208%
35	60%	71%	83%	99%	118%
45	38%	42%	47%	53%	60%
55	18%	19%	20%	21%	22%

Source: National Treasury analysis.

An age-graded dispensation, where the percentage cap rises with age to allow individuals to catch up on missed earlier retirement savings, has been created to deal with this difficulty. As such, a 27.5% cap is being proposed in respect of individuals aged 45 and older. Individuals should however not interpret this as a signal that it is sensible to save less when they are younger than when they are older (because of compound interest, it is not).

An age-graded dispensation has been created to allow individuals to catch up on missed earlier retirement savings.

Further, incomes fluctuate over time, which is one explanation for the high apparent rate of pension contributions among low-income earners shown in the analysis of tax statistics (table 3). (These individuals may be people who are members of plans, who for some reason have low incomes in the year of assessment, but high incomes in other years. This is especially likely to be the case for those individuals in the data who appear to be low income and who are contributing to retirement annuities.) Fluctuations in income will lower the attainable replacement rate.

In order to deal with the issue of fluctuating incomes, the 2012 Budget proposal was structured so that:

- Non-deductible contributions (in excess of the thresholds) will be exempt from income tax if, on retirement, they are taken as either part of the lump sum or as annuity income; and
- A rollover dispensation similar to the current retirement annuity contributions will be adopted to allow flexibility in contributions for those with fluctuating incomes.

The future role of the employer

Background

Currently the employer has an upfront deduction with no upfront inclusion for the employee.

The current structure of the retirement savings tax incentive regime allows an employer to claim a deduction for tax purposes of the contributions made (up to a specific percentage cap), whilst not increasing the employee's tax liability. A concern raised is that the 2011 Budget proposal would dilute the incentive for the employer to maintain an employer-affiliated fund because the employee will be taxed on the value of the employer's contributions. Government believes that both employers and employees have a strong interest in ensuring that there is sufficient provision of retirement benefits for all employees. Ultimately a partnership between employers, employees, and Government is needed to ensure a healthy retirement for employees.

Currently, employer-provided retirement funds offer many employees the most cost-effective way of saving for their retirement. This is the result of several factors, most notably the fact that the presence of the employer removes the need for the fund to pay for marketing and distribution costs, since membership of the fund is compulsory as a condition of employment if such a fund exists. Further, employer-sponsored funds allow access to cheaper risk benefits for employees, and bulk investment management and administrations costs.

Being a member of a pension or provident fund allows you to benefit from cost savings and bulk buying power. Also, it facilitates a partnership between employer and employee.

Finally, the fact that the savings decision is automated probably increases participation and savings. Employers therefore have a crucial role in providing retirement savings vehicles for their employees.

Discussion

What is the employer's role in the new regime?

Industry research from Alexander Forbes[7] shows that most employers regard the attraction and retention of staff as the primary motivator for provision of retirement benefits, and it is unlikely that the new regime will change this in any way. Furthermore, the value proposition for employers and employees in respect of employer-provided risk benefits remains.

Employer-provided risk benefits are cheaper than individually-purchased arrangements due to savings in transaction costs (employer systems are used to accommodate fund administration) and eliminating the need for underwriting. Furthermore, the fact that the employer, through the Board of Trustees, acts as the central buyer for retirement products through the fund eliminates the need for individual employees to acquire costly financial advice.

7 Alexander Forbes, "Total Rewards Perspective", 2nd Ed, 2009.

However, an employer can currently provide employees with risk cover by purchasing insurance policies outside of a retirement fund (unapproved risk benefits), or by arranging cover through a retirement fund (approved risk benefits). The relative tax treatment of the two options has been analysed and is shown in Table 6 below.

National Treasury has analysed the relative tax efficiency of the two methods of provision, whilst ignoring the issue of investment income on the reserves held. Premiums paid outside retirement funds are taxed upfront as a fringe benefit at the marginal rate of the employees, whereas benefits paid from inside retirement funds are taxed later as per the withdrawal or retirement tax tables. Furthermore, the withdrawal and retirement tax tables take into account prior withdrawal or retirement lump sum benefits. The two examples shown below are based on the assumption that the taxpayer has not previously received a lump sum from a retirement fund.

Unapproved: Contribution taxed upfront and payout tax free.

Approved: Contribution taxed upfront, often with a simultaneous deduction; and payout taxable against preferential tax table.

Table 6: Tax regime for risk benefits provided inside and outside retirement funds

Taxpayer	Unapproved risk benefits	Proposed: Approved risk benefits
Employer taxpayer	Premiums are allowed as an expense[8]	Premiums form part of contributions to the retirement fund, which are allowed as an expense[9]
Employee taxpayer	Premiums are a fringe benefit and included in "*taxable income*"[10]	Premiums form part of contributions to the fund and a fringe benefit is created, the individual is allowed a simultaneous deduction up to the value of the caps
Insurance taxpayer	Policy will enter the Corporate Policyholder Fund (CPF) in the four-fund system, investment income will be taxed at 30%*	Policy will enter the Untaxed Policyholder Fund (UPF) in the four-fund system, where the investment income will grow free of tax*
Beneficiary taxpayer	Tax free in the hands of recipient[11]	Benefits are considered a retirement benefit due to the circumstances surrounding the payout (death or permanent disability). SARS uses the retirement tax table, that incorporate a tax free lump sum, currently R315 000

* Typically, these policies are renewed on an annual basis, meaning that reserves held in respect of the policy by the life insurer are typically small and not much investment income arises. This source of tax is therefore unlikely to be material.

Using the approach described in the table, National Treasury has calculated the combination of salary and risk benefits (expressed as a *multiple* of salary) at which sponsors should be indifferent between purchasing group life insurance inside the fund, and purchasing it outside. The results are shown in the figure below.

Value proposition of providing risk benefits through a retirement fund.

8 Section 11(w) of the ITA.

9 Section 11(l) of the ITA.

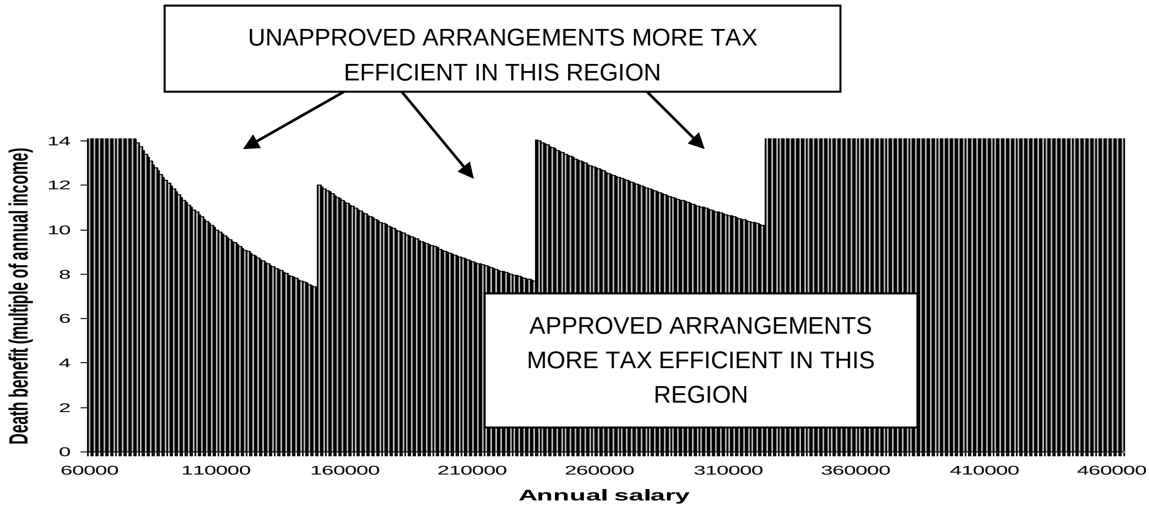
10 Paragraph 2(k) of the Seventh Schedule to the ITA.

11 Paragraph (d) of "gross income" in section 1 of the ITA, read with section 10(1)(Gg).

Table 7: Examples of tax treatment of risk benefits provided through retirement funds

Taxpayer	Individual earning R78 000 p.a., benefit of 5 times salary on death		Individual earning R750 000, benefit of 5 times salary on death	
	Outside fund (*'unapproved'*)	**Inside fund ('*approved*')**	**Outside fund (*'unapproved'*)**	**Inside fund (*'approved'*)**
Employee taxpayer (premiums)	Premiums taxed at the marginal rate of 18%	Premiums tax free	Premiums taxed at the marginal rate of 40%	Premiums tax free
Employee taxpayer (benefits)	Benefits tax free in the hands of recipients	Benefits taxed at average rate of 2.9%	Benefits tax free in the hands of recipients	Benefits taxed at an average rate of 30.7%

Graph 1: Tax efficiency of approved vs. unapproved arrangements



For anyone with a salary above R331 000 it is almost always preferable to purchase approved death benefits.

For combinations of death benefits (expressed as a multiple of salary) and salary which fall in the shaded area, it is more favourable to purchase group life insurance inside retirement funds. In the white area of the chart, it is more favourable to purchase insurance outside the fund.

Therefore, if you earn a salary above R331 000 you would almost always be better off if your death benefit were provided through a retirement fund. Further, if a fund has many members with salaries below R331 000 and very generous death benefits, it may be preferable to provide group life insurance outside the fund.

By allowing the cost of risk benefits (and administration costs) to be included in the cost of the fringe benefit allocated to employees, and permitting a deduction in respect of these contributions, Government is effectively retaining the tax efficiency of providing approved as opposed to unapproved risk benefits.

The effect of the caps on savings

Background

Retirement funds are the most important savings vehicle for the majority of retirement fund members or formally employed citizens in South Africa. According to data from the South African Reserve Bank[12],'retirement saving makes up 56.6% of the main contractual saving flows for households. Therefore, any changes to the retirement savings tax incentive regime should maintain the incentive for South African households to save through their retirement funds.

According to data from the South African Reserve Bank, retirement saving makes up 56.6% of the main contractual saving flows for households.

This is particularly true in an environment where the household savings rate in South Africa is very low. However, the concept of vertical equity across the income spectrum and the need to balance tax incentives more fairly between income earners have been under discussion for some time in the policy reforms applicable to retirement funding.

The proposed general R250 000 annual maximum limit and R20 000 minimum, implies that individuals earning between R88 889 p.a. (an amount that exceeds the revised tax threshold of R63 556), and R1 111 111 will be accommodated within the proposed 22.5% contribution limit. While the lower limit is intended to allow low-earning employees to contribute more to their retirement funds than 22.5% of their income, the maximum monetary caps are intended to limit access to the tax incentive to predetermined amounts.

The lower limit is intended to allow low-earning employees to contribute more to their retirement funds than 22.5% of their income.

If you are under the age of 45, you cannot deduct a contribution of more than R250 000 under the new proposal. R250 000 represents 22.5% of R1 111 111. Therefore, the R250 000 cap will only affect you if you contribute the maximum of 22.5% and you earn above R1 111 111.

If you are 45 years of age or above, you have a R300 000 cap. R300 000 represents 27.5% of R1 090 090.09. The cap will only affect you if you contribute the maximum of 27.5% and earn more than R1 090 090.09.

Concerns have been raised by the retirement industry regarding a number of possible consequences that may flow as a result of limiting access to the tax incentive:

- Long-term saving contributions may find their way into discretionary, shorter-term investment vehicles, particularly when the annuitisation requirements of certain funds are taken into account;
- Excess contributions could be invested outside South Africa;
- Some of the amount could be consumed rather than saved; and
- The introduction of caps could have the unintended consequence of signalling adequate levels of retirement contribution to taxpayers.

12 Genesis Analytics, 2011, "Incentivising retail savings in South Africa".

Discussion

In the first instance it must be noted that it is proposed that any contributions that are not allowed as a deduction in the year of assessment in which they were made will be rolled over to future years of assessment similar to the current position in respect of retirement annuity funds. Furthermore, any remaining non-deductible contributions will be exempt from tax upon retirement whether the payout is in the form of an annuity or a lump sum.

According to SARS data, the average pension contribution deduction claimed for people who earned more than R1m p.a., and who claimed a deduction, was only R43 656.

While the effects of the impact of tax incentives on creating new savings are divided empirically, indications are that wealthy individuals do optimise saving placement based on after-tax returns. This may be particularly true for individuals in the age groups approaching retirement.[13] In South Africa, SARS statistics indicate that while about 8% of taxpayers are older than 65 years, about 37% are in the 45 – 64 years age bracket. On an age profile basis, a significant portion of the taxpayer base is therefore sensitive to tax policy changes.

To analyse the likely effect of the upper limit, National Treasury has analysed the *Tax Statistics 2011* provided by SARS[14]. Selected data in respect of the 2010 tax year are shown in the tables below. According to SARS data, the average pension contribution deduction claimed for people who earned more than R1m p.a., and who claimed a deduction, was only R57 968. Since most retirement industry surveys appear to report a roughly equal employer-employee split across the industry, a reasonable estimate of total average contributions to employer-sponsored retirement plans for people in this income bracket would be around R116 000.

It would therefore appear that most individuals are well below the limit, even in the R1m p.a. income band, at least if they are members of DC funds (although it seems that there may be some individuals earning more than R2m for whom the general R250 000 cap may be binding when employer contributions are included). Some very highly-paid members of DB funds may also fall over the limit. Further, the total deductions claimed by people in this income bracket represented only 4.8% of the total deductions claimed.

For the members of retirement annuity funds, the average deduction claimed for people who earned more than R1m p.a. and who claimed a deduction was R43 845.

For the members of retirement annuity funds, the average deduction claimed for people who earned more than R1m p.a. and who claimed a deduction was R52 662, which also appears to be well below the limit, although it seems that there may be some individuals who do contribute more than general R250 000 limit, especially those in the R5m+ bracket. The total deduction claimed by people earning more than R1 million represented 14.9% of the total deductions claimed by people who purchased retirement annuities, although much of this is likely to lie below the cap.

13 Ayusa et al 2007.

14 Tax Statistic 2011, SARS.

Although the distribution of income and pension contributions within these bands matters (to get a better idea of the effects of these caps one would need to calculate ratios for each individual taxpayer and then average these, rather than take the average of ratios, as has been done in this paper) it appears to us that very few taxpayers will, in practice, be affected by the general R250 000 cap, and that the effect on savings flows will be correspondingly small.

One important assumption underlying the analysis is that deduction behaviour is independent of the speed of assessment. Examining earlier statistics – where a greater proportion of tax returns have been assessed – suggests that the average rate of deduction has, if anything, risen over the interim, indicating that this factor is not material.

On the face of it, it seems that deduction behaviour is independent of the speed of assessment.

Table 8: Representation of the income band to number of taxpayers and average income

Income band		Number of taxpayers	% of total number	Average income
W	1 000 001 – 2 000 000	40 944	1.0%	R 1 328 679
X	2 000 001 – 5 000 000	10 972	0.3%	R 2 857 924
Y	5 000 001 +	1 849	0.0%	R 9 429 763
Z	1 000 001 +	53 765	1.3%	R 1 919 357
All		4 275 480	100%	R 187 500

Source: Table A2.1.1of the Tax Statistics 2011. Figures reported for the tax year 2010

Table 9: Representation of employee pension deductions per income band

Income band		Employee pension deductions		
		Proportion of taxpayers claiming a deduction	Average amount, conditional on claiming a deduction	Proportion of total deductions in this band
W	1 000 001 – 2 000 000	34%	R 51 203	3.3%
X	2 000 001 – 5 000 000	31%	R 75 455	1.2%
Y	5 000 001 +	30%	R 121 381	0.3%
Z	1 000 001 +	34%	R 57 968	4.8%
All		43%	R 11 988	100%

Source: Tables A2.1.1 and A2.7.2 of the Tax Statistics 2011. Figures reported for the tax year 2010.

Table 10: Representation of individual retirement annuity fund deductions per income band

Income band		Retirement annuity fund deductions		
		Proportion of taxpayers claiming a deduction	Average amount, conditional on claiming a deduction	Proportion of total deductions in this band
W	1 000 001 – 2 000 000	57%	R 40 494	8.9%
X	2 000 001 – 5 000 000	53%	R 77 436	4.2%
Y	5 000 001 +	51%	R 201 700	1.8%
Z	1 000 001 +	56%	R 52 662	14.9%
All		29%	R 8 731	100%

Source: .Tables A2.1.1 and A2.7.3 of the Tax Statistics 2011. Figures reported for the tax year 2010.

It should be noted that these data are for the year 2010. To be applicable to the year 2011, some adjustments would need to be made to the thresholds to reflect wage inflation since 2010.

The effect of caps on cross-subsidisation

Background

High income earners in effect subsidise low income earners in respect of administration fees.

It has been reported that some funds charge administration fees as a percentage of contributions, even though administration costs are probably quite similar for members at different income levels. This results in a cross-subsidy between high income earners and low income earners, because the costs of high-income earners are lower than the charges they implicitly pay, while the opposite is true for low-income earners.

The proposed R250 000 and R300 000 monetary caps may cause high income earners to reduce their contributions, which may result in a higher administration costs for low income earners. In short, the caps may result in a regressive distribution of the fee base to the detriment of lower income earners, especially if greater consolidation across funds occurs. This may also affect the cross-subsidy implicit in the cost of risk benefits.

Discussion

It is National Treasury's view that there is a low risk of the caps having a significant impact on either contributions, or, indeed, on cross-subsidies.

While this point is valid in principle, the claimed magnitude of the effect is unconvincing. If only 4% of deductions for employee pension contributions are in respect of employees who earn more than R1 million, as the analysis of tax statistics appears to indicate, it is hard to understand how restricting contributions to R250 000 or R300 0000 will have a significant impact on either contributions, or, indeed, on cross-subsidies.

Although, one area where the R250 000 and R300 000 monetary caps may affect pension provision is through the decisions of senior decision-makers in pension funds who may be subject to the cap, and who may choose to reduce pension provision for their whole companies as a result. However, in the South African context where employer-related pension funds are the primary means by which most employees save for their retirement, this would be an unlikely possibility for most employers.

6. The future of provident funds

Background

Currently, no initial deduction is available for an employee in respect of contributions made to a provident fund. Instead, if employees choose to make contributions to provident funds, they are entitled to deduct the value of these contributions from any benefits paid when they exit the fund, before any tax is calculated. From the point of view of designing a tax incentive, the *quid pro quo* for not obtaining the tax deduction on their own contributions is the ability to take all benefits as a lump sum upon retirement. In contrast, pension fund members and retirement annuity fund holders must annuitise two-thirds of their retirement benefits when they retire, but they are entitled to receive tax relief on their own contributions to the fund.

It is proposed that individuals be allowed a deduction in respect of contributions made to a provident fund.

The paper *Preservation, portability and governance for retirement funds*, published on 21 September 2012, contains an overview of the current preservation requirements in South African retirement funds. It presents several options for consideration by key stakeholders, including workers, employers, retirement fund members and Government. NEDLAC will have a key role in the consultation process. Draft proposals will be made after finalising the consultation process over the options presented, and the draft proposals will also take accrued and vested rights into account.

Draft proposals will only be made after finalising the consultation process.

The draft proposals will take accrued and vested rights into account.

The paper discusses in detail the link between insufficient retirement income and lump sum pay-outs made from provident funds at retirement. The lack of annuitisation in provident funds means that many retirees may spend their retirement assets too quickly, and face the risk of outliving their retirement savings. By aligning the retirement benefits of provident funds to those of pension and retirement annuity funds, retirees from provident funds will be assisted to better manage longevity risk and investment risk.

Three options for the alignment are presented for consultation in the paper *Preservation, portability and governance for retirement funds*, with regards to provident fund benefits at retirement:

- Maintain status quo in principle;
- Access to nominal value of accumulated savings; and
- Phased approach.

Interested parties are encouraged to consider the proposals contained in that paper and engage with National Treasury regarding the option set out above.

Discussion

Tax incentive

The uniform retirement contribution model is based on one contribution flow regardless of the retirement fund that the individual (directly or indirectly through an employer) is investing in. In order to ensure that provident fund members do not suffer a negative cash flow impact, it is proposed that they be allowed a deduction in respect of contributions made by their employers to provident funds, and on which they will be taxed as a fringe benefit.

Annuitisation

There is no reason why low income workers should not also be provided with the same tax incentives and regulated protection against longevity risk and investment risk (through an annuity) as their higher income counterparts. In fact, the simplification of the retirement system is an important step in reducing retirement fund costs and in removing the historical legacy of inequality and inequity in the retirement system.

7. Policy matters under discussion

Due to the complexity of the factors involved, certain policy matters remain under discussion.

Defined benefit schemes

In a defined benefit fund, the benefit at retirement is based on a fixed formula which takes into account salary and number of years of service. The risk of ensuring that the fund has enough money to meet its obligations is on the employer. In short, the employer has to make a top-up payment if the fund has under-performed.

In comparison, a defined contribution fund pays the capital invested plus any growth at the date of retirement, regardless of the number of years of service. Therefore, the employee bears the risk of an under-performing market and high costs instead of the employer.

Most retirement fund members in South Africa are members of defined contribution funds.

Background

A defined benefit scheme seeks to provide a benefit at retirement related to the service that a member will eventually complete at retirement, as well as some measure of pensionable earnings. Since earnings and years of service are unknown until retirement actually occurs, the earliest date at which the actual cost of providing the retirement benefit can be determined is the date of retirement. For funds which pay benefits in the form of a pension out of the fund itself, rather than providing a lump sum which can be used to purchase an annuity from a life insurer, the cost of the benefit is only known much later, when the member (and possibly his or her spouse) has died.

In order to smooth the cost of providing the pension benefit, the fund valuator estimates from time to time the costs for each member individually, using assumptions as to future salary increases, investment returns, likely longevity, salary increases and length of service, amongst others. These assumptions are derived both from past experience and the valuator's view of long-term economic and demographic conditions.

In order to smooth the cost of providing the pension benefit, the fund valuator estimates from time to time the costs for each member individually.

In principle, the rate at which retirement benefits need to be funded is thus derived individually for each member. Since members are at different stages in their careers and have differing numbers of years still before their retirement date, the rate at which pensions need to be funded in financial terms is also different for each member.

However purely for convenience, the total cost of all the members is expressed as an overall funding rate as a percentage of the total pensionable payroll of the fund. A common misconception is that each member's benefits will be funded by an amount derived by applying the funding rate to that member's pensionable earnings. (It should also be borne in mind that pensionable earnings are often not the same as actual income.)

As a result of the unique structure of a defined benefit fund, a disconnect is created between contributions and benefits.

Pooling members' contributions creates a disconnect between contributions and benefits, so there is only an indirect link between the value of an employee's individual contributions and the benefits to which they become entitled upon exit from the fund.

Some existing defined benefit schemes have contribution rates greater than the general 22.5% cap. The most significant example is the Government Employees Pension Fund (GEPF), where the total contribution rate is currently 20.5% for non-uniformed members, so below the 22.5% threshold, but 23.5% for uniformed members because of their higher death benefits (although pensionable income is significantly lower than total salary for most members of the GEPF), indicating that contributions to the GEPF will fall within the limits in the 2011 proposal for all but the highest-paid members.

In general, it may be inadvisable to treat employer contributions to a the few remaining defined benefit schemes (in access of the 22.5% and 27.5% caps) as a fringe benefit, because the individuals that will be taxed as a result may not in fact be the individuals that actually benefit from the amount contributed by the employer upon retirement. This problem may be particularly severe under the following circumstances:

- A fund may be in financial difficulty, because of low investment returns, lower-than-expected mortality or some other reason, and would therefore require extra support from the sponsoring employer. It would be unfair to burden current members with tax on extra contributions that are funding a deficit which is in respect of benefits paid to past members of the scheme.

- Many defined benefit funds pay pensioners directly from fund assets rather than securing benefits by way of an annuity with an external provider. Such defined benefit funds may also run into a deficit and the employer may also be called upon to finance the deficit attributable to pensioners, either directly or indirectly.

- The fund may have an ageing member profile, particularly if the fund is closed to new members. Under these circumstances, a defined benefit fund will require an increasing contribution rate to maintain solvency. Such contributions could easily exceed the proposed cap as the average age of the fund increases. Many South African defined benefit schemes, which closed to new members when their sponsoring employers opened defined contribution schemes, may be in this situation.

- A minority of defined benefit funds have a substantial surplus, with the result that the employer does not have to pay any contributions, but rather draws down the employer surplus account for this purpose. It is not clear that current members should be entitled to use the fact that employer contributions to the fund are low in order to increase their contributions to their own private retirement funds.

To some extent, this problem may also apply to hybrid schemes, which have both a defined contribution and a defined benefit component in their design. Arguments could be made to treat these funds either as defined contribution or as defined benefit funds.

Discussion

The concerns raised are fair. The final proposal will have to take into account that there are a few large defined benefit schemes within South Africa. Typically, with the notable exception of the GEPF, these schemes are closed to new members, and thus have an ageing membership profile with correspondingly high contribution rates.

The final proposal will have to take defined benefit schemes into account.

The concern is that current members in a defined benefit fund will be taxed in the form of a fringe benefit if an employer is required to make a top-up payment.

National Treasury analysed a 2011 survey of 271 pension funds, excluding the GEPF, with 2 600 000 active members provided by the Financial Services Board (FSB). 92% of the active members are in defined contribution schemes, 7.6% in hybrid schemes (which usually contain both defined benefit (DB) and defined contribution (DC) sections), with only a negligible number belonging to pure defined benefit schemes. All funds not regulated by the FSB, including the GEPF and some other public sector funds, were excluded from the survey. These numbers are substantially different for retired members, with many still belonging to defined benefit schemes. This clearly reflects the conversion from DB to DC schemes during the 1980s and 1990s, particularly in the private sector.

A conditional exemption from the fringe benefit treatment for employer contributions to certain defined benefit retirement funds on a case-by-case basis.

Table 11: Breakdown of active members by plan design and sector

		Sector		
		Public	**Private**	**Total**
Plan design	**DB**	0.1%	0.3%	0.4%
	DC	4.1%	87.9%	92.0%
	Hybrid	0.7%	6.9%	7.6%
	Total	4.9%	95.1%	100.0%

Source: FSB Pension Fund Survey, analysed by National Treasury.

Two possible solutions to the problems posed by defined benefit pension funds are discussed here.

Ad-hoc rules-based approach

The first approach would be to create a conditional exemption from the fringe benefit treatment for employer contributions to certain defined benefit retirement funds on a case-by-case basis. This carve-out can apply in cases where there is a legitimate reason for an employer to meet a deficit or to substantially increase the contribution rate. However, such a carve-out would require an anti-avoidance mechanism in the form of a rule or model-based approach with a process that can be verified and audited.

A conditional exemption from the fringe benefit treatment for employer contributions to certain defined benefit retirement funds on a case-by-case basis.

For example, the Commissioner of SARS, with the consent of the Minister of Finance, could grant schemes a conditional exemption from the requirement to add employer contributions to employee packages in their entirety, under the following circumstances –

- if the scheme exists as at 1 March 2014, and
- if the scheme is closed to new members and has an ageing membership profile, requiring higher contributions. This exemption could only be granted if there have been no recent benefit improvements (e.g. improvements in the accrual rate, excessive pension increases, or large numbers of early retirements); or
- if the employer is required to make higher contributions to remedy a deficit that has arisen as a result of adverse experience (e.g. poor investment returns, light mortality, or large changes in member behaviour). This exemption could only be granted if the employer can show that the deficit was genuinely unanticipated, and not the result of low contributions, unrealistic assumptions, transfers, benefit improvements or individual benefit augmentations (e.g. early retirements or buy-backs of service at favourable rates).

Specifying the set of rules will be challenging.

These rules can apply for each section of the defined benefit fund independently. Therefore, to the extent that a defined benefit fund is funded with the express purpose of benefiting a certain section of the members, the tax effect of the funding will only impact on that section of the members.

However, specifying the set of rules will be challenging and may require the SARS together with the Financial Services Board (FSB) to specify a 'reasonable' valuation basis and set of benefits. In particular, splitting employer contributions to the fund between different sources – for instance, the portion due to past poor investment returns, scheme demography, past benefit improvements, and currently accruing benefits in a way that could easily be audited or verified would be difficult. Special arrangements would also need to be made for hybrid schemes.

Value of benefits approach

A second approach would be to tax employees on the value of benefits promised by defined benefit funds rather than on the value of the contributions used to provide them. This would require the value of the benefit accrued in each year by each employee to be assessed and added to their fringe-benefit income for that year, less any employee contributions to avoid double-counting.

Value the employer's contribution for fringe benefit purposes using a notional value of the defined benefit.

Most defined benefit plans pay benefits that are a combination of a pension, a lump-sum benefit at retirement, and risk benefits, all of which usually depend on salary. For tax purposes, these could be valued using factors from tables provided by SARS and the rules of the fund. There would be no need to make the tables perfectly accurate.

Further, to make the calculation easy, and to avoid the difficulties associated with schemes with ageing populations, the factors could be made independent of age and gender. To prevent unfairly encouraging (or discouraging) defined benefit schemes, the factors would need to be a reasonable estimate of the long-run cost of providing the benefit based on an average age distribution in the fund. For instance, the factors listed in Table 12 could be used.

In practice, this approach amounts to restricting, through the tax system, the benefits that defined benefit plans are legally permitted to pay, rather than the contributions that are used to fund these benefits. The following tables show how the proposed scheme would work for two defined benefit plans, one with a 'permitted' accrual rate, and one with an accrual rate that is considered too high to qualify for full tax relief. In each case, the factor used to value the pension benefit is 8. The advantages of this second approach are that it is relatively simple to implement; it taxes individuals based on the (approximate) value of the benefits they accrue from the scheme. The approach avoids difficulties associated with schemes in deficit or surplus, and eliminates the problems associated with ageing schemes[15].

In this approach the tax system restricts the benefits that defined benefit plans are legally permitted to pay, rather than the contributions that are used to fund these benefits.

Table 12: Possible factors for the valuation of DB pensions for tax purposes

Type of benefit	Factor	Note
Pension accrued per year of additional service, as a fraction of (final) salary	8	The factor should include the effect of any salary increases until retirement and the value of pension increase. May be differences in appreciate factor level between career average schemes and final salary schemes, schemes which pay different levels of pension increases, and schemes with different retirement ages.
Lump sum benefit at retirement, as a fraction of (final) salary	0.7	The factor should include the effect of any salary increases up until retirement.
Benefits on death-in-service, as a fraction of (current) salary	0.01	Under GEPF rules, the benefit depends on the length of service. The valuator would be required to estimate average death benefit levels for the scheme.

There is not enough detail in the FSB Survey on the benefit design of plans to permit an accurate analysis of the effects of this proposal on DB plans. If risk benefits and lump sum benefits at retirement are ignored, of the pure defined benefit schemes in the FSB sample analysed, which provided sufficient data, only one (the Joint Municipal Pension Fund, with 549 active members) has retirement benefits so generous that if a factor of 8 is used to value the pension, the plan falls above the general 22.5% limit. However, 3 out of 29 plans fall over the limit if a factor of 9 is used and 6 out of 29 for a factor of 10.

Only one surveyed DB fund has retirement benefits so generous that if a factor of 8 is used to value the pension, the plan falls above the general 22.5% limit.

[15] In practice, these factors may need to be made dependent on the age at entry and the age of retirement of the scheme to prevent tax arbitrage.

Table 13: Example of proposed methodology, individual below cap

1/60ths pension, no lump sum	Current situation	Proposed rule
Individual cash salary	R1 035 197	R1 035 197
Notional employer contribution to pension attributed to employee (= taxable value of pension less employees actual contribution)	-	R1 035 197x 8/60 – R62 112 = R75 914
Gross income	**R1 035 197**	**R1 111 111**
Employee pension fund contribution	R1 035 197 x 6% = R62 112	R1 035 197 x 6% = R62 112
Permitted maximum individual pension fund contribution	R1 035 197 x 7.5% = R77 640	Min (22.5% x R1 111 111, R250 000) = R250 000
Actual deduction	R62 112	R62 112 + R75 914 = R138 026
Taxable income	**R973 085**	**R973 085**

Table 14: Example of proposed methodology, individual above cap

1/30ths pension, no lump sum	Current situation	Proposed rule
Individual cash salary	R1 035 197	R1 035 197
Notional employer contribution to pension attributed to employee (= taxable value of pension less employees actual contribution)	-	R1 035 197x 8/30 – R62 112 = R213 940
Gross income	**R1 035 197**	**R1 249 137**
Employee pension fund contribution	R1 035 197 x 6% = R62 112	R1 035 197 x 6% = R62 112
Permitted maximum retirement fund deduction	R1 035 197 x 7.5% = R77 640	Min (22.5% x R1 249 137, R250 000) = R250 000
Actual deduction	R62 112	Min (R213 940 + R62 112, R250 000) = R250 000
Taxable income	**R973 085**	**R999 137**

Because the factors used will be approximate, there may be an incentive for schemes to alter their designs at the margin to take advantage of the difference between the actual and the taxable value of the benefits accrued. This will especially be true for employers with age distributions which are significantly different from the assumptions used to generate the factors. It will also be impossible to create factors for every type of benefit, and there may be some schemes whose benefits cannot easily be accommodated by the above formula.

Particular difficulties may be created by –

- hybrid schemes, in particular defined contributions schemes with defined benefit guarantees or underpins;
- pension increases which differ between schemes; and
- non-salary-related benefits.

Non-salary-related benefits are for example a fixed death benefit of R10 000; or a pension of R360 per year (such as in the GEPF) and member options (for instance, the GEPF allows members to reduce their pension or lump sum to increase their spouse's pension). We would also need to consider the tax treatment of individual benefit augmentations, such as in the case of early retirements.

Hybrids where the defined benefit component takes the form of an underpin or guarantee cannot easily be valued by this formula.

Hybrid schemes, where the defined benefit and defined contribution components can easily be separated (e.g. where the scheme contains a defined benefit and a defined contribution section or benefit component) can be valued using the contributions paid for the defined contribution component and the value of the benefits for the defined benefit component. However, hybrids where the defined benefit component takes the form of an underpin or guarantee cannot easily be valued by this formula. If the guarantee is very low, or expressed as an intention or promise, rather than a guarantee, it might be better to treat those as defined contribution schemes for tax purposes.

The valuation formula has two elements – factors, which reflect the value of particular benefits for tax purposes – and values, which reflect the actual benefits provided by the scheme in terms of the scheme rules The scheme valuator could be required to produce a certificate to provide the employer with the values to be used in the formula for each class of member of the scheme. The criterion used by the valuator would be that the values provided fairly reflect the expected benefits provided to members of the fund in terms of the fund rules. SARS and the FSB would need to produce guidance to assist valuators in calculating these values.

This proposal would require consultation with the retirement industry.

SARS and the FSB would be required to produce the factors. In general terms, their values would need to be carefully chosen to ensure that they reflected the average value of benefits accrued and did not either advantage or disadvantage members of defined benefit schemes relative to members of defined contribution schemes.

The proposed income base

Background

It was stated in the 2012 Budget proposal that the higher of employment or taxable income should be used as the base to calculate the value of the percentage cap. Although the two terms can roughly be equated with "*taxable income*" and "*remuneration*" as defined in the ITA, some adjustments may yet be made. When determining whether a certain contribution rate is sufficient, the required replacement rate should be determined.

Discussion

Taxable income

"Taxable income" is defined in the ITA.

"*Taxable income*" as defined in the ITA means the amount remaining after taking into account against "*gross income*", all exclusions and deductions (including assessed losses).

Table 15: The calculation required to determine "taxable income"

Gross income	
Less:	Exempt income
Income	
Less:	Deductions and allowances
Add:	Taxable portion of capital gains
Less:	Assessed loss brought forward
Equals:	**"taxable income"**

Should passive income form part of the base?

It is questionable whether the pre-retirement income that must be replaced should include passive (e.g. royalties, rent, interest, or dividends) as well as active income. Passive income can generally be defined as income that does not require direct action to generate, and is therefore generally unrelated to the active participation of the recipient. However, certain types of passive income do require an initial activity to set up, such as royalties from software or music. Furthermore, except in exceptional circumstances, the value of the income earned on these types of passive income generally tends to taper downward towards the end of its life cycle. For example, the royalties on a game made for a certain game console may initially sell well, only to become outdated later.

In order to provide a simple calculation that does not discriminate between the different ways that individuals earns income, it is proposed not to exclude passive income from the "*taxable income*"-leg of the base used to calculate the value of the percentage cap. The only exception will be dividends earned because they are taxed under a separate dispensation and do not form part of "*taxable income*".

In order to ensure that the calculation of this leg of the base to be used is not distorted, it is also proposed to exclude the effect of the "taxable portion of capital gains", as well as any "assessed loss brought forward". Government will also be open to consider further adjustments depending on the strength of the arguments put forward.

Employment income

In general terms '*remuneration*' means the total value of any salary (including commission, leave pay, bonus, etc.) as well as any benefits provided by the employer in respect of services rendered. Therefore, as a concept, the items included in "remuneration" are also included in "taxable income".

Remuneration is an income base created to allow employers to withhold employees' tax on a monthly basis from employees, and pay the tax over to SARS. Although ideally there should be a match between the employees' tax deducted and the eventual income tax paid by the individual upon assessment, it is not always the case.

The value of the employees' tax deducted does not always match the income tax to be paid by the individual upon assessment.

Most of the discrepancies result from the fact that at the time when employees' tax was withheld, the actual information needed to determine the income tax payable was not yet available. However, in order to allow the withholding system to function, the ITA contains deeming provisions that allows the employer to determine a value for the purposes of calculating employees' tax.

For example, depending on the proposed use of the vehicle, either 80% or 20% of the value of a taxable benefit stemming from a right to the private use of a motor vehicle must be included in an employee's "remuneration". However, upon assessment, if the individual can prove accurate records of distances travelled for private purposes, the taxable benefit can be reduced by business travel, and other expenses incurred by the individual.

In line with the aim of providing an income base that can be utilised by the majority of employees, it is proposed that the employment income-leg of the base for the calculation of the maximum permitted retirement contribution be "remuneration" as defined in the ITA, without any adjustments. By allowing individuals to use their "remuneration" as a base, the regime is simplified for employees, as well as for the employers that have to process the deductions. The benefit that will result from an exact calculation of employee income does not justify the administrative cost that such a calculation would necessitate.

8. Conclusion

This discussion paper has been drafted with the intention of providing the public with the background to the 2012 Budget proposal in respect of the retirement savings tax incentive regime. Particular reference was made to ways in which the 2012 Budget proposal will address the deficiencies of the current system whilst still ensuring that the regime will meet the criteria of an effective tax incentive regime encouraging retirement savings.

In this respect, we wish to thank the retirement industry for their comments and suggestions in relation to the inherent policy considerations. To the extent that concerns were raised, adjustments in line with Government's proposed future plans have been made. It is intended that the proposed regime should strike a good balance between protecting the fiscus and encouraging retirement saving.

Although most of the design around the regime has been settled as outlined in the paper, further consultation will follow with the public, but in particular with the retirement industry, SARS, and the FSB, in respect of the remaining policy matters under discussion:

- defined benefit schemes
- using the higher of taxable income and employment income as the base

The hope is that further engagement will provide optimal solutions that will ensure an effective tax incentive regime that sufficiently encourages retirement savings through the support of both the public and the private sector. With the view to providing a suitable base for discussions on the subject, the structure of the new system is set out in steps in Appendix A to this paper, in the order of the deductible and taxable components of the retirement tax regime.

Furthermore, a basic summary of the proposed legislation is contained in Appendix B to this paper. The discussions with the public will be held during the latter part of 2012 so at to accommodate the proposed effective date of 1st March 2014, announced in the Budget Review, 2012.

9. Request for comments

The public is invited to comment on the proposals contained in this discussion document by no later than **30 November 2012**. Comments may be submitted to:

Attention: Ms Beatrie Gouws, Director: Legal Tax Design, Private Bag X115, Pretoria, 0001. Or by fax to 012 315 5516; or by email to retirement.tax@treasury.gov.za

The paper released by National Treasury on 14 May 2012 titled *Strengthening retirement savings: An overview of proposals announced in the 2012 Budget*, http://www.treasury.gov.za/comm_media/press/2012/2012051401.pdf) listed the following technical discussion papers for release during the course of 2012:

A. *Retirement fund costs* – Reviews the costs of retirement funds and measures proposed to reduce them.

B. *Providing a retirement income* – Reviews retirement income markets and measures to ensure that cost-effective, standardised and easily accessible products are available to the public

C. *Preservation, portability and uniform access to retirement savings* – Gives consideration to phasing in preservation on job changes and divorce settlement orders, and harmonising annuitisation requirements. The aim is to strengthen retirement provisioning, long-term savings and fund governance

D. *Savings and fiscal incentives* – Discusses how short- to medium-term savings can be enhanced, and dependency on excessive credit reduced, through tax-preferred individual savings and investment accounts. It also discusses the design of incentives to encourage savings in lower-income households.

E. *Uniform retirement contribution model* – Proposes harmonising tax treatment for contributions to retirement funds to simplify the tax regime around retirement fund contributions.

Papers B and C have been released and are available on the National Treasury website (www.treasury.gov.za).

Papers D and E have different titles from what was specified in the overview paper. Paper E refers to this paper, which is now titled *Improving tax incentives for retirement savings*.

A

Structure of the retirement tax regime

The structure of the new system is set out in steps, in the order of the deductible and taxable components of the retirement tax regime.

Table 1: Structure of the retirement tax regime (ER = employer, EE = employee)

<table>
<tr><th>1. ER contribution to retirement fund</th><th>2. EE fringe benefit</th><th colspan="2">3. EE contribution to retirement fund</th><th>4. Retirement fund payout</th></tr>
<tr><td>Taxpayer ER Unlimited deduction against taxable income</td><td rowspan="2">Taxed on the value of the contribution to the retirement fund, including any portion used by the fund for risk benefits at individual’s marginal tax rate</td><td colspan="2">Deduction of contribution against taxable income limited to annual caps, remainder carried over to next annum</td><td>Lump sum: Taxable less non-taxable portion using cumulative retirement/withdrawal tax table</td></tr>
<tr><td>Exempt ER No deduction required - no limitation</td><td>Monetary caps: See hereunder</td><td>Percentage caps: See hereunder</td><td>Compulsory annuity: Taxable less non-taxable portion at individual's marginal tax rate</td></tr>
</table>

Step 1: Employer contribution to a pension or RA fund

As a general deduction allowed in the determination of taxable income, an employer may deduct any sum contributed during the year of assessment for the benefit of the employer’s employees to any pension or retirement annuity fund. No limitations will apply in respect of the amount that may be contributed. However, the contribution will only pertain to amounts that will:

1. Enhance the value of the accumulated retirement interest;
2. Enhance the fund reserves;
3. Fund risk benefits provided by the retirement fund; and
4. Cover fund administration costs.

Step 2: Employee fringe benefit

All employer contribution on behalf of an employee to a pension or retirement annuity fund will be deemed to be a taxable fringe benefit in the hands of the employee. The value of the taxable fringe benefit will be the value of the contribution made by the employer.

However, in the case of a defined benefit fund, the full value of the employer contribution will not necessarily be converted into a fringe benefit. The exact dispensation will depend on the approach that is decided upon (the ad-hoc rules-based, the value of benefits, or any other approach).

Step 3: Employee contribution to a pension or RA fund

The employer contributions will be deemed to have been made by the employee as a member of the fund to the extent that the contribution was taxable as a fringe benefit in the hands of the employee.

As a general deduction allowed in the determination of taxable income, an individual may deduct contributions made to a pension or retirement annuity fund during the year of assessment as a member of such fund that does not exceeds the annual caps.

The contribution will be limited per annum to the lower of the percentage or monetary caps as discussed below, subject to the minimum monetary amount. However, a rollover dispensation will be adopted to allow deductions in subsequent years of assessment for so much of the value of an individual's contributions that were not deductible in previous years of assessment.

Percentage caps

Individual taxpayer deductions will be set at 22.5% and 27.5%, for those below 45 years and 45 and above respectively, of the higher of employment or taxable income. However, it must still be determined whether "remuneration" and "taxable income" as defined in the Income Tax Act will be used, or whether an adjusted remuneration and an adjusted taxable income (for example, excluding the effect of capital gains, and any assed loss brought forward), will be used.

Monetary caps

Annual deductions will be limited to R250 000 and R300 000 for taxpayers below 45 years and 45 years and above respectively. A minimum monetary threshold of R20 000 will apply where an individual has contributed in excess of the percentage caps.

Step 4: Retirement fund payout

Upon retirement, when the retirement interest exceeds R75 000, at least 2/3rd of the value of the retirement interest must be used by the pension or retirement annuity fund to provide or acquire a compulsory annuity for the benefit of the member/former member.

As a general matter, non-deductible contributions will be exempt from tax when forming part of the retirement interest, regardless of whether the interest is withdrawn as part of a lump sum or by way of compulsory annuity. All non-deductible contributions are aggregated in respect of an individual. As a default rule, the exemption will first apply to eliminate lump sum amounts and then to eliminate compulsory annuity income on a “first come, first serve” basis.

Lump sums

When a retirement fund member elects to receive a portion of the retirement fund interest in the form of a lump sum upon retirement or withdrawal, that lump sum will be subject to tax as per the retirement lump sum benefit tax table or the retirement lump sum withdrawal tax table. However, in calculating the tax due on the lump sum, the former member is afforded an exemption to the extent the member has made non-deductible contributions to retirement funds. This exemption applies in respect of retirement and pre-retirement withdrawals.

Compulsory annuity

Any amount received in respect of a compulsory annuity is taxable in the hands of the individual at the individual’s marginal tax rate. However, as per the 2012 Budget Review, it is proposed that non-deductible contributions to retirement funds be exempt from income tax in respect of retirement interests, regardless of whether these interests are withdrawn as part of a lump sum or by way of compulsory annuity.

B

Summary of proposed legislation

The summary of the proposed legislation follows below. It should be noted that where a policy decision must still be taken, the provisions in the legislation that would need to be amended to facilitate the decision are indicated, however no details are being provided.

For ease of understanding, the structure of the new system is set out in steps in the order of the deductible and taxable components of the retirement tax regime. Questions that arose during the composition of the proposed legislation are indicated.

Step 1: Employer contribution to a retirement fund

Section 11(l)

Summary

- Section 11(l) should permit an employer to deduct in the determination of its taxable income any sum contributed by the employer during the year of assessment for the benefit of its employees to any pension fund, provident fund, or retirement annuity fund.
- The deduction must be only be allowed in the case of current employees, if the rules of the fund make provision for the 'acceptance' of the contribution, and the contribution is intended to: enhance the value of the accumulated retirement interest; enhance the fund reserves; fund risk benefits provided by the retirement fund; and cover fund administration costs (refer to "questions" below).
- The deduction must only be allowed in the case of retired employees to pension or provident funds if: (a) the rules of the fund make provision for the 'acceptance' of the contribution; and (b) the contribution does not exceed the amount required to augment the annuities of existing retired employees to the extent of compensating them partially or in full for any decrease in the purchasing power of their annuities as a result of inflation.
- The word "employees" include current as well as retired employees, but does not include foreign employees seconded to a local employer.
- For the purpose of the deduction a partner in a partnership is deemed to be an employee of such partnership.

Questions

- It is not clear whether the following summary of the uses to which the contribution must be put is sufficient: Enhance the value of the accumulated retirement interest; enhance the fund reserves; fund risk benefits provided by the retirement fund; and cover fund administration costs

Miscellaneous

- Make all the necessary changes to references in the legislation to section 11(l) required as a result of the changes to the section.

Step 2: Employee fringe benefit

Paragraph 2(l) of the Seventh Schedule

Summary

- The sub-paragraph must create a taxable benefit when an employer has directly or indirectly made a contribution or a payment during the year of assessment for the benefit of an employee or the employees' dependants to a pension, provident, or retirement annuity fund
- In the case of an employer contribution to a defined benefit fund, the value of the fringe benefit can be limited or determined in accordance with the policy decision taken in respect of defined benefit funds – refer to Chapter 5 above.

Step 3: Employee contribution to a pension or RA fund

Section 1 - definition of "adjusted remuneration"

Summary

- To be determined.

Section 1 - definition of "adjusted taxable income"

Summary

- To be determined.

Section 1 – definition of "retirement-funding employment"

- Delete the definition.

Section 11(k)

Summary

Current contributions

- Paragraph (i) of the new section will apply to current contributions. Current contributions means contributions made in respect of current year of assessment. However, no deduction will be allowed if the contributions were not made for the benefit of the person making the contribution. Arrear contributions pertaining to a previous tax year are clearly not deductible under this provision.
- The employee is one who derives in respect of employment any income constituting "remuneration" and is a member of and contributes to a pension fund or a provident fund established for the benefit of employees of the employer from whom that income is derived. Accordingly, when an employee resigned from employment and ceased membership of the employer's pension fund or provident fund, the premiums paid on an insurance policy taken out in terms of the rules of the pension fund or provident fund on cessation of membership will be held not to be contributions to a "pension fund" or a "provident fund".
- Furthermore, in order to be deductible under s 11(k), contributions must be made to a "pension fund" or "provident fund" as defined in section 1, which means that the fund must be approved and registered in South Africa. In respect of retirement annuity funds, the term 'retirement annuity fund' is defined in section 1.
- Individual contributions to any approved retirement fund will only be deductible if made by a South African resident. The term "resident" is defined in section 1 and includes persons that meet either the ordinary or the physical presence residency tests. The reason for the limitation is that the retirement savings tax incentive regime is intended to benefit South African residents. Although foreigners that contribute to South African retirement funds will not be eligible for a deduction, the capital contributed will be distributed tax free from the retirement fund.

Arrear contributions

- Paragraph (ii) of the new section will apply to arrear contributions. In order to be eligible for a deduction in the current year of assessment, the amount must have been paid during the current year of assessment.
- The employee is one who derives in respect of employment any income constituting "remuneration" and is a member of and contributes to a pension fund or a provident fund established for the benefit of employees of the employer from whom that income is derived.

- A deduction is allowed for any sum paid during the year of assessment to a pension or provident fund by any person who, as a member of the fund, has in terms of the rules governing the fund undertaken to pay the sum in respect of any past period that is to be reckoned as the member's pensionable service. The deduction is not limited other than in respect of the monetary and percentage thresholds.
- In order to be deductible, an arrear contribution must have been paid "in respect of any past period which is to be reckoned as pensionable service". The deduction for arrear contributions therefore appears to be designed mainly to assist a member of a pension fund who wishes to improve his ultimate benefits from the fund by making contributions relating to a period prior to becoming a member of the fund.
- The deduction in respect of arrear contributions to a retirement annuity fund is allowed in respect of any contributions to a retirement annuity fund made during the year of assessment by any person as a member of the fund and when the contributions are made under conditions prescribed in the rules of the fund in terms of which a member who had discontinued contributions prematurely is entitled to be reinstated as a full member of the fund and the current contributions to the fund have been paid in full.
- The main requirements appear to be that the member have discontinued contributions prematurely, thus ceasing to be a full member of the fund, and that the contribution envisaged make it possible for him to be reinstated as a full member.
- Individual contributions to any approved retirement fund will only be deductible if made by a South African resident. The term "resident" is defined in section 1 and includes persons that meet either the ordinary or the physical presence residency tests. The reason for the limitation is that the retirement savings tax incentive regime is intended to benefit South African residents. Although foreigners that contribute to South African retirement funds will not be eligible for a deduction, the capital contributed will be distributed tax free from the retirement fund.

Proviso

- In respect of each year of assessment, individual taxpayer deductions will be limited to the lower of the percentage and the monetary caps. The monetary cap is set at R250 000 for persons below 45 years or R300 000 for persons aged 45 years and above respectively. The percentage caps are set at 22.5% and 27.5%, for those below 45 years and 45 and above respectively, of the higher of employment or taxable income. Depending on the tax policy decision taken, employment income will either be based on "remuneration" as defined in the Fourth Schedule or on "adjusted remuneration", which will be defined in section 1. Similarly, taxable income will either be "taxable income" as defined in section 1 or an "adjusted taxable income" as defined in section 1.

- However, to the extent that the contribution/payment made exceeds R20 000, the contribution allowed as a deduction will be at least R20 000, irrespective of the amount determined when applying the percentages cap.
- In effect, the current and arrear contributions are accumulated, and only to the extent that the current contributions do not exceed the percentage and monetary cap, may the individual be entitled to deduct any arrear contributions.
- A member of a retirement annuity fund is precluded from claiming the deduction for an amount paid into his retirement annuity fund that was a lump-sum benefit or retirement fund lump sum withdrawal benefit derived by the member from a pension, provident or retirement annuity fund qualifying for deduction from any amount to be included in the member's gross income under paragraph 6(1)(a) of the Second Schedule to the Act (that is, a tax-free amount arising upon the withdrawal or resignation of a member of a pension or provident fund or upon the winding-up of a pension, pension preservation, provident, provident preservation or retirement annuity fund) .
- An amount paid or contributed, whether in respect of current or arrear contributions, that is disallowed solely by reason of the fact that it exceeds the amount of the deduction allowable in a particular year of assessment is carried forward and deemed for the purposes of section 11(k)(i) to be a sum paid in the next succeeding year of assessment. However, the amount will not be carried forward to the extent that the 'excess' contributions have been 'accounted for' under paragraphs 5(1) or 6(1)(b) or (3) of the Second Schedule. These provisions effectively allow for the deduction from otherwise taxable lump-sum benefits from funds of previously disallowed contributions on the retirement, death, withdrawal or resignation of the member or the winding-up of the fund. The possibility of a double deduction is thus prevented.
- For the purpose of the deduction a partner in a partnership should be deemed to be an employee of such partnership.
- No deduction may be made for an arrear contribution relating to a year of assessment that, if the contribution had been made during that year, would not have qualified for deduction as a current contribution in that year of assessment.
- Any contribution made by an employer of the taxpayer for the latter's benefit is deemed, to the extent that it was included as a taxable benefit in terms of the Seventh Schedule, to have been made by the taxpayer.

Questions

- The following matters were catered for in the legislation, but do not form part of the proposal:
  - Paragraph (aa) of the proviso to section 11(k): “the deduction to be allowed in respect of any sums so paid (other than a sum paid by a “former member of a non-statutory force or service” as defined in the Government Employees’ Pension Law, 1996 (Proclamation No. 21 of 1996), in terms of Rule 11.9.2.1 of the Rules of the Government Employees’ Pension Fund contained in Schedule 1 to that Proclamation), shall not in the year of assessment exceed the sum of R1 800;”
  - Paragraph (cc) of the proviso to section 11(k): “the provisions of this subparagraph shall apply for the purpose of determining the taxpayer’s total taxable income for any year of assessment ended or ending on or after 28 February 1981 whether such taxable income is derived from the carrying on of any trade or otherwise;”
  - Section 11(n)(i)(bb): Limitation of R1 800 in the case of arrear contributions.
  - Paragraph (bb) of the proviso to section 11(n): “the deductions in terms of subparagraph (i) (aa) shall not exceed an amount equal to the amount remaining after deducting from or setting off against the income derived by the taxpayer during the year of assessment the deductions and assessed losses admissible against such income under this Act (excluding subparagraph (i) (aa), sections 17A and 19 (3) and paragraph 12 (1) (c) to (i), inclusive, of the First Schedule);”
  - Paragraph (dd) of the proviso to section 11(n): “no deduction shall be made under subparagraph (i) (bb) in respect of any contribution relating to any year of assessment which, if such contribution had been made during that year, would not have qualified for deduction under this paragraph, as applicable in relation to the said year;”
  - Paragraph (gg) of the proviso to section 11(n): “where any such contribution was allowed as a deduction to a taxpayer, no deduction in respect of such contribution shall be allowed to such taxpayer’s spouse; and”

- The following matters are not currently catered for in the legislation, but they do form part of the proposal:
  - Section 11(k): This section will allow a deduction in respect of individual contributions to a provident fund.

- Section 11(k): Individual contributions to any approved retirement fund will only be deductible if made by a South African resident. The term "resident" is defined in section 1 and includes persons that meet either the ordinary or the physical presence residency tests. The reason for the limitation is that the retirement savings tax incentive regime is intended to benefit South African residents. Although foreigners that contribute to South African retirement funds will not be eligible for a deduction, the capital contributed will be distributed tax free from the retirement fund.
- Section 11(k): No deduction will be allowed if the contributions were not made for the benefit of the person making the contribution.

Section 11(n)

- Delete paragraph (n) of section 11.

Miscellaneous

- Make all the necessary changes to references in the legislation to section 11(k) and section 11(n) required as a result of the changes to the section 11(k) and the deletion of section 11(n).

Step 4: Retirement fund payout

- No amendments are required.