momentum

9 March 2011

LEGAL UPDATE 3/2011: BUDGET SPEECH RETIREMENT REFORMS

1. **From March 2012, an employer's contribution will be treated as a taxable fringe benefit and employees will be allowed to deduct up to 22.5% of taxable income for contributions to approved retirement funds. A maximum of R200 000 a year will be deductible, with the minimum amount set at R120 000 per year.**

   Currently members of occupational retirement funds (funds that have been put in place by the employer) can claim deductions against taxable income up to 7.5% of their pensionable income. This pensionable income is used to determine the level of contributions to an occupational retirement fund. Members can also claim up to 15% of non-pensionable income that is contributed to a retirement annuity fund.

   Employers are currently allowed to deduct up to 20% of a member's pensionable income for contributions to retirement savings, group insurance, (life, disability and other insurance benefits), as well as medical aid contributions. These contributions by an employer are not taxed as income in the member's hands until the contributions are actually received as income upon exiting the fund.

   From 1 of March 2012 contributions to occupational pension funds and retirement annuity funds will be treated the same. This means that the difference between pensionable and non-pensionable income will fall away. The effect is that the deductible amount will be based on a percentage of taxable earnings. Members are therefore going to be allowed to deduct up to 22.5% of taxable income for contributions to pension, provident and retirement annuity funds. What this means is that any contribution over 22.5% will be disallowed as a deduction. If the current practice is to be continued, the contributions that exceed the 22.5% limit should be allowed to be claimed on withdrawal or retirement, as a member contribution that did not previously rank as a deduction on such withdrawal or retirement.

   Members can therefore be encouraged to make up the difference between their current maximum amount and the maximum amount that will be allowed from 1 March 2012 by making additional contributions. This should decrease the member's tax liability.

   Employers can also be encouraged to convert their contributions to employee contributions, in line with a salary sacrifice set up. This means that an employee gives up some of their salary in order to receive certain benefits from their employer. This may result in an employee's pay being taxed at a lower rate. Much depends upon how salary sacrifice is structured and what types of benefits are offered to the employee.

   This can be explained by way of the following example:

   "The example is based on the following assumptions: annual taxable income of R450 000 (R300 000 retirement funding (pensionable) and R150 000 non-retirement funding); employer contribution of 6.5% to an occupational fund; employee contribution of 6.5 %and 15% of non-pensionable income to a retirement annuity.

The example shows that from a tax deduction point of view the two systems are equal on a rand-for-rand basis. However, the maximum rand amount deductible in the example under the current system is R22 500 (7.5% of pensionable income) plus R22 500 (15% of non-pensionable income) = R45 000.

Under the proposed structure the maximum amount deductible from taxable income would be R101 250 (22.5% of R450 000). So the member will be able to make up the difference with additional contributions to substantially reduce their annual tax liability and to enjoy a comfortable retirement."

Treasury has commented that *any amount paid by* [an] *employer for retirement fund administration costs and group life assurance is not included in the 22.5 %. The calculation will be restricted to actual retirement saving contributions.* Based on this statement, one can assume that premiums for self standing (unapproved) insurance benefits would not be included in the 22.5%.

2. With a view to protecting workers' savings, it is proposed that the one-third lump sum withdrawal limit applicable to pension and retirement annuity funds should also apply to provident funds.

Currently, members of provident funds are not allowed to deduct their contributions from their taxable income. These contributions are however added to the tax-free portion of their lump sum upon exiting the fund. Provident fund members are allowed to take the entire amount as a lump sum.

The latest proposals are "*to protect workers' savings, government proposes to subject lump-sum withdrawals from provident funds to the one-third limit applying to pension and retirement annuities."*

The effect of the above is that members of provident funds will no longer be able to access the full benefit upon retiring from the provident fund; two thirds of the benefit will have to be used to purchase a pension for life.

Government has confirmed that there will be what is known as "grandfather clauses". A grandfather clause is an exception that allows an old rule to continue to apply to some existing situations, when a new rule will apply to all future situations.

There will be extensive consultation with the industry prior to the enactment of this piece of legislation.

3. Government to reconsider divorce clean-break principle

The implementation of the clean-break principle has led to an increase in the number of divorces. Members get a divorce so that they can lay their hands on their retirement savings by awarding the non-member spouse 100% of the retirement savings.

Currently a non-member spouse can either transfer their share to another fund (tax-free) or take their share in cash and pay tax. Members then face hardship during their retirement if this money is used for something other than saving for retirement.

At this stage it is unclear as to what government has in mind.

4. Improvement of treatment of lump sums at retirement

In previous years, Government has indicated that it intended to force retirement fund members to preserve their retirement savings until they actually retire. However nothing was done apart from making the taxation on the withdrawal of lump sums before retirement more stringent than at retirement.

It was therefore proposed that, as from 1 March 2011, Government will increase the tax-free lump sum benefit upon retirement from R300 000 to R315 000. The revised rates for the taxation of lump sums upon retirement and severance benefits are set out below.

Taxable income from lump sum benefits	Rate of tax
Not exceeding R315 000	0% of taxable income
Exceeding R315 001 but not exceeding R630 000	R0 plus 18% of taxable income exceeding R315 000
Exceeding R630 001 but not exceeding R945 000	R56 700 plus 27% of taxable income exceeding R630 000
Exceeding R945 001	R141 750 plus 36% of taxable income exceeding R945 000

Anthea Mara
Legal adviser at FundsAtWork
Momentum