OUR INDUSTRY IS CHANGING. ARE WE?

"Rights and obligations in an evolving Retirement Funds environment"

PENSION LAWYERS ASSOCIATION

THE **2006 PENSION LAWYERS ASSOCIATION CONFERENCE**

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INTRODUCTION

- Budget Speech 2006
- Reform document on retirement funds
- 18% to 9%
- Welcome Concession

REDUCTION OF TAXATION ON RETIREMENT FUNDS

- Lower-income earners pay more on retirement than working life
- Tax relief supposed to increase savings
- Change to retirement taxes will require adjustment period

WHOLESALE CHANGE TO TAX SYSTEM

- Transition period
- Hybrids
- Change will weigh up interests etc. (see overpage)

CHANGE WEIGH UP

- Interests of-
  - Government - GDP
  - Life officers
  - Members

TRFA

- Katz Commission 3rd report – recommended holistic change
- Tax on Retirement Funds Act 38 of 1996 (“TRFA”)
- TRFA is a separate act to the Income Tax Act

SECTION 103

- Whenever the Commissioner is satisfied that any transaction –
  - has been entered into or carried out which has the effect of avoiding tax; and
  - was entered into or carried out in a manner which would not normally be employed for bona fide business purposes, other than the obtaining of a tax benefit; and
  - has created rights or obligations which would not normally be created between persons dealing at arm's length under a transaction of the nature of the transaction in question; and
  - **was entered into or carried out solely or mainly for the purposes of obtaining a tax benefit**

ANTI–AVOIDANCE AMENDMENT – S103

- One of the proposed amendments is to s103 which will impact on retirement investments recommended by product managers
- One of the main purposes of transaction, operations or scheme is to obtain a tax benefit
- Previously if the main purpose was to obtain a tax benefit i.e. if also commercial benefit it fell out of S103

OBJECTIVES FOR A HEALTHY TAX SYSTEM

- Ensure that retirement life similar standard to working life
- Encourage people to save for retirement so as to reduce the cost to the state
- Paternalistic method
- Empirical evidence tax incentives not help to save

REFORM OF TAX REQUIRES -

- Affordability – concession one area burdens another
- Consistency – of principles
- Intergrity – no arbitrage opportunities
- Certainty – change is not sudden

DIFFERENT RETIREMENT SYSTEMS

1. EET – contributions from income pre-tax, does not tax funds, tax on benefits (pension)

2. TEE – post-tax deduction, exempt tax on funds, exempt benefits (tax-free withdrawal)

3. TTE – post-tax deduction, tax on funds, exempt benefits

4. ETT – pre-tax deduction, tax on funds, tax on benefits

EET and TEE

Consume Now

Consume Later

Timing Difference
Tax effect neutral

SUGGESTED TAXING SYSTEM (Cont.)

- Neutral tax effect for different types of saving whether consume now or later
- TEE-
  - Overcomes inflation
  - Limits tax avoidance and evasion
  - Ensures collection from foreign workers
  - Collects more from higher income earners
- Problem – psychologically up-front relief favoured

- Tax on contributions
- Tax on income from funds
- Tax on withdrawals

Difference in treatment
Self-Employed and
Employed

Pension

Provident

EMPLOYED PERSONS

- Employed persons are entitled to the following deductions in –
  - Up to 20% of their earnings contributed by their employers to either a pension or provident fund (fully deductible by the employer)
  - A further tax deduction of 7.5% of retirement funding income and for an employee that contributes to a pension fund (in total 27,5% is deductible in respect of pension, medical aid contributions disability insurance)

SELF-EMPLOYED AND EMPLOYED PERSONS

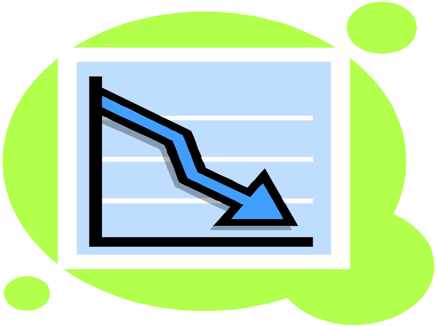
- The deductions of contributions to a retirement annuity which are available include the following –

  - a deduction of the greater of either R1 750 or R3 500 less contributions made to a pension fund; or

  - a deduction of 15% of non-retirement funding income (ie. employment income less contributions to pension/provident fund.)

PROPOSED CHANGES TO THIS & PROBLEMS WITH REFORM

- Set a limit which is fair to lower income earners
- System of credits
- Disappearing credit
- Refundable credit



TAX ON FUNDS

- Affects retirees when funds are taxed
- Not subject to normal tax – why pay tax when retired?
- 18% - 9%
- Arbitrage – abuse of tax concessions

WITHDRAWALS

- Liable to tax at higher of average rate applicable in year of withdrawal over and above R1800
- Job to job
- Move Cash in retirement funds
- Preservation fund
- But funds needed to service current debt
- Penalty introduced so as not to cash-in

LUMP SUM PAYMENTS

- A person who retires or dies in employment isentitled to receive the greater of –
  - R120 000 of the lump sum due to him/her; or
  - R4 500 multiplied by the number of year’s service which is received as a lump sum wholly exempt from income tax.
- Lump sum over and above exempt sum taxed at average rate of 2 tax years
- 2 tax years to ensure no avoidance
- Reduction of marginal rate because of s5(10) lost

ANNUITY

- Taxed at marginal rate
- Since deducted contributions
- Tax incentive for annuity required
- Tax retirement funds?

FOREIGN PENSION FUNDS

- Residency basis of taxation
- CIR only approve pension funds established in South Africa
- Tax treatment of contributions and pension funds received by SA residents from overseas
- S10(1)(g) exemption source
- Deeming provision (s9(1)(g))
- Lever Bros : Case - source

PROBLEMS THAT NEED TO BE ADDRESSED

- Change limits to keep up with inflation
- Formula A + B complicated – simplify system
- Disparity between rich and poor should close
- Uniformity of treatment
- Learn from lessons of other jurisdictions

DESIGNING TAX CONCESSIONS

- Tax concessions in regard to deductions – benefit higher income earners
- Tax credit system
  - -refundable credit or
  - -disappearing credit

COMPULSORY SAVINGS PLAN

- Raise level of saving – compulsory savings contributions
- Use by example – post World War II
- If no income to cope with current expenses – why save?
- New Zealand – freedom of choice
- Most jurisdictions paternalistic
- Tax concessions make compulsory laws more acceptable to voters

OVERSEAS EXAMPLE

- Income accrues tax free or lower than marginal rates (Sweden & Australia)
- Withdrawals are tax exempt in New Zealand
- Tax free lump sum – Ireland, Japan, Australia and the UK
- Change usually less generous
- Early withdrawal penalty – (US & Austria)

PENSIONS

- Annuity rather than lump sum
- Lump sum used up but current debt needs to be satisfied
- Could charge a surtax if lump sum not used for particular purpose
- Australia small amount used for what you choose, remainder annuity

DISCLOSURE RULES

- Rules so that investors aware of-
  - Initial or ongoing & terminating costs
  - Historical performance of investments
  - Choice of individual employee – cost to employer
  - Incentive of compliance tax incentive
  - Fail to comply - disqualified

CHANGES IN TAX TREATMENT

- Change from EET to TEE
- How will post-amendment distributions be affected?
- Trace every entitlement & freeze them until change granting a tax credit
- Australia problem transition rule extended to benefits accumulated and earnings made prior to change
- Change in rules – members should not suffer as a result

CHANGES IN TAX TREATMENT (Cont.)

- Problems of defined benefit plans
- Discourage non-pension benefits – create greater tax concessions

CONCLUSION

- Tax free amounts should follow inflation
- Difference between pension and provident fund
- Tax currently encourages lump sum tax free instead of annuity
- Preservation fund
- Self employed

THANK YOU

The End