Tax treatment of Retirement Fund benefits

Pension Lawyers Association Seminar – June 2011

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Agenda

- Joining a fund – types of funds
- Leaving a fund
  - Withdrawal
  - Divorce
  - Retrenchment
  - Retirement
  - Death

  - Group Assurance policies
  - Budget proposals
Retirement funds

- Occupational Funds (retirement age 55-70)
  - Pension and/or Provident fund
- Individual (retirement age 55 onwards)
  - Retirement Annuity
- Preservation (retirement age 55-70)
  - Pension Preservation
  - Provident Preservation

  - Early retirement due to Disability

  - Regulated by the FSB in terms of the Pension Funds Act and approved by SARS
Deductible Contribution – 2011 Budget Proposal to “roll all 3”

- Provident fund:
  - Employer - 10% of employee’s Approved Remuneration (SARS practice is 20%)

- Pension fund:
  - Employee – Greater of 7.5% of taxable income or R1 750
  - Employer - 20% of employee’s Approved Remuneration (SARS practice)

- Retirement annuity:
  - Greater of 15% of taxable non-retirement funding income, or
  - R3 500 less allowable pension fund contributions,
  - Or
  - R1 750
Taxation of Retirement Funds

- Investment return in retirement funds are tax exempt as RF tax stopped in 2007
- RA’s – Cannot withdraw prior to retirement unless emigration,
- Pen and Prov. Funds can withdraw total amount on leaving employer
- Pension Preservation and Provident Preservation funds allow one withdrawal prior to retirement
Taxation of Lump-sums paid from Funds

Para. 2 of the Second Schedule to the Income Tax Act

- the amount to be included in “gross income” of any person shall be:
  - 2(1)(a): lump sum benefits received as a consequence of retirement or death or retrenchment less allowable deductions
  - 2(1)(b)(iA): any divorce award deducted from his/her former spouse’s minimum individual award (the “person” is the non-member spouse) less allowable deductions
  - 2(1)(b)(iB): any transfer to any approved fund for the benefit of the taxpayer less allowable deductions
  - 2(1)(b)(ii): any other lump sum benefits received as a consequence of membership or past membership of a fund less allowable deductions
Allowable deductions from lump sum payments into Second Schedule:

- On death, retirement or retrenchment, unless previously claimed, the following amounts are deductible:
  - Previously disallowed contributions
  - Previously taxed divorce award transfers to any approved fund
  - Previously taxed transfers to approved funds
  - Previously taxed unclaimed benefits transferred to preservation funds
  - The tax-free portion of transfers from state funds

- Gross lump sum benefit – deductions = taxable amount
- Then apply the Retirement Fund lump sum table
Withdrawal from a fund

- Pre-retirement withdrawals from Pension and Provident funds allowed when member leaves employer.
- Pre-retirement withdrawals from an RA are not allowed, unless the member is emigrating.
- Pre-retirement withdrawals are taxed according to the retirement fund lump sum tax table on withdrawal.
Retirement from a fund

- Provident Fund – any amount may be taken as a lump sum (taxable) and balance, if any used to purchase an annuity.

- Pension and R.A. funds – maximum of 1/3\(^{rd}\) may be commuted to a lump sum taxable amount.
  - Balance to purchase a compulsory annuity, unless:
  - The 2/3rds amount less than R50 000 or if the member is deceased.
### Tax rates for lump sum withdrawal benefits - Pre-retirement withdrawal

<table>
<thead>
<tr>
<th>Amount</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not exceeding R22 500</td>
<td>0% of taxable income</td>
</tr>
<tr>
<td>Exceeding R22 500 but not exceeding R600 000</td>
<td>18% of taxable income exceeding R22 500</td>
</tr>
<tr>
<td>Exceeding R600 000 but not exceeding R900 000</td>
<td>R103 950 plus 27 per cent of taxable income exceeding R600 000</td>
</tr>
<tr>
<td>Exceeding R900 000</td>
<td>R184 950 plus 36 per cent of taxable income exceeding R900 000</td>
</tr>
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</table>
Tax rates for lump sum retirement benefits - Retirement, Death and Retrenchment

<table>
<thead>
<tr>
<th>Amount</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not exceeding R315 000</td>
<td>0% of taxable income</td>
</tr>
<tr>
<td>Exceeding R315 000 but not exceeding R630 000</td>
<td>18% of taxable income exceeding R315 000</td>
</tr>
<tr>
<td>Exceeding R630 000 but not exceeding R945 000</td>
<td>R56 700 plus 27 per cent of taxable income exceeding R630 000</td>
</tr>
<tr>
<td>Exceeding R945 000</td>
<td>R141 750 plus 36 per cent of taxable income exceeding R945 000</td>
</tr>
</tbody>
</table>
Lump sum payments in terms of a divorce award

Where the amount accrues to the non-member spouse after 1 March 2009:

- Lump sum is taxed according to the retirement fund lump sum table less the portion of the divorce award that is transferred to an approved fund (e.g.: pension to pension / provident to provident)

- The table applied is the withdrawal table unless amount transferred to another approved fund.

- The amount of tax is deducted from the non-member spouse’s allocation
Lump sum payments from a fund due to retrenchment

Where the amount becomes payable on or after the 1 March 2009:

- Lump sum is taxed according to the retirement fund lump sum table as a retirement benefit, less
- the portion of the amount that is transferred to an approved fund (eg: pension to pension / provident to provident – including preservation funds)
Severance, Retrenchment and Retirement Effective 1 March 2011

- R30 000 exemption (Sec. 10(1)(x)) for lump sums - abolished
- Average rating formula for lump sums (Sec.7A(4A)) abolished
- Lump sum severance/retrenchment benefits are taxed together with retirement fund lump sums according to the retirement table – cumulative
- Not possible to avoid tax by transferring the severance package paid by the employer to another approved fund
Preservation Funds

- A retirement fund to preserve retirement savings when changing jobs
- Able to accept transfers of allocations from funds to a non-member spouse in a divorce
- Able to accept money which has not been claimed by an exited member or a deceased member for 24 months or more
Preservation Funds

- WEF 1 March 2008 Preservations were defined in the ITA and needed approval by 30 September 2009.
- Transfers from pension funds to pension preservation funds, between RAs and from provident funds to provident or pension preservations – not taxable.
- Split transfers are not allowed except splits from a pension fund to an RA and a pension preservation fund.
- RF 1/2011 allows RA’s to accept transfers from pension funds – ITA requires amendment before this is possible.
Preservation fund withdrawals

- One taxable withdrawal allowed prior to retirement – taxable
- Withdrawal prior to transfer into preservation fund or deduction into Section 37D or withdrawal into a divorce award – not one withdrawal
- Transfers between preservation funds are not withdrawals, but currently FSB requires a section 14 transfer.
- Currently members of preservation funds who have taken their one withdrawal, cannot withdraw balance due to emigration prior to retirement
Aggregation of taxation of lump sum benefits

- All previous fund lump sum withdrawal benefits received after 1 March 09 and retirement/retrenchment lump sum benefits received after 1 October 07 by the taxpayer is added to the current lump sum death/retirement/retrenchment benefit.
- A “hypothetical” Tax is calculated according to the Retirement Fund lump sum table on the combined amount.
- Tax is calculated on previous lump sum amounts (regardless of reason) using current table and that amount is deducted from the “hypothetical” tax amount.
- The net amount is the amount of tax payable.

- Ref- Item 10(b) of Appendix 1 of the Income Tax Act
Example:

Joe retires and commutes R2m of his pension fund. He receives a “golden hand-shake” of R1m. His average rate is 30% and his marginal rate is 40%.

**Old Tax:**
- R2m: R300 000 tax-free, R300 000 at 18%, R300 000 at 27%, R1.1m at 36% =R531 000(R135000 plus 36% on 1.1m)
- R1m: R30 000 tax free and balance at 30%(R970 000x30%)=R291 000
  - **Total=R822 000**

**New Tax:**
- R2m+R1m taxed according to Retirement lump sum table.
- 36% of amount above R945 000 ie: **R141 750** plus **R739 800**
  - **Total=R881 500**
Example cont:

- If Joe had been retrenched by a previous employer after 1 March 2011 and received a lump sum from his retirement fund of R1m taxed according Retirement lump sum scale =
  - R315 000 tax free (R0)+
  - R315 000 at 18%+ (R56 700)
  - R315 000 at 27%+ (R141 750)
  - R55 000 at 36%= (R19 800)
  - R141 750+R19 800=**R161 550 tax**

- Then later he retires and receives the R2m lump sum from his pension fund plus a golden hand-shake of R1m.
  - He is already at the 4th tier of taxation at 36%
  - Total R3m taxed at 36%=**R1 019 850 tax**
Example cont:

- If Joe decides not to commute R2m of his pension and, instead, purchases a living annuity (RDDA):
  
  - R2m used to purchase a living annuity with no tax deducted
  
  - R2m (R1m original package + R1m golden handshake) taxed at R141 000 + 36% x of amount above R945 000 (R379 800)

  = R520 800 (total tax (hypothetical), less original tax
  
  - R161 550 (on first package)

  = R359 250
Tax treatment of Life assurance benefits

- Fund owned policies (DC):
  - Benefit is outlined in the fund rules
  - Premium is paid by the fund and is built into the **deductible**
    Fund contributions made by the ER.
  - On death of a member the amount of insurance cover is paid to the fund and the lump sum paid to dependants is a combination of fund credit and life assurance benefit.
  - Lump sum is taxed according to the retirement tables as if the member had retired and the after tax amount is paid to dependants
  - Tax calculation will take account of prior lump sums taken by the member
Beneficiaries of lump sum benefits from a fund on death of a member

- Payment is in terms of Section 37C of the Pension Funds Act
  - Legal and financial dependants
  - Nominated beneficiaries considered last

- Lump sum is not part of the estate of the deceased member
  - Not subject to estate duty
  - Not subject to Executor’s fees

- This presents an estate planning opportunity in respect of RA funds
2011 Budget Review Proposals
effective 1 March 2012

- Contributions to a retirement fund by the employer on behalf of an employee deemed a taxable fringe benefit – not clear how “on behalf of” will apply
- Individuals may claim a deduction of a minimum of R12 000 and a maximum of 22,5% of taxable income to a max. of R200 000 pa. (reached at taxable income of R888 899 pa)
- Split of 1/3rd lump sum and 2/3rds compulsory annuity for Provident Funds – not intended to apply to existing benefits
- Introduction of mandatory preservation
- Discussion documents to be published in July
Mandatory Preservation

- It may be a less optimal decision because:
  - Not all South Africans are covered by occupational funds or have RAs...
  - What about the rest? Should auto-enrolment be considered?

- What about people who genuinely need access to these funds:
  - Retrenchees – not sure whether mandatory preservation will apply
  - For education
  - Housing purposes
  - UIF is exhausted
if Budget proposals apply

- **Tax treatment of contributions**
  - Joe’s taxable income is R900 000pa. He contributes 22.5% to an R.A. (total R202 500)
  - He will only be able to claim a deduction of R200 000.
  - However, it appears that the disallowed contribution will be allowed to be claimed in future years into 2\textsuperscript{nd} schedule.

- Mary’s taxable income is R51 000 pa. She may contribute and claim a deduction of R12 000pa rather than R 11 475 (22.5% of R51 000)
- NB - his is an interpretation of proposals
if budget proposals apply

- Same contribution scales for all types of fund at member level
- Anticipate the same retirement benefits structure from all types of funds
- Pre-retirement withdrawals will not be allowed and mandatory preservation will apply

NB – all the above will incur Rule changes and member communication and education
THANK YOU FOR PARTICIPATING

– QUESTIONS?