BETWEEN THE TIDES

THE 2012 PENSION LAWYERS ASSOCIATION CONFERENCE

Tax changes affecting the retirement industry

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PENSION LAWYERS ASSOCIATION

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Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

DISCUSSION

- Legislative process around the Taxation Laws Amendment Act (TLAA)
- 2011 TLAA: Retirement & insurance related amendments
- 2012 Legislative cycle
- Looking ahead

TLAA LEGISLATIVE PROCESS

- Initiation
- Draft Bill
- Bill With Parliament
- Promulgation
- Engagement

INITIATION

- New proposals & feedback on current legislation

– Chapter 4 – substantive policy matters

– Annexure C – anomalies between legislation & current policy framework, as well as technical amendments

- Origination – submissions, meetings & workshops; both internal & external

- Process commences as soon as previous TLAB has been introduced in Parliament

DRAFT BILL

- Policy decisions finalised & consensus reached prior to commencement of drafting
- Drafter’s notes compiled & drafting commences
- Draft TLAB published for comment
- Briefing & hearings at Parliament – TLAB up for discussion; public invited to take part in hearings

DRAFT BILL - CONTINUED

- Review of comments received on draft TLAB: Internal, external & from the briefing & hearings at Parliament

- Meetings & workshops, both internal & external to discuss merit of comments

- Document prepared for Parliament on response to comments received by National Treasury (NT) & the South African Revenue Service (SARS)

- Changes to draft TLAB as a result of comments received

- The reworked draft TLAB is reviewed by NT & SARS

BILL WITH PARLIAMENT

- Minister of Finance introduces the TLAB in Parliament

- Passage through Parliament (highlights)
  - TLAB is referred to the Standing Committee on Finance
  - NT & SARS brief Standing Committee & submit final response document
  - First & Second Reading debate in National Assembly
  - Approval by National Assembly & referral to Select Committee on Finance of the National Council of Provinces
  - NT & SARS brief Select Committee
  - Debate in National Council of Provinces
  - Approval by National Council of Provinces

PROMULGATION

- President assents & signs TLAA into law
- TLAA published in Government Gazette
- TLAA published on NT & SARS websites

ENGAGEMENT

- Substantive matters can be raised throughout the year, however they require extensive research & consultation & are often only addressed in subsequent years

- Anomalies between the current Legislation & the policy framework must be raised ASAP after introduction of the TLAB; these matters often require consultation, which may delay the implementation of an appropriate amendment

- Technical amendments should be raised immediately after introduction of the TLAB

- Some proposed changes may form the basis of a proposal for the following year's legislative amendments

ENGAGEMENT - CONTINUED

- Where do you direct your query?
  - NT for policy matters
  - SARS for rulings & interpretation of tax Legislation
  - FSB for rulings & interpretation of retirement fund legislation

- Chief Directorates in the office of the Deputy-Director General (DDG) of Tax, Financial Sector Policy:
  - Financial Sector Development
  - Financial Services
  - Financial Stability
  - Economic Tax Analysis
  - Legal Tax Design

ENGAGEMENT - CONTINUED

- Some of the entities that may be consulted depending on the matter:
  - Other DDG offices within NT
  - Other Ministries (e.g. Department of International Relations & Cooperation “DIRCO”)
  - SARS
  - Financial Services Board (FSB)
  - Public Investment Corporation (PIC)
  - The Government Employees Pension Fund (GEPF)
  - The Financial Intelligence Centre (FIC)
  - South African Reserve Bank (SARB)

DISCUSSION

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RETIREMENT & INSURANCE RELATED AMENDMENTS

- Retirement lump sum & severance benefit tax table
- Transfers to a pension preservation fund
- Transfers to a retirement annuity fund
- Employer-owned insurance policies

RETIREMENT LUMP SUM & SEVERANCE BENEFIT TAX TABLE

TAXABLE INCOME	RATE OF TAX
R0 to R300 000	0%
R300 001 to R600 000	18% of amount above R300 000
R600 001 to R900 000	R54 000 + 27% of amount above R600 000
R900 001 +	R135 000 + 36% of amount above R900 000

TAXABLE INCOME	PROPOSED RATE OF TAX
R0 to R315 000	0%
R315 001 to R630 000	18% of amount above R315 000
R630 001 to R945 000	R56 700 + 27% of amount above R630 000
R945 001 +	R141 750 + 36% of amount above R945 000

RETIREMENT LUMP SUM WITHDRAWAL BENEFIT TAX TABLE

TAXABLE INCOME		RATE OF TAX		
R0	to R22 500	0%		
R25 500	to R600 000	18%	of amount above	R22 500
R600 001	to R900 000	R103 950 + 27%	of amount above	R600 000
R900 001	+	R184 950 + 36%	of amount above	R900 000

- There is a built-in penalty for individuals who withdraw from a retirement fund prior to retirement

TRANSFERS TO PENSION PRESERVATION FUNDS

- As from 1 March 2012, the 2011 TLAA allows transfers from <u>provident</u> & <u>provident preservation</u> funds to pension preservation funds

- The transfers are exempt from tax

- An amendment was made to the definition of “pension preservation fund” in section 1 in order to allow for the transfers to be made

- The tax exemption of these transfers were granted in paragraph 6 of the Second Schedule to the Income Tax Act

TRANSFERS TO RETIREMENT ANNUITY FUNDS

- As from 1 March 2012, the 2011 TLAA allows transfers from <u>pension preservation</u> & <u>provident preservation</u> funds to retirement annuity funds

- The transfers are exempt from tax

- An amendment was made to the definition of “retirement annuity fund” in section 1 in order to allow for the transfers to be made

- The tax exemption of these transfers were granted in paragraph 6 of the Second Schedule to the Income Tax Act

- It has been noted that this transfer does not constitute the ‘one withdrawal’ by the member & a technical correction is being considered to confirm this position

EMPLOYER-OWNED INSURANCE POLICIES

- Background
- Employer-owned insurance policies for the benefit of the employee
- Employer-owned insurance policies for the benefit of the employer
- Cession of employer-owned insurance policies
- Capital Gains Tax

BACKGROUND

- The only insurance policies at issue here are policies relating to the death, disability or severe illness of an employee

- ‘Approved group life policies’ are ‘employer-funded’, not ‘employer-owned’ – the retirement fund is the policyholder

- Employer-owned insurance policies are entered into either:
  - For the benefit of the employee, and/or his/her dependents or beneficiaries (hereafter only referred to as the ‘employee’); or
  - For the benefit of the employer

- Employer-owned insurance policies can be structured either as long-term or short-term insurance policies

EMPLOYER-OWNED INSURANCE POLICIES FOR THE BENEFIT OF THE EMPLOYEE

- Types of employer-owned insurance policies for the benefit of the employee:
  - Employer-owned death or disability risk policies through an ‘unapproved' plan
  - Employer-owned income protection risk policies
  - Employer-owned compensation policies

- The beneficiary to the policy may either be the employer or the employee

- However, where the beneficiary is the employer, but the benefit is intended for the employee, there is often a side arrangement or an established practice that obliges the employer to turn over the insurance proceeds (or their equivalent) to the employee

EMPLOYER-OWNED INSURANCE POLICIES FOR THE BENEFIT OF THE EMPLOYEE - CONTINUED

- Employer-owned death or disability risk policies

– The result should be a matching effect with the employer being entitled to the deduction in respect of the premiums paid & the employee being taxed on the value of the insurance cover provided as a fringe benefit

– The design of the tax regime is that the employer/insurer payout to the employee will in the first instance be taxable, but subsequently exempted depending, in the case of <u>pure risk policies</u>, on whether <u>all</u> the premiums <u>on or after 1 March 2012</u> were taxable in the hands of the employee as a fringe benefit

– The 1 March 2012 cut-off date was introduced in order to allow taxpayers & employers to start with a clean slate

EMPLOYER-OWNED INSURANCE POLICIES FOR THE BENEFIT OF THE EMPLOYEE - CONTINUED

- Employer-owned income protection risk policies

– The tax regime is designed to initially have the same effect as employer-owned death or disability risk policies, with a matching deduction (employer) & inclusion (employee)

– To create parity between individual income protection plans & employer-owned income protection risk policies, the employee will be entitled to a deduction in respect of the employer premium paid up to the value of the fringe benefit

– Because the employee will also be entitled to a deduction, the proceeds will be taxable upon payout, regardless of the fact that the employee included the value of the premium as a fringe benefit

EMPLOYER-OWNED INSURANCE POLICIES FOR THE BENEFIT OF THE EMPLOYEE - CONTINUED

- Employer-owned compensation policies

– Traditional employer-owned hybrid investment/risk policies for the benefit of employees created a mismatch; however, as from 1 March 2012, it is clear that the employer premium is deductible for the employer, but taxable as a fringe benefit for the employee

– Although the employer payout to the employee will in the first instance be taxable, the proceeds will subsequently be exempted depending in the case of any policy <u>other than a pure risk policy</u>, if <u>all</u> the premiums payable in respect of the policy were indeed taxed as a fringe benefit in the hands of the employee

– The intention with the tax design was to ensure that all traditional deferred compensation policies exit the system – refer to "cession of employer-owned insurance policies" hereunder

EMPLOYER-OWNED INSURANCE POLICIES FOR THE BENEFIT OF THE EMPLOYER

- Keyperson insurance policies on the life of an employee is intended to protect an employer against the loss that will result from the injury, disability or death of an employee

- Under the previous dispensation, the employer either:
  - Qualified for a deduction of the premiums (with an inclusion of the proceeds in taxable income) if the policy met certain requirements
  - Did not qualify for a deduction of the premiums (with no inclusion of proceeds in taxable income)

- From discussions with the industry, it was determined that by far the majority of employers with keyperson policies prefer to forgo an upfront deduction in order to ensure untaxed proceeds

EMPLOYER-OWNED INSURANCE POLICIES FOR THE BENEFIT OF THE EMPLOYER - CONTINUED

- The Legislation was amended so that as from 1 March 2012, premiums are deductible & the payouts taxable for employers that meet the objective requirements, & that opt into the tax regime

- Inaction means that the premiums will remain non-deductible & the proceeds initially taxable, with an exemption applying should the employer not have opted into the regime

- The intention to opt into the regime must be expressed through a one-off selection made:
  - At inception in the policy agreement of a policy concluded on or after 1 March 2012
  - By 31 August 2012 in an addendum to a policy pre-dating 1 March 2012

EMPLOYER-OWNED INSURANCE POLICIES FOR THE BENEFIT OF THE EMPLOYER - CONTINUED

- The objective requirements:

  - The business must be insured against the loss of a keyperson by reason of death, disability or severe illness

  - The policy must solely be a risk policy (without any cash or surrender value associated with investment policies)

  - The taxpayer must be the sole owner of the policy (setting aside the holding of technical title by creditors as collateral security)

CESSION OF EMPLOYER-OWNED INSURANCE POLICIES

- Employer-owned insurance policies are on occasion ceded to an employee or to an entity (often a retirement fund) for the benefit of an employee

- Employer-owned insurance policies can be:

– Investment policies or hybrid investment/risk policies (often deferred compensation policies); or

– Pure risk policies (often redundant keyperson policies):

CESSION OF EMPLOYER-OWNED INSURANCE POLICIES - CONTINUED

- Employer-owned investment or hybrid policies:

– The intention was to create an exit route that will tax the employee on the value of the policy upon cession regardless of whether the policy is ceded to the employee or to a retirement fund for the benefit of the employee

– However, the income will not be taxable as a “severance benefit” regardless of the circumstances of the cession

– Where an employer cedes an employer-owned investment policy, the value of the policy will in the first instance be taxable, the proceeds will subsequently be exempted if <u>all</u> the premiums payable in respect of the policy were indeed taxed as a fringe benefit in the hands of the employee

CESSION OF EMPLOYER-OWNED INSURANCE POLICIES - CONTINUED

- Employer-owned pure risk policies:

  – When the policy is ceded, the employee will have the obligation to pay the premiums & have the benefit of being the policyholder; there is a cessation of the employer's involvement with the policy, with the employee assuming all risks & entitlements

  – The cession of pure risk policies will not generate income in the hands of the employee

  – The exclusion applies regardless of how the previous policyholder (i.e. the previous employer) treated the policy from a tax point of view

CAPITAL GAINS TAX

- It is NT policy to continue to subject second-hand long-term insurance policies to capital gains tax in order to continue to discourage the trade in second-hand policies
- However, as from 1 March 2012, all risk policies are specifically excluded from the application of capital gains tax (including second-hand policies)
- The nature of a risk policy prohibits these policies from being regularly traded as a ‘second-hand’ policy because these policies do not have inherent tradable value

DISCUSSION

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- Looking ahead

2012 LEGISLATIVE CYCLE

- 2012 Budget: Chapter 4
- 2012 Budget: Annexure C

2012 BUDGET: CHAPTER 4

- Retirement reforms
  - Uniform retirement contributions
  - Gradual alignment of pension & provident funds
- Encouraging household savings

UNIFORM RETIREMENT CONTRIBUTION

- To encourage savings employer contributions on behalf of employees will be deemed to be taxable fringe benefits in the hands of employees
- All contributions up to a limit will be tax deductible – this will apply to pension, provident & retirement annuity funds

UNIFORM RETIREMENT CONTRIBUTION - CONTINUED

- Individual taxpayer deductions will be limited to 22.5% for those below 45 years & 27.5% for those of 45 years & above, calculated on the higher of employment or taxable income
- Annual deductions will be limited to R250 000 for taxpayers below 45 year & R300 000 for those of 45 years & above
- 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 later on as annuity income

UNIFORM RETIREMENT CONTRIBUTION- CONTINUED

- Measures to address some of the complexities in the case 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
- Contributions towards risk benefits & administration costs within retirement savings will be included in the maximum percentage allowable deduction
- These amendments will come into effect on 1 March 2014

GRADUAL ALIGNMENT OF PENSION & PROVIDENT FUNDS

- Lump sum withdrawals upon retirement from pension & retirement annuity funds are restricted to a maximum of one-third of accumulated savings

- Consultations will be held with interested parties to align pension & provident fund provisions & will precede any amendments

- In addition, amendments will take into account vested rights & provide for transitional arrangements

ENCOURAGING HOUSEHOLD SAVINGS

- Tax-preferred savings & investment accounts are proposed as alternatives to the current tax-free interest-income caps
- Returns generated within these vehicles (including interest, capital gains & dividends) & withdrawals will be tax exempt
- Aggregate annual contributions could be limited to R30 000 per year per taxpayer, with a lifetime limit of R500 000
- The design & costs (banking & other fees) of these vehicles may be regulated to help lower-income earners to participate
- Government proposes to introduce tax-preferred savings & investment vehicles by April 2014; a discussion document will be published by May 2012

2012 BUDGET: ANNEXURE C

- False job terminations
- Employer-owned insurance intended to cover a contingent liability
- Taxation of payouts from South African or foreign retirement funds
- Taxation of divorce order-related retirement benefits

FALSE JOB TERMINATIONS

- Employees cannot withdraw funds from employer-provided retirement schemes before retirement unless an employee terminates employment with that employer

- In some instances, employees terminate their employment solely to gain access to employer-provided retirement funds

- In the most egregious circumstances, employees quit employment only to be rehired by the same employer shortly thereafter

- Access to withdrawal under these artificial circumstances will no longer be permitted

EMPLOYER-OWNED INSURANCE INTENDED TO COVER A CONTINGENT LIABILITY

- In 2011, the taxation of employer-provided insurance was rationalised; one unresolved issue relates to the purpose for which genuine key person insurance is intended

- Insurance to cover against operating losses due to the loss of an employee clearly should be deductible for an employer if desired

- However, deducting premiums for insurance to purchase ownership interests of an employee-shareholder or to repay the allocation of debt guaranteed by an employee-shareholder is questionable

- The continued allowance of deductible premiums in these latter circumstances will be explored in 2012 or 2013 (depending on the press of other matters)

TAXATION OF PAYOUTS FROM SOUTH AFRICAN OR FOREIGN RETIREMENT FUNDS

- There are currently a number of anomalies in the tax treatment of lump sum & annuity payouts from South African or foreign retirement funds, depending on whether a South African resident or a non-resident receives the payout

- An important factor is whether the services that relate to the payout were rendered in South Africa or elsewhere

- The issue will receive due consideration during the course of 2012 & 2013

TAXATION OF DIVORCE ORDER-RELATED RETIREMENT BENEFITS

- The “clean-break” principle was introduced to private-sector funds in 2007 so that divorcing spouses could fully separate their pension interests without any ongoing connection
- This principle will also form part of the Government Employees Pension Fund (GEPF)
- The National Treasury proposes that the taxation of retirement interests paid out as a result of divorce orders for the GEPF should roughly mirror private-sector funds

TAXATION OF DIVORCE ORDER-RELATED RETIREMENT BENEFITS - CONTINUED

- In the case of retirement fund payouts stemming from divorce orders issued on or after 13 September 2007, each individual spouse will be responsible for the tax on the portion that they receive

- The transitional rules applicable to private-sector funds are extended to GEPF payouts, so that retirement fund payouts stemming from divorce orders issued prior to 13 September 2007 will not lead to any tax consequences for either spouse

- Formula C, which preserves a public-sector fund member's right to a tax-free retirement benefit prior to 1 March 1998, will be extended to the non-member's portion of the pre-1 March 1998 interest

- The proposed date of implementation is 1 March 2012

TAXATION OF DIVORCE ORDER-RELATED RETIREMENT BENEFITS - CONTINUED

- Although the introduction of the "clean-break" principle in private-sector funds has been largely successful, there are still some anomalies that result in continued engagement

- It is proposed that these anomalies be addressed so that the overall tax treatment of all divorce-order retirement benefits paid out as a result of a divorce order will fully apply the clean-break principle from 1 March 2012

TAXATION OF DIVORCE ORDER-RELATED RETIREMENT BENEFITS- CONTINUED

- Current tax regime

SCENARIO	TAX PAYABLE
Clean-break divorce orders issued pre - 13 September 2007 + election on or after 1 March 2009	No tax payable
Clean break divorce order issued 13 September 2007 onwards + election on or after 1 March 2009	Non-member taxpayer
No clean-break or no election pre-fund exit (death, resignation or retirement)	Member taxpayer (member with a right to recover) on the portion of the pension/retirement interest that is paid to the non-member upon death, resignation or retirement.

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TAXATION OF DIVORCE ORDER-RELATED RETIREMENT BENEFITS - CONTINUED

- Proposed tax regime: **Accrual or receipt on or after 1 March 2012**

SCENARIO	CURRENT DISPENSATION		RESULTS OF PROPOSED AMENDMENTS
	Election in time on/after 1 March 2009	**No election on/after 1 March 2009 or no clean break**	**Election or no election; whether the fund has incorporated clean break or not**
Divorce pre-13 September 2007	No tax	Member taxed	No tax
Divorce on/after 13 September 2007	Non-member taxed	Member taxed	Non-member taxed

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LOOKING AHEAD

- In 2012, a series of discussion papers will be released on promoting household savings and reforming the retirement industry.

- Consultation with the industry, employers and trade unions will take place on these reforms.

- Among the issues are improved governance over pension funds, including more effective interventions to eliminate corruption and fraud and ways to improve preservation of retirement fund assets to ensure higher levels of income in retirement.

LOOKING AHEAD- CONTINUED

- To encourage competition in respect of post-retirement income products and providers, Government proposed in the Budget 2011 to broaden the list of service providers that would be able to provide “living annuities”

- Other than retirement funds and long-term insurers, the intention is to also allow Collective Investment Schemes (CIS) to provide “living annuities”, and to create a Government post-retirement income product, which will use the National Treasury’s RSA Retail Savings Bonds as the underlying investment asset

- A separate bill will be issued in due course which should create the framework within which post-retirement income products and service providers must operate

Thank you