



Financial Intermediaries Association  
of Southern Africa

## **Employee Benefits Update**

Herewith the first update on Employee Benefit issues for 2011 for your information. We hope that you will find this informative even if you are not directly involved in this aspect of our business personally.

### **TAX LEGISLATION**

The Taxation Laws Amendment Act, 7 of 2010 was promulgated on 2 November 2010. It introduced a number of significant employee benefit-related changes. The most important changes are outlined below.

#### **Severance payments**

The 2009 amendments to the Income Tax Act changed the taxation of retrenchment benefits payable by a retirement fund by providing that such benefits will be taxed similar to retirement lump sum benefits with effect from 1 March 2009.

Employers often pay a severance award to retrenched employees. Previously, these severance payments qualified for a R30 000 tax exemption. With effect from 1 March 2011, **any** lump sum received by or accrued to an employee upon retrenchment on or after that date, whether it is severance pay received from the employer or a lump sum retirement fund withdrawal accrued from a retirement fund, will be subject to the special tax rates table applicable to lump sum retirement benefits. A retrenched employee will therefore qualify for the R300 000\* exemption applicable to lump sum retirement benefits and the principles of life-time accumulation will apply.

This means that the R30 000 tax exemption previously granted in respect of severance awards paid on retrenchment, are phased out.

\*But see the increase as described later on

#### **Taking a portion of retrenchment benefits in cash and transferring the balance to another approved fund**

When a retrenched member elects to receive part of his/her retirement fund retrenchment benefit in cash and to transfer the remainder of the benefit to a retirement annuity fund or to his or her new employer's fund, the transfer to such other approved fund will be tax-free with effect from 1 March 2009.

A distinct tax disadvantage arises when such a member exits the retirement annuity fund or his or her new employer's fund, as the exit benefit is not taxed using the retirement lump sum benefits tax table but at the rate of the more penal withdrawal benefit tax table.

### **Commutation of annuities into lump sums**

All lump sums resulting from the commutation of annuities payable by a retirement fund on or after 1 March 2011, whether it occurred during the member's life or afterwards, will be subject to the special tax rates table applicable to lump sum retirement withdrawals. This amendment serves to clarify any uncertainty that existed, especially with regard to living annuity commutations by the successors of a retired member.

If the commutation occurs during the member's life or on the member's death, the lifetime accumulation will apply in respect of the member. If the commutation occurs during a successor's life or on the successor's death, the lifetime accumulation will apply in respect of the successor.

### **Transfers to preservation funds on the partial winding up of funds**

The previous definitions of pension and provident preservation fund were interpreted to mean that only transfers into such funds resulting from the *full* winding up of a pension or provident fund (and thus not also the partial winding up of a pension or provident fund) are allowed. The definitions have now been clarified to also provide that, with effect from 1 March 2008, pension preservation funds and provident preservation funds are allowed to receive benefit transfers if a fund is partially wound up.

Transfers of money from umbrella funds to preservation funds on the termination of a participating employer's participation in the fund is thus now allowed.

### **Divorce order deductions**

The pension interest allocations made to non-member spouses in terms of divorce orders granted before 13 September 2007 and deducted from members' pension interests in retirement funds on or after 1 March 2009, are now tax-free.

### **Accrual of Section 37D deductions**

In terms of Section 37D of the Pension Funds Act, a fund may make deductions from a member's withdrawal benefit in respect of *inter alia* housing loans and guarantees, as well as for compensation in respect of damage caused to the employer as a result of the dishonesty, fraud, theft or misconduct of the member. As part of the 2009-amendments to the Income Tax Act, the taxation of withdrawal benefits are deferred until the member elects to receive a cash payment or the benefit is transferred to another fund. This amendment resulted in a timing mismatch between the payment of section 37D-deductions and the payment of tax thereon.

Section 37D deductions made by a fund on or after 1 March 2011 will now trigger a tax accrual event at the moment of payment to the relevant third party. The timing and issuing of tax directives will therefore coincide with such payments to third parties.

## **CONSUMER PROTECTION ACT**

The Consumer Protection Act 68 of 2008 became fully operational on 31 March 2011. The main purpose of this Act is to promote and advance the social and economic welfare of consumers by reducing any disadvantages experienced in accessing the supply of goods and services by consumers.

Retirement funds fall under the definition of “supplier” in terms of this Act and are required to ensure that all communication to members are in plain and simple language, taking into account that not all of the members may be literate.

## **NEW REGULATION 28**

The new regulation 28 will be effective from 1 July 2011. Regulation 28 provides prudential investment guidelines for retirement funds but it has become increasingly outdated and somewhat restrictive in managing retirement fund assets as the investment industry became more sophisticated due to asset classes evolving.

The key changes in the new regulation evolve around changes in asset class limits and groupings, of which the inclusion of hedge funds and private equity are probably the most significant, as well as a requirement of compliance at individual member level. The new regulation further introduces the look-through principle in terms of which retirement funds will have to account for the underlying asset exposure and will not be able to use an investment vehicle to “package” certain investments in order to circumvent the regulation.

With regards to the changes in asset class limits and groupings, the focus remains on limiting exposure to asset classes and single assets. The current limit of 75% in respect of equities remains. An investment in unlisted shares in companies (excluding property companies) is increased to 10% while the limit for immovable property is 25%. In terms of the new regulation, retirement funds are now allowed to invest up to 10% in commodities listed on an exchange, as opposed to the current regulation that only allowed for Krugerrands. The big change on asset class allocation in the new regulation is, however, that retirement funds will be allowed to invest up to 15% in hedge funds, private equity funds and other assets not listed in the schedule to the regulation.

Another important development with regards to the allowed asset allocation of retirement funds, although not directly related to the new regulation 28, is the relaxation of foreign exchange requirements, which was announced in December 2010. Retirement funds can now invest up to 25% internationally as well as an additional 5% in Africa which means a fund can have up to 30% invested outside of South Africa.

A key issue for many retirement funds is the requirement to be compliant with the new regulation on a member level. Retirement annuity funds and, to some extent, umbrellas funds might be the most affected by this new requirement. It is, however, important to note that while the new regulation 28 will become effective on 1 July 2011, the portion of assets of a fund held in respect of a member before 1 April 2011 need not comply with the limits on a member level until the contractual terms relating to the amount or frequency of premiums or contributions are amended, or any change is made to the categories of assets held in respect of the member.

The regulation further provides that transitional arrangements may be prescribed to enable a retirement fund to make its investments regulation 28 compliant. Exemption in respect of some of the provisions of the regulation may also be granted to a retirement fund.

## **ANTICIPATED IMPACT OF THE 2011/2012 BUDGET ON RETIREMENT BENEFITS**

### **Retirement fund contributions**

Contributions made by an employer to a retirement fund in respect of an employee will be treated as a taxable fringe benefit in the hands of the employee with effect from 1 March 2012.

Employees will however be allowed to deduct up to 22,5% of their taxable income in respect of contributions to pension, provident and retirement annuity funds. Legislation has not yet been published, but it seems that this 22,5% limit will only be applicable to retirement savings and will not include the costs of risk benefits and the administration of the fund.

In addition, two tax deductible contribution thresholds will be established – a minimum annual deduction of R12 000 and a maximum annual deduction of R200 000.

Therefore, with effect from 1 March 2012, all contributions made towards retirement funding, whether it is to an employer sponsored pension or provident fund, or to a retirement annuity fund, will be treated the same way for tax deductibility purposes.

Currently, the tax deductibility of employer contributions to a pension fund is limited to a maximum of 20% of the employee's pensionable remuneration and the tax deductibility of member contributions is limited to 7,5%. A member of a pension or retirement annuity fund is also in terms of current tax legislation allowed to deduct up to R1 800 per year in respect of any additional contributions made. With effect from 1 March 2012, all of these different tax concessions will be contained in the one 22,5% allowable tax deduction.

### ***Example 1: An employee is a member of a provident fund***

- (i) Currently, contributions made by an employee to a provident fund are not tax deductible, whilst the tax deductibility of contributions made by an employer to a provident fund are limited to a maximum of 20% of the employee's pensionable remuneration.

- (ii) With effect from 1 March 2012, the contributions made by an employer to a non-contributory provident fund will be included in the employee's taxable income as a taxable fringe benefit and will be taxed in full in the hands of the employee but the employee will be able to deduct up to 22,5% of their taxable income.

**Example 2: An employee's annual taxable income is R53 000 and he is a member of a pension fund-**

- (i) Currently, an employer is allowed to make tax deductions of amounts up to 20% of an employee's pensionable remuneration to a pension fund. These contributions are not taxed as income in the hands of the employee. The employee is then allowed to contribute a further 7,5% of his pensionable remuneration or an amount of R1 750 (whichever is the greater) tax-free to the pension fund.
- (ii) With effect from 1 March 2012, the employee can contribute more than 22,5% of his taxable income of R4 416 per month to the pension fund, as he will be able to deduct R12 000 and not only 22,5% of his remuneration (that is, R11 925 which is 22,5% of R53 000) per year.

**Example 3: An employee's annual taxable income is R1 200 000 with a pensionable income of R1 000 000 and he is a member of a pension fund and a retirement annuity fund-**

- (i) Currently, an employer is allowed to make tax deductions of amounts up to 20% of an employee's pensionable income to a pension fund. These contributions are not taxed as income in the hands of the employee. The employee is then allowed to contribute a further 7,5% of his pensionable remuneration or an amount of R1 750 (whichever is the greater) tax-free to the pension fund, as well as R1 800 for arrear contributions AND a further 15% of his non-retirement funding taxable income, or R3 500 less deductible allowable pension fund contributions, or R1 750 (whichever is the greater) to the retirement annuity fund.
- *Tax deductible contributions to the pension fund:* The employer can deduct R200 000 (20% of R1 000 000) and the employee can deduct R76 800 (7,5% of R1000 000 plus R1 800).
  - *Tax deductible contributions to the retirement annuity fund:* The person can deduct R30 000 (15% of R200 000).
  - *Total tax deductible contributions:* An amount equal to R306 800.
- (ii) With effect from 1 March 2012, such employee's tax deductible contributions will be restricted to 22,5% of his taxable income limited to a maximum annual amount of R200 000. The employee will only be able to deduct R200 000 and not the previously allowable R306 800. Such an employee will thus **not** benefit from the revised taxation of contributions.

**Provident fund lump sums**

Government proposes to subject lump sum retirement benefits from provident funds to the maximum one-third cash limit applicable to pension funds and retirement annuity funds.

This means that provident fund members will no longer be allowed to take their full fund credit at retirement as a lump sum but will have to use at least two-thirds of their retirement benefit to purchase a pension.

This proposal will require some rethinking on the part of those members of provident funds whose savings plans are based on the full lump sum being available as a cash payment when they retire.

When this proposal is implemented, there will no longer be any advantage in participating in provident funds and provident funds will effectively be phased out. Government provided the assurance that the implementation date of this proposal will be subject to full consultation with trade unions and other interested parties and that the vested rights of members will be protected.

### **Taxation of lump sum benefits on retirement, death and retrenchment**

As from 1 March 2011, the tax-free lump sum benefit upon retirement, death and retrenchment was increased from R300 000 to R315 000. The revised rates for the taxation of these lump sums are set out below.

<b>Lump sum amount</b>	<b>Taxation</b>
0 - R315 000	0 per cent of amount
R315 001 - R630 000	R0 plus 18 per cent of amount exceeding R315 000
R630 001 - R945 000	R56 700 plus 27 per cent of amount exceeding R630 000
R945 001 and above	R141 750 plus 36 per cent of amount exceeding R945 000

### **Competition for the provision of living annuities**

Living annuities can currently only be provided by long-term insurers and retirement funds. To encourage competition, it is proposed that the range of service providers allowed to provide living annuities be extended to include collective investment schemes and the National Treasury's retail savings bond scheme.

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