



**NATIONAL
TREASURY**

DRAFT EXPLANATORY MEMORANDUM

ON THE

REVENUE LAWS AMENDMENT BILL, 2023

9 JUNE 2023

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1. INCOME TAX: INDIVIDUALS, SAVINGS AND EMPLOYMENT

1.1 TWO-POTS RETIREMENT SYSTEM

[Applicable provisions: Definitions of “gross income”, “pension fund”, “pension preservation fund”, “provident fund”, “provident preservation fund” and “retirement annuity fund” in section 1(1) of the Income Tax Act, No. 58 of 1962 (“the Act”); New definitions for “legacy retirement annuity fund” “member’s interest in the retirement component”, “member’s interest in the savings component”, “member’s interest in the vested component”, “savings component”, “savings withdrawal benefit” “retirement component”, “retirement interest” “total retirement contribution” “vested component”, in section 1(1) of the Act; section 10C of the Act , new paragraph 6B in the Second Schedule to the Act and paragraphs 1 & 9 of the Fourth Schedule to the Act]

I. Background

South Africa has different retirement fund vehicles available to individuals who wish to save for retirement, namely, pension funds, pension preservation funds, provident funds, provident preservation funds and retirement annuity funds. Historically, these funds had differing tax treatments for contributions to the funds, as well as differing rules as relates to withdrawals from these funds. In an attempt to promote retirement savings, the retirement savings regime has, since 2012, undergone some significant reforms. These reforms include, *inter alia*, harmonising the tax treatment of contributions to the different types of funds (which came into effect from 1 March 2016) and increasing preservation at retirement by harmonising the requirement for annuitisation upon retirement across all retirement funds (which came into effect from 1 March 2021).

Government now wishes to focus on pre-retirement preservation. In accordance with the current retirement regime individuals are able to make full withdrawals from their pension or provident fund when they cease employment. Further to the above, individuals are also able to make once-off withdrawals from their pension preservation or provident preservation fund(s). What is of concern for Government is the fact that many of the above-mentioned withdrawals are taking place irrespective of the tax rates applied upon withdrawal.

II. Reasons for change

Government has two primary concerns with the design of the current retirement regime. The first is the lack of preservation pre-retirement, which Government has highlighted in previous discussion papers. The ability for pension and provident fund members to access their retirement interest when terminating employment can create the incentive for fund members to terminate employment as a means of gaining access to those funds, thus prematurely terminating the ability to preserve these funds until normal retirement age is, per the fund rules, attained.

The second concern is that some households in financial distress have assets within their retirement fund(s) that are not accessible in case of emergencies or financial hardship. This has become more prominent since the onset of the COVID-19 pandemic, with numerous calls for financially distressed individuals to be given access to their retirement funds to alleviate their financial hardship.

III. Proposal

In an attempt to address the above-mentioned concerns, Government therefore proposes a further reform to the retirement saving regime. This reform will see the introduction of the so called “two-pots” retirement system. The “two-pots” regime seeks to retain the current principle of exempting contributions and growth thereon while taxing withdrawals of benefits (i.e. the current EET system applicable to the current retirement regime will be retained). The tax treatment of the newly introduced pots will however be different (further details provided below). The EET system is retained as a means of, *inter alia*, ensuring that income is only taxed once, retaining the logic applied in the 2016 retirement reform which served to harmonise the tax treatment across various retirement funds, and minimising the complexity that comes with valuing growth on contributions.

Members of retirement funds will be allowed a deduction for amounts contributed (be it by themselves or their employer on their behalf) to retirement funds. The deduction

applicable under the current retirement regime will apply under the “two-pots” regime (i.e. a deduction on contributions, limited to the lesser of R350 000 or 27,5% of the higher of taxable income or remuneration).

Employer contributions made on behalf of employees will be treated as a taxable fringe benefit in the employee’s hands.

Arrear contributions that relate to a pre-implementation period will be allocated to the respective pre-implementation period and will be subject to the rules applicable under the current retirement regime. Arrear contributions that relate to a post-implementation period will be allocated to the respective “savings component” and “retirement component”.

A. This new regime proposes the creation of the following three components within the retirement funds, as well as the introduction of the definitions of “savings component”, “retirement component” and “vested component” in section 1 of the Act

Savings Component

In accordance with this new regime, retirement funds will on or after 1 March 2024, be required to create a component known as the “savings component, which will be housed within the currently available retirement fund. Individuals will be required to contribute an amount of one-third of the total individual retirement fund contributions to the “savings component”. This one-third of the individual’s retirement assets in the “savings component” will be available for withdrawal before retirement. The ability to access the “savings component” will be provided without the member having to cease employment.

Amounts contributed to the “savings component” are accessible without the member having to resign or retire from their respective fund. A member will be allowed to make a single withdrawal within a year of assessment. The minimum withdrawal amount is R2 000 (there is however no limit on the maximum amount a

member can withdraw). In the event that a member resigns from employment and such member has already made use of their single withdrawal, an additional withdrawal will be allowed provided the member's gross interest in their "savings component" is less than R2 000. The ability to withdraw from the "savings component" will be applicable on a per fund or per contract basis. Withdrawals from the "savings component" will be added to the individual's taxable income and will be taxed at their marginal rate. In the event that a member dies, their beneficiary can opt to receive the benefit in the "savings component" as either a lumpsum, or they can transfer it to their "retirement component" and receive an annuity.

Retirement Component

Retirement funds will on or after 1 March 2024, be required to create another component known as the "retirement component, which will be housed within the currently available retirement fund. Individuals will be required to contribute an amount of two-thirds of the total individual retirement fund contributions to the "retirement component". This two-thirds of individual's retirement assets in the "retirement component" will be required to be preserved until retirement (i.e. withdrawals from this component will be triggered by the member reaching normal retirement age per the fund rules).

Amounts contributed to the "retirement component" are only accessible upon retirement. Once a member has reached retirement age, the "retirement component" is to be paid in the form of an annuity (including living annuities). The current de-minimis as relates to the commutation of annuities (currently R165 000) will apply to annuities from this component. The ability to commute an annuity will be determined with reference to the member's interests in their "vested component" and "retirement component" and will be determined on a per fund basis. The current provisions as relates to the payments of benefits to beneficiaries of deceased members will apply to payments from the "retirement component" (i.e. the beneficiary will continue to receive an annuity).

Withdrawals from the “retirement component” are accessible as a lump sum when an individual emigrates from South Africa and ceases to be a tax resident. The payment of the said lump sums is however subject to the 3-year rule that under the current regime applies to members of a retirement annuity fund, pension preservation fund or provident preservation fund.

Vested Component

Retirement funds will on or after 1 March 2024, be required to create another component known as the “vested component”. Retirement funds will be required to value a member’s retirement interest on the date immediately prior to implementation date, which is 1 March 2024, as these amounts will be subject to the current retirement regime (i.e. vested and non-vested rights arising as a result of the annuitisation reform which came into effect from 1 March 2021 will be retained). Vested rights as relates to the “vested component” and the rules that apply thereto under the current regime will continue to apply after the implementation of the “two-pots” regime.

Once the regime comes into effect, members will no longer be able to make contributions to their “vested component”. This will however not apply to members of a provident fund who were 55 years or older on 1 March 2021. These members have the ability to continue making contributions into their “vested component” will apply until they either retire from or leave the fund they were a member of on 1 March 2021. Should they choose to keep contributing to their “vested component” their full contribution will be allocated to the “vested component”. Continued contribution to their “vested component” means they will not be able to contribute to the “savings component” and “retirement component”. Provident fund members who were 55 years and older on 1 March 2021 are however not precluded from participation in the “two-pots” regime, should they wish to participate in the new regime they will no longer be able to continue contributing to their “vested component” (i.e. their contributions will be split between the “savings component” and “retirement component” as is applicable to other retirement fund members).

Amounts contained in the “vested component” will be subject to the current retirement regime. This includes, *inter alia*, the ability to make once-off withdrawals from preservation funds, the ability to access pension and provident funds upon resignation, the continued protection of vested rights arising as a result of the annuitisation reform, and the mandatory annuitisation of two-thirds of a members retirement interest with effect from 1 March 2021.

Withdrawals from the “vested component” are accessible as a lump sum when an individual emigrates from South Africa and ceases to be a tax resident. The payment of the said lump sums is however subject to the 3-year rule that under the current regime applies to members of a retirement annuity fund, pension preservation fund or provident preservation fund.

B. This new regime proposes the creation of “Seed capital”

It is proposed that the regime makes provision for the creation of seed capital. This will make provision for immediate access to the available balance in the retirement fund on implementation date of the “two-pots” retirement system. Seed capital refers to the starting balance in the “savings component” on 1 March 2024, which should be available to the member of the retirement fund for withdrawal on implementation date of the “two-pots” retirement system. This starting balance is to be provided in the “savings component” from the “vested component”. In order to limit the adverse implication on liquidity, it is proposed that seed capital should be calculated as ten percent of the “vested component”, limited to R25 000 (whichever is the lesser). This is meant so as not to erode the retirement benefit but at the same time enable pre-retirement access to the benefits. The provision for seed capital is included in paragraph (a) of the definition of “savings component” in section 1 of the Act.

C Inclusion of defined benefit funds in the new regime

In view of the fact that contributions by a member to the defined benefit fund is based on a defined formula, without reference to contributions and investment performance, it is proposed that provision should be made for the inclusion of defined benefit funds in the “two-pots” retirement regime. As such, defined benefit funds will be required to calculate the one-third contributions to the “savings component” with reference to one-third of the member’s pensionable service and the two-thirds contributions to the “retirement component” with reference to two-thirds of the member’s pensionable service with effect from 1 March 2024. Also, with regard to defined benefits, seed capital is to be calculated as stated above and can be accommodated with a past service adjustment. The provision for defined benefit funds is included in the further proviso of paragraph (b) of the definition of “savings component” as well as the further proviso of paragraph (a) of the definition of “retirement component”.

D. This new regime proposes the introduction of the “savings withdrawal benefit” as well as the inclusion of such definition in section 1 of the Act

Savings Withdrawal Benefit

Retirement funds will on or after 1 March 2024 be required to allocate a portion of the member’s interest known as “savings withdrawal benefit” to the savings component”, which will be available to the individual for withdrawal before retirement, but without termination of the membership of the fund, subject to the following limitations:

- The member’s right is limited to one withdrawal during a year of assessment;

- Where a member has multiple contracts in the same fund, the member may be allowed one withdrawal during a year of assessment from each of the contracts;
- The value of each withdrawal before taking into account any charges or transaction costs may not be less than R2 000.
- If a member resigns from employment within any year of assessment and such member has already made a withdrawal and the value of the members interest in the savings component is less than R2 000, such member may be allowed a second withdrawal of his or her total balance in the savings component.

E. This new regime proposes the introduction of the following definitions “members interest in the retirement component”, “members interest in the savings component” and “members interest in the vested component” in section 1 of the Act

The main aim of the introduction of the definitions dealing with a member’s interest in the above-mentioned components is to cater for the ability for pension, provident and retirement annuity funds to receive contributions or for pension preservation or provident preservation funds to receive payments into the two new components.

F. This new regime proposes the exclusion of the “legacy retirement annuity funds” from the regime as well as the introduction of the definition of “legacy retirement annuity fund” in section 1 of the Act

It is proposed that legacy retirement annuity fund be excluded from the provisions of the “two-pot” retirement system, as the inclusion of the legacy retirement annuity fund policies in the “two-pot” retirement system would require a re-design of these historically acquired legacy retirement annuity fund policies. It is however important to note that this exemption is not a blanket exemption, and will be applicable to legacy funds with the following features:

- Pre-universal life policies and/or conventional policy with or without profits;
- Universal life policies with life and/or lumpsum disability cover; and
- Reversionary bonus or universal life policies as defined or referenced in the insurance legislation.

To ensure that the exemption as relates to legacy polices applies only to legacy policies entered into before the formulation of the “two-pots” regime, it is proposed that the exemption applies to legacy policies entered into before the publication of the December 2021 Discussion Paper published on the “two-pots” regime. As such, the exemption shall apply to legacy policies entered into before 1 January 2022. The legacy fund must have submitted a signed declaration to the Financial Sector Conduct Authority (FSCA) stating that they meet the above criteria. The FSCA may conduct verification that funds meet the exemption criteria.

G. This new regime proposes the introduction of tax-free transfers between funds as well as the introduction of paragraph 6B of the Second Schedule to the Act, dealing with these transfers

Members will be allowed to make the following intra-fund transfers at any time they wish, these transfers will be treated as tax free transfers:

- From their “savings component” to their “retirement component”; and
- From their “vested component” to their “retirement component”.

Inter-fund transfers are only permissible when a member resigns or retires from their respective fund. Should a member choose to make an inter-fund transfer all components will need to be transferred to the transferee fund (i.e. the member is not able to transfer only one component while leaving the other components behind). The below inter-fund transfers will be permissible as tax-free transfers (provided that the transfer is a transfer of all relevant components):

- From the transferor fund's "saving component" to the transferee fund's "saving component";
- From the transferor fund's "saving component" to the transferee fund's "retirement component";
- From the transferor fund's "vested component" to the transferee fund's "vested component";
- From the transferor fund's "vested component" to the transferee fund's "retirement component";
- From the transferor fund's "retirement component" to the transferee fund's "retirement component";

The ability to effect both inter and intra fund transfers will be subject to the fund obtaining a tax directive.

H. Inclusion of amounts in terms of section 37D of the Pension Funds Act, 1956 in the new regime

Section 37D deductions as contained in the Pension Funds Act, 1956 will be permissible against the "vested component" and "retirement component".

- **Example: Application of the new regime**

Person A is employed and has R200 000 in a provident fund at the time of implementation of the "two-pots" regime. From implementation date onwards, one-third of their contributions are deposited into a "savings component" and two-thirds of their contributions are deposited into the "retirement component".

After two years, there is R20 000 in the "savings component", R40 000 in the "retirement component" and R220 000 in the "vested component". Person A faces some financial difficulties and can withdraw the R20 000 from their "savings component" without resigning to gain access to their retirement funds. Any amounts withdrawn from the savings pot will be included in Person A's taxable income. Seeing as Person A has not

resigned from employment, no further withdrawals can be made from the “savings component” until the next year of assessment.

After another two years, Person A has R25 000 in the “savings component”, R100 000 in the “retirement component” and R250 000 in the “vested component”. Person A resigns to join another company. On resignation, the “savings component” and the “retirement component” can either stay in the current fund or be transferred to another fund which has a “savings component” and a “retirement component”, potentially at their new employer. The “savings component” would still be accessible at any time. For the “vested component”, Person A would have the following options:

- Withdraw the R250 000 “vested component”, the amount would be subject to tax according to the withdrawal tax table.
- Transfer the R250 000 to the “vested component” of a provident preservation fund. The amount would remain eligible for a once-off withdrawal up to the full value at any point before retirement. The transfer will be tax-free, but any future withdrawal would be treated as indicated directly above.
- Transfer the R250 000 to the “retirement component” to consolidate retirement funds, by which he or she would forfeit the once-off withdrawal. The transfer will be tax-free.

After another 10 years, Person A has reached retirement age. There is R75 000 in the “savings component” and R600 000 in the “retirement component”. Person A retires and can either withdraw the R75 000 from the “savings component” as cash (taxed as normal income) or transfer any remainder to the “retirement component”. Upon retirement Person A is required to purchase an annuity with the balance in the “retirement component”, which would amount to R600 000 in the absence of any transfers from the “savings component” upon retirement.

IV. Effective date

The proposed amendments will come into effect on 1 March 2024 and will apply in respect of amounts contributed to retirement funds on or after that date.