[W.P. – '22]

NATIONAL TREASURY

DRAFT EXPLANATORY MEMORANDUM

ON THE

REVENUE LAWS AMENDMENT BILL, 2022

29 July 2022

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EXPLANATION OF MAIN AMENDMENTS

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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 “savings pot”, retirement pot”, “vested pot”, “total retirement contribution”, “savings withdrawal benefit” and “retirement withdrawal benefit” in section 1(1) of the Act; section 10C of the Act and new paragraph 6B in the Second Schedule to the Act]

I. Background

South Africa has different retirement fund vehicles available to individuals, including pension funds, provident funds, retirement annuity funds, pension preservation funds and provident preservation funds. Historically, each of these funds had a different tax treatment for contributions, alongside different rules for withdrawals.

Since 2012, the South African retirement fund regime has been undergoing fundamental reforms, after a series of technical papers were published on options to promote retirement savings. The papers included wide-ranging tax amendments to harmonise the tax treatment of contributions to the different types of funds, measures to increase preservation, both before retirement and at retirement, and reforms to lower charges and improve defaults, governance and market conduct. Many of these reforms have been implemented, such as the harmonisation of the tax treatment of contributions to funds, which was implemented with effect from 1 March 2016, and the preservation of retirement funds at retirement through annuitisation, effective from 1 March 2021.

One of the proposals that has not yet been implemented is pre-retirement preservation. Individuals can access their pension or provident funds in full when they cease employment. Similarly, individuals have a once-off option to take any amount out of their pension preservation funds or provident preservation funds. Data from retirement fund administrators and SARS suggests that many of these withdrawals are taking place, notwithstanding the potentially high tax rates that are applied. The discussion paper entitled *Preservation, portability and governance for retirement funds* which was published on 21 September 2012, and the paper entitled *2013 Retirement reform proposals for further consultation* which was published on 27 February 2013, both included options to increase the level of pre-retirement preservation.

II. Reasons for change

There are two primary concerns with the current design of the retirement system. The first is the lack of preservation before retirement, which has been highlighted in previous discussion papers. For pension funds and provident funds, this access is dependent on an employee terminating employment. Individuals can then access their funds, in full, when changing or leaving a job, and in some cases, it can create an incentive to leave their employment to gain access to those funds in the short-term, ceasing prematurely the prospects of maintaining preservation for a longer period (at least until such time normal retirement age is attained per fund rules). The second issue is that some households in financial distress have assets within their retirement fund(s) that are not accessible, even in case of emergencies. This issue has become more prominent since the COVID-19 pandemic, with numerous calls for financially distressed individuals to be given immediate access to their retirement funds to alleviate financial hardship.

On 15 December 2021, Government published a discussion document entitled *Encouraging South Africans to save more for retirement*, which proposed a new retirement fund regime that aims to address both concerns – this in the form of a “two-pot” system for retirement savings. Individuals can contribute to a “savings pot” which is accessible (without any links to changing their employment status), and a “retirement pot” which must be preserved until retirement. The aim is to have a system that will allow resources to be available when needed, but that will also increase the overall level of savings that are dedicated to retirement.

III. Proposal

Tax treatment

The new two-pot system seeks to retain the principle of exempting contributions and growth, while taxing withdrawals and benefits (EET). The tax treatment for withdrawals will be amended, as the value of any withdrawals from the “savings pot” and annuity income from the “retirement pot” will be included in that year’s taxable income. This will therefore require changes to the “gross income” definition contained in section 1(1) of the Act.

The EET principle is retained as the main design to ensure that the income is taxed only once.

- From an economic perspective, this is best achieved if the tax is levied when the funds are disposed for consumption.

- From a behavioural perspective, this principle supports prudent savings decisions by providing the deduction when savings decisions are taken.

- From a policy consistency perspective, retaining the EET-basis underscores the logic of the 2016 reforms, as it puts all retirement fund types on the same footing. This offers flexibility to fund members, with simplified options for transfers of funds based on fundamentals.

- From an administrative perspective, the complexity of valuing the growth of the interest is kept to a minimum, as the final combined value is included in taxable income.

The public comments that were submitted on the tax design also indicated that this principle garnered strong public support: of the 15 comments that indicated a preference among the options, only one preferred an alternative design.

The decision to include non-annuitised withdrawals (i.e. withdrawals from the “savings pot”) in taxable income, rather than taxation through the respective lump-sum tables is based on the following reasons:

- It restores the progressivity of the Personal Income Tax (PIT) system by levying the rates applicable to other incomes

- It restores equity within the withdrawal system by taking other income sources into account when levying tax. This means that taxpayers with other sources of income do not face an artificially low tax rate for withdrawals, but also ensures that taxpayers with low incomes do not face an artificially high tax rate due to a withdrawal from the “savings pot”.

- It ensures that a taxpayer in income distress who makes an emergency withdrawal is charged at a rate that may well be lower than their previous tax rate, rather than an artificially high rate.

- It is simple, certain and transparent.

- From a behavioural perspective the intent is to ensure that fair application of the tax system discourages unnecessary early withdrawals, to the extent possible

From the public consultation process, there was an even support for retaining the status quo (i.e. retaining the lump-sum tables) and taxing withdrawals at normal rates. The latter is an effective increase in tax rates for these withdrawals, premised on the reasons outlined above. Commentators in support of this outcome indicated that this was a fair outcome.

<u>Amendments to support broader reform</u>

In line with the details included in the discussion document, government proposes the following to enable the new two pot system:

A. Funds

The creation of a new “retirement pot” and a “savings pot” that can each receive retirement contributions is therefore necessary. Practically, these pots can be housed within the current types of available funds, be it a pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund. All prior contributions and growth (i.e. retirement interest) will have to be valued at the date immediately prior to implementation, to enable vesting of rights. Legislatively this will have to be enabled by retaining the definitions of the existing retirement fund types for contributions up to 28 February 2023, referred to colloquially in this note as the “vested pot”. The “retirement pot” and “savings pot” will then be accumulated from 1 March 2023, which means that there is no seeding finance into either pots. To effect these changes, section 1(1) of the Act will include the following new definitions: “savings pot”, retirement pot” and “vested pot”.

B. Withdrawals

Amounts contributed to the “retirement pot” cannot be accessed before retirement. At retirement date, the total value must be paid in the form of an annuity (including a living annuity). The current minimum amount for purchasing an annuity (*de minimus* of R165 000) will apply to the retirement pot’. This will therefore require that a “retirement withdrawal benefit” be defined in section 1(1) of the Act.

Amounts contributed to the “savings pot” can be accessed without any conditions, but only one withdrawal can be made during any twelve-month period. For example, if Person A makes a withdrawal on 21 March 2025, the next withdrawal can only be made on or after 22 March 2026. The minimum withdrawal amount is proposed to be R2 000. These withdrawals will be subject to the fund rules allowing them. Withdrawals from the “savings pot” will be added to taxable income in the year of withdrawal. This will therefore require that a “savings withdrawal benefit” be defined in section 1(1) of the Act. Should an individual opt not to make a withdrawal within a specific twelve-month period, the funds available in the “savings pot” come the subsequent twelve-month period will be available for withdrawal.

Permissible withdrawals from the “vested pot” will be taxed according to the respective withdrawal tables.

In the case of divorce orders, the division stipulated in the order applies to each pot (vested, savings and retirement).

However, full withdrawals from the retirement, savings and vested pots can take place if an individual ceases to be tax resident for a period of at least 3 years, with the appropriate tax treatment based on the facts and circumstances of the case. In these instances, the “vested pot” will be taxed in accordance with the pre-1 March 2023 tax provisions, the “savings pot” will be included in gross income and the “retirement pot” will be taxed in accordance with the lumpsum withdrawal tables.

Any funds available in the “savings pot” at retirement or death can either be withdrawn in full or transferred to the “retirement pot”. Where the member opts to withdraw funds from the “savings pot” as a lumpsum on retirement, the available balance will be taxable as a retirement lumpsum benefit subject to the retirement lumpsum table. This could result in a tax-free withdrawal of up to R500 000 upon retirement.

C. Contributions

Members of retirement funds can receive a deduction on contributions up to the higher of 27.5% of gross remuneration or R350,000 per tax year. A maximum of one-third of the total contribution can go to the “savings pot”, with the remaining amount going to the “retirement pot”. Given that the ratios contributed into the respective pots can vary per individual (subject to meeting the one-third and two-thirds contribution maximums and minimums), contributions not allocated to the “savings pot” should be allocated to the “retirement pot”. Any contributions above the deductible amount will only flow to the “retirement pot” for any offsets against section 11F. As a result, contributions in excess of the allowable deduction will not be permitted into the “savings pot”. Section 10C will therefore need to be amended to cater for annuities received from the “retirement pot”. Investment growth within the “retirement pot” and the “savings pot” will follow the same treatment as other retirement funds (i.e. tax is deferred until it is withdrawn or paid out as annuity benefits).

No further contributions can be made to the “vested pot” from pension funds, provident funds or retirement annuity funds, except for members of provident funds who were 55 years or older on 1 March 2021, as they are able to contribute to those funds until they either leave the fund or retire.

D. Vested rights

The current provisions for contributions to pension funds, provident funds, pension preservation funds, provident preservation funds and retirement annuity funds will continue to apply for contributions and accumulated interest before the implementation date, together with the associated growth of that total, for each existing member until their retirement. As such, individuals who resign from their employment will be able to access the value of their pension fund or provident fund as at 1 March 2023, plus any growth on that amount. Members of preservation funds will still be able to utilise their once-off withdrawal on amounts (and growth) within those funds.

E. Transfers

Individuals cannot transfer amounts out of the “retirement pot”, but can only transfer to another “retirement pot” tax free. Transfers can be made into the “retirement pot” tax free from any other pot. No transfers can be made into the “savings pot”, unless they are from another “savings pot” and subject to fund rules.

It is proposed that “retirement pots” and “savings pots” cannot be split between funds (i.e. you cannot transfer a “savings pot” to another provider without also transferring the relevant “retirement pot” to that same provider). Given that a member could opt that 0% of the contribution flows to the “savings pot”, the practical result is that a member may well only have a positive balance in the “retirement pot”. Therefore, a “retirement pot” could conceivably be a stand-alone pot, but an “savings pot” cannot stand alone from a “retirement pot”, or be located at a different provider. Amendments detailing with the permissible and non-permissible transfers will be outlined in the new paragraph 6B of the Second Schedule to the Act.

<u>Examples:</u>

Person A is employed and has R200 000 in a provident fund at the time of implementation of these amendments on 1 March 2023. From 1 March 2023 onwards, one-third of their contributions are deposited into an “savings pot” and two-thirds of their contributions are deposited into the “retirement pot”.

- After two years, there is R20 000 in the “savings pot”, R40 000 in the “retirement pot’ and R220 000 in the “vested pot”. Person A faces some financial difficulties and can withdraw the R20 000 from their “savings pot” without resigning to gain access to their retirement funds. Any amounts withdrawn from the “savings pot” would be included in Person A’s taxable income. No further withdrawals from the “savings pot” can be made for another year.

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

    - Withdraw the R250 000 vested right, although the amount would be subject to tax according to the withdrawal tax table

    - Transfer the R250 000 to another “vested pot” within a provident preservation fund. The amount would remain eligible for a once-off withdrawal of up to the full value at any point before retirement. The transfer would not have any tax consequences, but any future withdrawal(s) would be treated as indicated directly above.

    - Transfer the R250 000 to the “retirement pot” to consolidate retirement interest, which would forfeit the once-off withdrawal. The transfer will not have any tax consequences.

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

IV. Effective date

The proposed amendments will come into effect on 1 March 2023 and will apply in respect of amounts contributed to retirement funds on or after that date.