ENCOURAGING INDIVIDUAL RETIREMENT SAVINGS IN SOUTH AFRICA

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by

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DECLARATION

I hereby declare that this dissertation is entirely my own work.

Signed: ………………………………………….

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My husband, Robert Mc Intyre, who has been an anchor of support for most of my adult life.

ABSTRACT

Many South Africans may not have adequate retirement savings when they retire and this has the effect of a low income replacement ratio on retirement that may lead to a decrease in the standard of living of the retiree and in extreme cases the retiree becoming dependent on their family and the government. Owing to this trend of no or inadequate retirement savings, South Africa embarked on a retirement reform journey in 2004.

The goal of this research is to determine whether the retirement reform mechanisms outlined by National Treasury would encourage individual retirement savings that should assist South Africans to achieve stability of income in their retirement. This research analysed the current retirement savings options and vehicles available for South Africans, the current tax incentives and disincentives and reviewed the proposed changes to tax incentives and disincentives during the accumulation phase of retirement savings and explained how these proposed tax incentives are harmonised for the accumulation phase of retirement. The research explained how National Treasury aims to limit pre-retirement withdrawals and how it intends to encourage the annuitisation of post-retirement benefits. The penultimate chapter of this research measured the effect (by making certain assumptions) of the changes proposed by National Treasury on the income replacement ratio of the retiree. Throughout the research comparisons were made between *The OECD Roadmap for the good design of defined contribution pension plans* and National Treasury's proposals.

This research did not directly address the effect of increased life expectancies on retirement savings or increases in youth unemployment and the effect that this may have on retirement savings. The effect of financial charges levied on retirement savings on the income replacement ratio of a retiree was also not explored. Furthermore, not all pension funds are regulated by the Pension Funds Act and how these pension funds can be brought within the purview of the Pension Funds Act was not investigated. Automatic enrolment of retirement savings for all employees in South Africa in retirement vehicles is a further research area that could be addressed.

Key words: Income Tax, income replacement ratio, accumulation of retirement savings, pre-retirement withdrawals, annuitisation of post-retirement benefits, retirement benefit funds, pension fund, provident fund, retirement annuity fund, pension and provident funds, purchased annuities

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CHAPTER 1: INTRODUCTION

1.1 RESEARCH CONTEXT

National Treasury, South Africa, explains (2004: 11) that:

> The World Bank distinguished three separate "pillars" of a retirement funding system:
>
> - The first pillar is a public benefit programme, funded from general government revenue, which is aimed at redistribution (from the more well-off to the poor) in order to prevent poverty in old-age.
> - The second pillar is typically privately managed, fully or partially funded, with mandatory participation, within which individuals save to provide themselves with income during retirement.
> - The third pillar comprises voluntary savings, permitting individuals to choose how they allocate income over their lifetime.

Within the South African context the first pillar refers to the social old-age grant. This social old-age grant is available to all individuals who are over 60 years old, South African permanent residents, not in receipt of another social grant, and who (together with their spouse, if applicable) meet the requirements of a "means test" (Western Cape Government: 2014). The South African Social Security Agency Annual Report 2011/2012 (South African Social Security Agency: 2013) disclosed that 2 750 857 old-age grants were paid during the period 1 April 2011 to 31 March 2012, which had increased from 2 195 018 during the 2006/2007 year, an increase of 20 per cent over this six-year period. The increase in the number of social old-age grant recipients may be of concern to the government and may have resulted in a sharpened focus on retirement reform within the private and public sectors.

The second pillar of the retirement system refers to various pension and provident arrangements associated with formal sector employment, in either the private or public sectors. The Income Tax Act 58 of 1962 (referred to hereafter as "the Income Tax Act") allows employers to deduct their contributions to pension and provident funds in terms of section 11(*l*). Individuals who contribute towards pension funds are granted a section 11(k) pension fund deduction. The Income Tax Act does not presently provide a tax incentive for those individual employees who contribute towards a provident fund. National Treasury is considering equal tax incentives across all retirement vehicles. Should individuals change employment, they may preserve their pension and provident benefits (by transferring these benefits into a preservation vehicle) and this will not result in the payment of any taxes, or they may withdraw their savings from their pension or provident fund. These lump sum withdrawals from pension or provident funds are subject to income tax in terms of the Second Schedule of the Income Tax Act. The withdrawal benefits are taxed in accordance with a progressive tax rate applying to withdrawal benefits. The withdrawal benefits table is a punitive measure for those individuals who choose to access their retirement savings in excess of R22 500. Certain individuals may choose to access their retirement funds before their projected retirement dates – referred to as "pre-retirement leakage" – and this has the effect of reducing an individual's income replacement ratio on retirement. Purcell (2012) defines the income replacement ratio as retirement income expressed as a percentage of pre-retirement income.

Furthermore, not all employers within the formal sector require their employees to belong to a pension or provident fund. This means that certain employees may not be contributing to any retirement savings vehicle and this may result in them not having any retirement savings when they retire. Their individual replacement ratio on retirement will therefore be zero per cent. These individuals may apply to the government for a social old-age pension.

The government has identified that pre-retirement leakage and the absence of retirement savings may result in a greater financial burden on the government in future years. National Treasury is addressing this risk by introducing retirement reforms that encourage greater participation in pension and provident vehicles. The National Treasury Task Team recommended that:

> Participation be encouraged by the following measures:
>
> 1.6.1.1 The determination of the particular fund to which a category of employees would belong, and the benefits, contribution rates, and determination of pensionable remuneration applicable in that fund, would form part of the conditions of employment to be negotiated between employer and employees (or trade unions representing the employees);
>
> 1.6.1.2 If an employee is not required to belong to a particular retirement fund as a condition of employment, the employer will be required to offer to each new employee:
>
> (a) education on the desirability of retirement savings and information on his or her retirement savings options; and
>
> (b) payroll facilities so that the employee may join an individual retirement fund (defined as retirement fund membership of which does not depend upon an

> employer/employee relationship), or the National Savings Fund . . . , with contributions deducted automatically from the employee's earnings (National Treasury, 2004: 19).

The National Treasury Task team recommendations are in line with *The OECD [Organisation of Economic and Co-Operative Development] roadmap for the good design of defined contribution pension plans* recommendations that "Plan members should have free and ready access to comparative information about costs and performance of different providers, and the language used in disclosed materials should be readily understood by them" (OECD, 2012: 2).

In order to encourage participation within the second pillar of the retirement system, National Treasury is considering automatic enrolment to a retirement system for all employees who are engaged in formal employment.

> . . . Government is exploring ways to increase retirement fund coverage to all workers. This is a complex issue, given the large proportion of uncovered workers who earn below the tax threshold, who work for small employers, or who have a tenuous connection to the formal labour force, for instance because they work in construction or domestic service (National Treasury, 2013a: 3).

A further retirement reform being considered is to encourage employees to work and contribute to their retirement savings for a longer period. "Any biases in retirement funds which may discourage individuals from working past the retirement age of their funds will be identified and removed" (National Treasury, 2013a: 3). This is in line with *The OECD roadmap for the good design of defined contribution pension plans* recommendations which "encourage people to enrol, to contribute and contribute for long periods" (OECD, 2012: 1).

The third pillar of the retirement system refers to voluntary saving. In South Africa self-employed individuals may not participate in occupational retirement funds, and for this reason they may save through a retirement annuity fund vehicle. Furthermore, individuals who are members of occupational retirement funds may voluntarily make additional provision for retirement through a retirement annuity fund vehicle. Individuals who contribute towards a retirement annuity fund are tax incentivised through a section 11(n) deduction in terms of the Income Tax Act. The section 11(n) deduction is calculated on a different basis to the pension fund deduction in terms of section 11(k). Individuals who belong to retirement annuity funds may not withdraw their retirement benefits prior to reaching the age of 55 years, on death or retirement and these withdrawals are subject to the same punitive tax rates as pension and provident fund withdrawals.

The National Treasury Task Team recommended:

> For people with middle and higher incomes, particularly independent contractors and the self-employed, who are denied access to occupational retirement funds because there is no employer/employee relationship, conditions for favourable tax treatment should be harmonised for all types of retirement funds including those that do not operate in the context of an employment relationship (National Treasury, 2004: 24).

The World Bank retirement system focuses on the accumulation phase of retirement savings and does not allow retirement savings to be withdrawn during the accumulation phase. However, pension, provident and retirement annuity fund vehicles in South Africa allow a retiree to withdraw a lump sum (commutation) from their pension or retirement annuity fund accumulated benefits of up to one-third of the amount. This lump sum is taxed in accordance with a progressive tax rate applying to retirement benefits (the first R315 000 being tax-free). The withdrawal of a lump sum has the effect of reducing the income replacement ratio on retirement. Provident funds are not governed on the same basis as pension and retirement annuity funds, and this has resulted in members of a provident fund electing to receive their full lump sum from the provident fund when they retire. This lump sum is subject to tax on the same basis as pension and retirement annuity funds, however after the lump sum has been withdrawn the individual does not receive an annuity (as he or she has withdrawn all their funds immediately).

> . . . currently, annuitisation requirements only apply to members of pension funds and retirement annuity funds. . .
>
> Inadequate retirement provision is exacerbated when members of provident funds take lump-sum payouts on retirement. In the absence of annuitisation requirements, many members may spend down these assets quickly, being forced to rely on the state or family members to support their consumption thereafter.

> Individuals and households need to manage their post-retirement assets to provide income for the rest of their lifetime. After retirement, retirees and their families face many risks. The biggest risk is that they might outlive retirement savings (longevity risk) or that their retirement assets underperform (investment risk) – or both (National Treasury, 2012e: 21).

The National Treasury recommendations for the annuitisation of provident fund payouts are in alignment with *The OECD roadmap for the good design of defined contribution pension plans* which "recommends that defined contribution pension plans should encourage annuitisation (at the payout phase) as a protection against longevity risk" (OECD: 2012).

It is submitted that it is in the best interest of the government of South Africa to place restrictions on pre-retirement leakage and to encourage annuitisation of post-retirement benefits as this would mitigate a greater burden on the social old-age grant which has had an increasing number of recipients since 2006/2007.

The recommendations made to equalise the tax incentives across all retirement vehicles, the limitation of pre-retirement withdrawals and the annuitisation across all retirement vehicles was to be implemented with effect from 1 March 2015. However, on 16 October 2014 National Treasury announced the postponement for a year to allow further consultations at the National Economic Development and Labour Council. The implementation date may be moved to 1 March 2017 should there be no agreement at the National Economic Development and Labour Council by the end of June 2015 (Musviba, 2014 and KPMG, 2014).

The Pension Funds Act 24 of 1956 (referred to hereafter as "the Pension Funds Act") governs private pensions and certain (but not all) public pensions and National Treasury (2013a: 3) is considering Pension Fund governance for all pension funds. "A process is currently underway to bring public pension funds not governed under the Pension Funds Act, including the Government Employees Pension Fund (GEPF), Transnet, Telkom and Post Office retirement funds, into purview of the Act."

A further factor that affects retirement savings is the regulation of the fee charges among different retirement vehicles. Certain guidelines for fee charges exist for pension funds that are regulated in terms of the Pension Funds Act, however living annuities are regulated by the Long-Term Insurance Act, which does not regulate the maximum charges to be levied for assets under management, and does not limit the charges that can be levied by each tier of the living annuity structure. However, the regulation of fee structures of retirement vehicles is still under discussion and consultation by National Treasury and relevant stakeholders. It is beyond the scope of this research to discuss these regulatory charges in any detail.

South Africa embarked on its own retirement reform journey that commenced in 2004 when National Treasury issued its first discussion paper on *Retirement Fund Reform: a discussion paper* (National Treasury: 2004). National Treasury (2007) issued a second discussion paper on Social Security and Retirement Reform. During 2012 the Minister of Finance in his budget speech addressed certain tax changes identified in the Taxation Laws Amendment Bill that would later be incorporated into the Income Tax Act that is administered by the South African Revenue Services (National Treasury, 2012a). National Treasury issued a number of technical discussion papers on certain aspects of Retirement Reform in 2012 (National Treasury, 2012b; National Treasury, 2012c; National Treasury, 2012d; National Treasury, 2012e; National Treasury, 2012f). It is these proposed reforms that form the basis of the present research.

1.2 INCOME REPLACEMENT RATIO

Retirement Planning (2014) describes why saving for retirement is important:

> The greatest reason why you should save for retirement is because it is your life. The amount of money that you save for retirement will have a profound effect on how your life is lived. Do you have dreams or goals? Typically, retirement is the best time to meet your goals and transform your dreams into reality, but you can only do so if you are financially prepared. If you are not, you may be worried where you will live or where your next meal will come from, as opposed to wondering when the best time to take a vacation is.

Stinson (2014) mentions that the *Retirement Confidence Survey* (published in the United States of America) indicates that seven per cent of individuals plan never to retire, 26 per cent plan to work until they reach the age of 70 years, while only six per cent of the retired individuals continued to work until they reached the age of 70. Nearly half of retired individuals indicated that they had to stop working earlier than planned, mostly due to health problems (55 per cent), caring for family members (23 per cent) and by unemployment as a result of downsizing or closure of a business (20 per cent).

When individuals retire, they should receive some level of income based on their retirement savings made whilst they were working, or at worst they may apply for an old age grant, which is currently R1 260 per month.

Aon Consulting (2008: 1) refers to the replacement ratio as "a person's gross income after retirement, divided by his or her gross income before retirement". In terms of the definition by National Treasury (2012c: 15) "an income replacement ratio/rate is the percentage of pre-retirement income that a retiree would need to receive after retirement in order to have a post-retirement standard of living equivalent to his or her pre-retirement standard of living". The Aon Consulting (2008) *Replacement Ratio Study: A Measurement Tool for Retirement Planning* reasons that an individual needs less gross income after retiring. In the South African context this is due to two factors: income taxes reduce after retirement because a secondary rebate (currently R6 750 for those individuals over 65 years old) and a tertiary rebate (currently R2 250 for those individuals over 75 years old) is available and taxable income usually decreases at retirement, and saving for retirement is no longer needed. In addition to the two factors mentioned above changes in age- and work-related expenditures that occur at retirement also influence the amount of income that an individual needs at retirement and these expenditures vary from person to person.

Although the Aon Consulting (2008) report was written for the American market, it showed that an individual who retires at 65 years old and who earned $60 000 would need an income replacement ratio of 78 per cent without reducing his or her standard of living. This is attributable to tax savings and no longer having to save for retirement.

Masilela (2008: 1) notes that the income replacement ratio in South Africa is "constrained by various factors, ranging from inabilities to save, income inequalities, poverty, poor information and appreciation for long term savings, poor capital markets performance and sub-optimal drawdown programmes".

Aon Consulting (2008) mention that age- and work-related expenditure influence the amount of income that an individual needs at retirement. Masilela (2008: 8) provides the following table that shows changes in expenditure patterns in retirement:

Table 1: Changes in expenditure patterns on retirement

Expenditure category	**Direction of change**
Self-reading and education	- ve
Children reading and education	Ambiguous
Health care	+ ve
Utilities	- ve
Household operations	- ve
Shelter	- ve
Debt service	- ve
Other financial services related costs	- ve
Entertainment	- ve
Travelling	Ambiguous
Transportation	- ve
Food	- ve
Clothing	- ve

The World Bank (1994: 320) undertook cross-country modelling to ascertain indicative replacement ratios, per income group, which they propose as guiding targets:

Table 2: Cross-country modelling to ascertain indicative replacement ratios, per income group

		Mandatory target		
Pension as a percentage of	Household target	Low income	Middle income	High income
Net average lifetime wage	100	81	78	78
Gross average lifetime wage	78	63	60	60
Net final year wage	70	55	53	53
Gross final year wage	54	44	42	42
Gross economy-wide range	n/a	33	42	42

The above table used the following assumptions: all individuals start working at 20 years old, retire at 60 years old and die at 80 years old, there are equal numbers of low income, middle income and high income individuals, the starting wage is 33 per cent higher for middle income and 67 per cent higher for high income individuals, the annual wage growth is two per cent, the saving or contribution rate is 22.5 per cent.

The most recent cross-country comparison done by the World Bank in 2007 showed that the average replacement ratio for the OECD countries was 56 per cent whilst the Middle East and Africa was 75 per cent. Masilela (2008: 12) notes that: "In South Africa, it has been found that people, on average, retire with a replacement ratio of less than 30 per cent. This is uncomfortably low, if one considers that the bulk of the savers are in the middle to low end of the income brackets".

Masilela (2008: 13) refers to a table prepared by Sanlam showing replacement ratios by years of contribution. The assumptions made in the calculations reflected in this table were that real returns were three per cent and the contribution rate towards retirement savings was 10 per cent. This table is shown below:

Table 3: Replacement ratios by years of contribution

Years of contribution at time of retirement	**Replacement ratio (%)**
More than 35	38
30 – 35	32
25 – 30	28
20 – 25	23
15 – 20	18
10 – 15	15

Masilela (2008: 13) notes that "government has proposed a target minimum of a 40% replacement in the new dispensation". Whilst the level targeted by government is better than the estimated average (as shown in Table 3 above), it is lower than what is seen as an ideal level. Masilela (2008), after taking the replacement ratio of the OECD countries into consideration, believes that South Africa's ideal replacement ratio should be in the region of 60 per cent.

Butler and van Zyl (2012: 21) indicate that "replacement ratio goals of 70% to 79% used by retirement funds imply that pensioners can tolerate a substantial drop in income at retirement". The authors conclude that "the results of their research suggest that there is no evidence to suggest reduced consumption at or in retirement, there is thus doubt whether a goal of 70% to 79% is adequate".

None of the above authors agree on an optimal income replacement ratio on retirement. The South African government targets a minimum replacement ratio of 40 per cent, Masilela (2008) believes that the ideal South African replacement ratio should be 60 per cent, and Butler and van Zyl (2012) suggest that an income replacement ratio of between 70 per cent and 79 per cent may not be adequate.

National Treasury does not know what the optimal income replacement ratio is, but an assessment of the effect of the proposals adopted by National Treasury can be made, and a conclusion can be reached on whether the proposals have an influence on increasing the income replacement ratio on retirement.

1.3 GOALS OF THE RESEARCH

The overarching research goal is to determine whether the retirement reform mechanisms outlined by National Treasury will encourage individual retirement savings that should assist South Africans to achieve stability of income in their retirement.

The overarching research goal will be addressed by the following sub-goals:

- Analysing current retirement savings options and vehicles available for South Africans;
- Analysing current tax incentives and disincentives available for South Africans;
- Reviewing proposed changes to tax incentives to encourage retirement savings during the accumulation phase of retirement savings;
- Reviewing proposed changes to discourage pre-retirement withdrawals (also known as pre-retirement leakage);
- Reviewing proposed changes for the annuitisation of post-retirement benefits;
- Measuring the effects of retirement reform proposals recommended by National Treasury; and
- Where possible, comparing South Africa's retirement reform proposals to *The OECD roadmap for the good design of defined contribution pension plans* (OECD: 2012).

1.4 METHODS, PROCEDURES AND TECHNIQUES

An interpretative research approach will be adopted for the present research as it seeks to understand and describe (Babbie & Mouton: 2009). The research methodology to be applied can be described as a *doctrinal* research methodology. This methodology provides a systematic exposition of the rules governing a particular legal category (in the present case the legal rules relating to provision for retirement in terms of the Income Tax Act, Pension Funds Act and Long-term Insurance Act 52 of 1998 (referred to hereinafter as "the Long-term Insurance Act")), analyses the relationships between the rules, explains areas of difficulty and is based purely on documentary data (McKerchar: 2008).

The documentary data to be used for the research consists of:

- legislation (Income Tax Act, Pension Funds Act and Long-term Insurance Act);
- National Treasury technical discussion papers on Retirement Reform (National Treasury, 2004; National Treasury, 2007; National Treasury, 2012a; National Treasury, 2012b; National Treasury, 2012c; National Treasury, 2012d; National Treasury, 2012e; National Treasury, 2012f; National Treasury, 2013a; National Treasury, 2013b; National Treasury, 2013c);
- articles in accredited journals;
- textbooks and other writings.

The research is conducted in the form of an extended argument, supported by documentary evidence. The validity and reliability of the research and the conclusions will be ensured by:

- adhering to the rules of the statutory interpretation, as established in terms of statute;
- placing greater evidential weight on legislation, and the writings of acknowledged experts in the field;
- discussing opposing viewpoints and concluding, based on a preponderance of credible evidence; and
- the rigour of the arguments.

As all the data is available in the public domain, no ethical considerations arise in relation to the data. Interviews will not be conducted; opinions will be considered in their written form.

1.5 STRUCTURE OF THE THESIS

The remaining chapters of this thesis are structured as follows. Chapter 2 outlines the current retirement savings options and vehicles available for South Africans. Chapter 3 defines the current tax incentives and disincentives available for South Africans. Chapter 4 discusses the harmonisation of retirement savings deductions that have been proposed as amendments to the

Income Tax Act. Chapter 5 explains that pre-retirement withdrawals erode retirement savings and the proposals that National Treasury has made to limit pre-retirement withdrawals. Chapter 6 examines the current options for post-retirement savings as well as the proposals that have been recommended by National Treasury regarding the annuitisation of post-retirement benefits. Chapter 7 attempts to measure the effects of the retirement reform proposals and the effect that these proposals may have on the income replacement ratio of the retiree. Chapter 8 concludes the thesis with a summary of its goals, a review of the research findings, limitations of the research and recommendations for future research.

CHAPTER 2: CURRENT SOUTH AFRICAN RETIREMENT SAVINGS OPTIONS AND VEHICLES

2.1 INTRODUCTION

The overarching research goal of this research is to encourage individual retirement savings that should assist South Africans to achieve stability of income in their retirement. One of the sub-goals of this research is to analyse the current retirement savings options and vehicles that are available for all South Africans and this will be discussed in this chapter. The retirement savings options are referred to as retirement benefit plans and fall within two categories, either a defined benefit plan or a defined contribution plan. Within the retirement benefit plan stable, there are five retirement vehicle options that are governed by legislation, namely pension funds (not all pension funds fall within the purview of the Pension Funds Act), provident funds (regulated by the Pension Funds Act), retirement annuity funds (governed by the Pension Funds Act), living annuities and purchased annuities (both living annuities and purchased annuities fall within the ambit of the Long-Term Insurance Act). Pension preservation and provident preservation funds are governed by the Pension Funds Act and only become relevant when employees leave their employment and do not “cash out” or redeem any or all of their pension and provident benefits, but instead opt to preserve these benefits. A purchased annuity is not necessarily a retirement savings vehicle, but a purchased annuity may be used as a means of investing a lump sum amount in return for a regular payment in the form of an annuity. Purchased annuities are of value in providing for post-retirement income, although they have not been exclusively designed for retirement. The final option available for retirement savings is self-savings by an individual, without using any legislated retirement vehicles. Purchased annuities and self-savings are not dealt with as part of the retirement reform proposed by National Treasury.

2.2 RETIREMENT BENEFIT PLANS

International Accounting Standard 26: Accounting and Reporting by Retirement Benefit Plans (IFRS, 2004) identifies two types of retirement benefit plans: defined benefit plans and defined contribution plans. Irrespective of the type of retirement benefit plan, each plan requires that each fund creates a separate fund, to which contributions are made and from which retirement benefits are paid.

Paragraph 8 (IFRS: 2004) defines a "defined benefit plan" as:

> Defined benefit plans are retirement benefit plans under which amounts to be paid as retirement benefits are determined by reference to a formula usually based on employees' earnings and/or years of service.

A defined benefit plan places the risk of the payment of promised retirement benefits, investment performance and operating efficiency of the plan in the hands of the plan. The risks of the defined benefit plans lie with the employer. For this reason an employer who has a defined benefit plan for its employees needs the periodic advice of an actuary to assess the financial condition of the plan, review the assumptions and recommend future contribution levels.

Paragraph 8 (IFRS: 2004) defines a "defined contribution plan" as:

> Defined contribution plans are retirement benefit plans under which amounts to be paid as retirement benefits are determined by contributions to a fund together with investment earnings thereon.

Paragraph 14 (IFRS: 2004) describes the risk profile of a defined contribution plan:

> Under a defined contribution plan, the amount of a participant's future benefits is determined by the contributions paid by the employer, the participant, or both, and the operating efficiency and investment earnings of the fund. An employer's obligation is usually discharged by contributions to the fund. An actuary's advice is not normally required although such advice is sometimes used to estimate future benefits that may be achievable based on present contributions and varying levels of future contributions and investment earnings.

Paragraph 15 (IFRS: 2004) identifies who has a vested interest in the defined contribution plan:

> The participants are interested in the activities of the plan because they directly affect the level of their future benefits. Participants are interested in knowing whether contributions have been received and proper control has been exercised to protect the rights of the beneficiaries. An employer is interested in the efficient and fair operation of the plan.

From the above, it is clear that the employee bears the ultimate risk for their own retirement income. The employer caps its liability of funding its employees' retirement income and this is attractive to the employer from a financial perspective.

Owing to the potential future financial saving in respect of a contingent liability (as in the case of a defined benefit plan) that a defined contribution plan offers an employer, there has been a trend (which has become apparent both nationally and internationally) for employers to encourage their employees to opt for a defined contribution plan.

This retirement benefit plan background provides some insight into the five retirement vehicle options that will be discussed in the rest of this chapter.

2.3 PENSION FUNDS

In *Retirement Fund Reform: a discussion paper*, National Treasury explained as follows (2004: 10):

> In the 1970's, most retirement funds in South Africa and in fact worldwide were defined benefit funds, managed by employer-appointed boards of management. Benefit design favoured retirement and death but penalised resignation: a member's own contributions were refunded with a rate of interest lower than rates available on discretionary savings, and an increase (representing a share of employer contributions) was only included after a long period of service, in order to encourage employees to commit to their employer for the long-term.

Section 1 of the Pension Funds Act defines a pension fund as a "pension fund organisation". A pension fund organisation refers to an association of persons or business whose object is to provide annuities or lump sum payments to members or former members when they reach their retirement, or in the case of dependants of former members upon the death of the former member. The object of the pension fund organisation is to receive, administer, invest and pay pension benefits.

Section 1 of the Income Tax Act defines a "pension fund" as any pension, provident or dependants' fund or pension scheme that has been established by law. The definition of a pension fund further includes pension funds established by municipalities, local authorities, a control board as defined in section 1 of the Marketing of Agricultural Products Act, 1996, Development Bank of South Africa and the Municipal Councillors Pension Fund. Section 1 of the Income Tax Act continues to define a pension fund which meets the following conditions or limitations:

> Provided that the Commissioner may approve a fund subject to such limitations or conditions as he may determine, and shall not approve a fund in respect of any year of assessment unless he is in respect of that year of assessment satisfied –
>
> (i) that the fund is a permanent fund *bona fide* established for the purpose of providing annuities for employees on retirement from employment or for the dependants or nominees of deceased employees, or mainly for the said purpose and also for the purpose of providing benefits other than annuities for the persons aforesaid or for the purpose of providing any benefit contemplated in paragraph 2C of the Second Schedule or section 15A or 15E of the Pension Funds Act; and
>
> (ii) that the rules of the fund provide –
>
> (*aa*) that all annual contributions of a recurrent nature of the fund shall be in accordance with specified scales;
>
> (*bb*) that membership of the fund throughout the period of employment shall be a condition of employment by the employer of all persons of the class or classes specified therein who enter his employment on or after the date upon which –
>
> (A) the fund comes into operation; or
>
> (B) the employer becomes a participant in that fund;
>
> (*cc*) that persons who immediately prior to the said date were employed by the employer and who on the said date fall within the said class or classes may, on application made within a period of not more than 12 months as from the said date, be permitted to become members of the fund on such conditions as may be specified in the rules;
>
> (*dd*) that not more than one-third of the total value of the retirement interest may be commuted for a single payment, and that the remainder must be paid in the form of an annuity (including a living annuity), except where two-thirds of the total value does not exceed R50 000 or where the employee is deceased;
>
> (*ee*) that a partner of a partnership is regarded as an employee of the partnership; and
>
> (*ff*) that the Commissioner shall be notified of all amendments of the rules; and
>
> (*gg*) . . . . . .
>
> (iii) that the rules of the fund have been complied with.

The receipts and accruals of pension funds, pension preservation funds, provident funds, provident preservation funds and retirement annuity funds as defined in section 1 of the Pension

Funds Act are exempt from tax in terms of section 10(1)(d)(i) of the Income Tax Act. The Pension Funds Act governs private pensions and certain (but not all) public pensions. As part of the retirement reform process National Treasury is considering the application of the Pension Funds Act across all pension funds, including the Government Employees Pension Fund, Transnet, Telkom and the Post Office. Those pension funds that do not fall within the ambit of the Pension Funds Act, are taxed in accordance with the Tax on Retirement Funds Act 38 of 1996 (referred to hereafter as "the Tax on Retirement Funds Act") which taxes retirement funds at a rate of 9 per cent of the taxable amount determined in accordance with a formula as outlined in section 5 of the Tax on Retirement Funds Act.

Retirement reform is particularly relevant in the application of Regulation 28 of the Pension Funds Act which outlines the asset composition requirements of pension fund investments, referred to as the Prudential Investment Guidelines. A brief description of the Prudential Investment Guidelines is provided in the table below:

Table 4: Asset requirements in terms of the Prudential Investment Guidelines

	Categories of assets	**Maximum percentage of total assets of fund**
1	**CASH**	
	Held in South Africa	25%
	Held outside South Africa (by a foreign bank)	5%
2	**DEBT INSTRUMENTS INCLUDING ISLAMIC DEBT INSTRUMENTS**	
	Debt instruments issued by the government of the Republic	100%
	Debt instruments issued by the government of a foreign country	10%
	Debt instruments issued by a South African bank	75%
	Debt instruments issued by an entity listed on an exchange, or issued by a public entity under the Public Finance Management Act, 1999 (Act No. 1 of 1999)	50%
	Other debt instruments	25%
3	**EQUITIES**	75%
4	**IMMOVABLE PROPERTY**	25%

	Categories of assets	Maximum percentage of total assets of fund
5	**COMMODITIES**	10%
6	**INVESTMENTS IN THE BUSINESS OF A PARTICIPATING EMPLOYER INSIDE THE REPUBLIC IN TERMS OF –**	
	Section 19(4) of the Pension Funds Act	5%
	To the extent that it has been allowed by an exemption in terms of section 19(4) of the Pension Funds Act	10%
7	**HOUSING LOANS GRANTED TO MEMBERS IN ACCORDANCE WITH THE PROVISIONS OF SECTION 19(5)**	95%
8	**HEDGE FUNDS, PRIVATE EQUITY FUNDS AND ANY OTHER ASSETS NOT REFERRED TO IN THIS SCHEDULE**	15%
	Hedge funds	10%
	Private equity funds	10%
	Other assets not referred to in this schedule and excluding a hedge fund or private equity fund	2.5%

Pension Funds that do not fall within the purview of the Pension Funds Act do not have to follow the Prudential Investment Guidelines, which may mean that their asset allocations may be inappropriately diversified (or not diversified at all) and this may result in pension fund assets not being invested to ameliorate "longevity, investment and inflation risk" (Jennings, 2013: 1).

An approved pension fund allows the equivalent cash value of a maximum of one-third of the pension benefit at retirement to be taken in the form of a cash lump sum, and the remaining two-thirds thereof, if the maximum cash option is selected, is payable in the form of a regular monthly income (pension) after retirement (ISASA Pension Scheme and Provident Fund: 2014).

2.4 PROVIDENT FUNDS

"In a provident fund, the full benefit of retirement is a cash lump sum as opposed to a pension" (National Treasury, 2004: 10).

> The 1980's and 1990's saw a dramatic transfer of employees from these defined benefit funds to defined contribution schemes. This was viewed positively by trade unions, which saw advantages for their members in the better resignation benefits offered by newly established national provident funds, and by white-collar employees who sought to capture the investment rewards of a bull market. Employers preferred a defined contribution arrangement, since it provided for the capping of their personnel expenses, eased the introduction of package remuneration approaches, and it transferred the investment and expense risks to the employee. In most cases the old defined benefit fund was closed to new employees (National Treasury, 2004: 10).

The Pension Funds Act does not define a provident fund. A provident fund is defined in section 1 of the Income Tax Act, and refers to any fund (other than a pension fund, pension preservation fund, benefit fund or retirement annuity fund) which is approved by the Commissioner and is registered under the provisions of the Pension Funds Act. The Commissioner must be satisfied that the provident fund is established solely for the purpose of providing benefits for employees on retirement from employment or solely for the purpose of providing benefits for the dependants or nominees of deceased employees or deceased former employees. The provident fund inclusions are exactly the same inclusions as those of pension funds (i.e. it applies to provident funds established by municipalities, local authorities, a control board as defined in section 1 of the Marketing of Agricultural Products Act, 1996, Development Bank of South Africa and the Municipal Councillors).

In most instances, the provident fund pays the total retirement benefit as a cash lump sum. Certain provident fund rules may allow a retiring member the option to purchase a compulsory annuity instead of receiving the full retirement benefit in cash (ISASA Pension Scheme and Provident Fund: 2014). Currently, most retirees choose to access their entire provident fund lump sum. This may result in the retirees not preserving their lump sum, and they may spend their lump sum, or they may not invest the lump sum wisely in growth assets. National Treasury (2013a) proposes annuitisation of provident funds in order to prevent the entire provident lump sum from being utilised unwisely.

2.5 PENSION PRESERVATION FUNDS AND PROVIDENT PRESERVATION FUNDS

The membership of a pension, provident or both pension and provident fund occurs when the employer requires an employee to join a pension or provident fund. It is a condition of employment which requires the employee to be a member of a pension fund, provident fund, or of both. Should the employment relationship cease, then membership of the fund is no longer required. A former employee has the option of "cashing out" their pension or provident fund savings, and this is referred to as a pre-retirement withdrawal. Certain tax implications arise upon pre-retirement withdrawals, and the taxation treatment is discussed in chapter 3. National Treasury (2012e) is considering measures to prevent pre-retirement withdrawals. A former employee may choose not to withdraw his or her pension, provident or both pension and provident fund benefits when the employment relationship ceases, and instead may opt to transfer the accumulated pension fund benefit into a pension preservation fund or the accumulated provident fund benefit into a provident preservation fund. When preservation of a pension or provident fund benefit occurs the taxation thereof is deferred until the member withdraws the pension or provident benefit or when the member retires or dies.

Section 1 of the Income Tax Act defines both a pension preservation fund and a provident preservation fund. The definition of these two terms is almost identical except that one definition refers to a pension fund and the other refers to a provident fund. Members of both pension and provident funds may cease to be members of such funds for a number of reasons, such as:

- resignation, retrenchment or dismissal from employment;
- winding up or partial winding up of a fund;
- transfer of business from one employer to another in terms of section 197 of the Labour Relations Act, 1995.

Should the above instances occur, the employee may decide not to "cash out" or redeem their pension or provident benefits, but instead opt to preserve these benefits. These benefits maintain their nature, i.e. a pension fund becomes a pension preservation fund and a provident fund becomes a provident preservation fund. No further contributions are made to these funds, and the funds are preserved in their current form.

It is important for members to preserve their accumulated benefits in a pension preservation fund or provident preservation fund, as this will prevent them from not eroding their retirement savings when there is a change in their employment status or when a fund is wound up or partially wound up. One of the recommendations that National Treasury is considering is the limitation of pre-retirement withdrawals. Should a member not opt to preserve their accumulated pension or provident benefit through a pension preservation fund or provident preservation fund, then they will make a pre-retirement withdrawal (which has a tax implication and will be discussed in chapter 3) and thereby erode their retirement savings. The only exception where a pension preservation fund is not required to be preserved is when the total value does not exceed R75 000 or where the member is deceased.

2.6 RETIREMENT ANNUITY FUNDS

The requirement of belonging to a pension or provident fund is governed by an employment relationship. Membership of a retirement annuity fund is not governed by such a requirement, and therefore individuals who belong to a pension or provident fund may voluntarily choose to contribute towards a retirement annuity fund, or self-employed or unemployed individuals may use a retirement annuity fund as a form of saving for their retirement.

Retirement annuity funds fall within the ambit of the Pension Funds Act, and section 1 of the Pension Funds Act defines a retirement annuity fund as follows:

> "**retirement annuity fund**" means a retirement annuity fund as defined in section 1 of the Income Tax Act of 1962 (Act No. 58 of 1962).

Section 1 of the Income Tax Act defines a retirement annuity fund as a fund (other than a pension fund, provident fund or benefit fund) which is registered in terms of the Pension Funds Act. The retirement annuity fund must be a permanent fund *bona fide* established for the sole purpose of providing annuities for the members of the fund or their dependants or nominees of the deceased dependants. The rules of a retirement annuity fund provide for contributions by members, including contributions transferred by members from their interests in approved pension funds, pension preservation funds or other retirement annuity funds. Members of retirement annuity funds may commute a lump sum of not more than one-third of the total value of the retirement interest as a single payment and the balance after the commutation must be taken in the form of an annuity (including a living annuity), provided that the remainder left in the retirement annuity fund (after commutation) is not less than R75 000.

Should a member of a retirement annuity fund discontinue their contributions before retirement date, then they are able to withdraw their funds either in the form of an annuity or as a lump sum benefit provided that they have reached retirement age (and this will be taxed in accordance with the retirement withdrawal tables), or the member may request to be reinstated as a full member in terms of the rules and conditions of the retirement annuity fund.

The only instance when a member may withdraw a lump sum from a retirement annuity fund before they reach retirement date occurs should they emigrate from South Africa and the emigration is recognised as such by the South African Reserve Bank.

2.7 LIVING ANNUITIES

The Association of Savings and Investments in South Africa (2010) defines a living annuity as a special type of purchased annuity offered by insurers and retirement funds, under which the income (or annuity amount) is not guaranteed but is dependent on the performance of the underlying investments. It allows the holder of the living annuity to select an annuity based on a percentage of the capital value of the fund that ranges between a pre-defined minimum and maximum level. The nature of living annuities is such that the holder of the living annuity bears the investment and longevity risk in full. The income over the annuitant's lifetime will depend on the length of that lifespan, drawdown rates selected and the investment performance of the chosen funds. Guidance provided by the insurer or retirement fund on drawdown rates and appropriate investments can increase the probability that the living annuity provides a sustainable income for life, but the nature of the product means that this can never be assured. Guidance cannot preclude situations where the capital is only able to support an annuity that reduces over the annuitant's remaining life time, even though the income continues for life. However, should the remaining assets in the living annuity drop below a certain level (currently R75 000) then the full remaining assets of the living annuity may be paid out as a lump sum. Any balance of the capital value of the fund is passed on to the beneficiaries of the living annuity, and does not fall within the deceased estate of the annuitant unless the beneficiary of the living annuity was the estate of the deceased annuitant.

Section 1 of the Income Tax Act defines a living annuity. A living annuity is an annuity that is purchased after the retirement date of a member. The seed capital for a living annuity may arise from a number of recognised retirement vehicles, such as a pension fund, a pension preservation fund, provident fund, provident preservation fund or retirement annuity fund. This seed capital for a living annuity is what distinguishes it from a purchased annuity (discussed in section 2.8 below).

Section 1 of the Income Tax Act defines "retirement date" as the date on which a member of a retirement vehicle (pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund), in terms of the rules of the fund, becomes entitled to an annuity or lump sum benefit or subsequent to attaining normal retirement age or on the death of the member of the fund.

The retirement date refers to the "normal retirement age" which is defined in section 1 of the Income Tax Act as:

> (a) in the case of a member of a pension fund or provident fund, the date on which the member becomes entitled to retire from employment for reasons other than sickness, accident, injury or incapacity through infirmity of mind or body;
>
> (b) in the case of a member of a retirement annuity fund, a pension preservation fund or a provident preservation fund, the date on which the member attains 55 years of age; or
>
> (c) in the case of a member of any fund contemplated in this definition, the date on which that member becomes permanently incapable of carrying on his or her occupation due to sickness, accident or incapacity through infirmity of mind or body.

In most instances living annuities will only be created when a member is over 55 years old through a pre-existing retirement vehicle (discussed in section 2.3 to 2.6 above).

National Treasury (2014) identifies the living annuity structure as an "untaxed policy holder fund" which is exempt from income tax, and for this reason it is a structure that is favoured by high net worth individuals, as it allows them to grow their investment assets and cap the value of their estates (other than through the medium of a trust). One of the disadvantages of a living annuity is that there is no regulation of the charges that can be levied by the provider, as it falls outside the Pension Funds Act (which provides governance guidelines on charges levied by a

Pension Fund) and is governed by the Long-Term Insurance Act which does not provide guidance on maximum charges to be levied for assets under management, and does not limit the charges that can be levied by each tier of the living annuity structure.
National Treasury (2013b: 40) highlights the high cost structures of the products governed by the Long-Term Insurance Act:

> Finally, sponsors of commercial umbrella funds may profit from cross-selling various services, such as living or conventional annuities, home loans, insurance products or investment services to fund members.
>
> . . .
>
> At present there is no regulation governing the disclosure of costs and charges after entry into a commercial umbrella fund. Although members of funds are entitled to see the fund's rules and financial statements, few probably do so, and not all charges may be reflected in these documents, especially if the funds invest through CIS's [collective investment schemes], hedge funds, private equity funds or insurance policies rather than directly. Most commercial umbrella funds probably exceed these requirements, since it is unlikely that employers would elect to remain participants in a fund whose disclosure levels were inadequate. However, the opportunities for imperfect disclosure of charges to members may be substantial.

Furthermore, as a living annuity falls within the scope of the Long-Term Insurance Act, the Prudential Investment Guidelines for asset allocation do not apply to living annuities. This may result in fund managers taking greater investment risks within living annuities than fund managers who are required to comply with the Prudential Investment Guidelines in the Pension Funds Act.

2.8 PURCHASED ANNUITIES

Prudential (2014) defines a purchased annuity as an annuity "bought with a lump sum of money from personal savings or investments. Part of the annuity is deemed to be interest paid on the capital and is taxed. The other part is considered to be "a return of capital" which is exempt from income tax in terms of section 10A of the Income Tax Act.

Although a purchased annuity is not solely a retirement product, it may be suitable for certain retirees who may want to manage their investment and longevity risk in full. The purchased annuity may be a better option than a living annuity for those retirees who have a poor understanding of finance and who want a consistent guaranteed income.

2.9 SELF-SAVINGS

In addition to the regulated retirement vehicles discussed in section 2.3 to 2.6, living annuities discussed in section 2.7 and purchased annuities discussed in section 2.8, an individual may voluntarily choose to self-save for their retirement through cash investments (bank deposits and government bonds), unit trusts (also referred to as collective investment schemes), real estate investment trusts and share portfolios (either self-managed or through an investment manager). The self-savings option is a good option for those individuals who are well-disciplined (and will not access their retirement funds during difficult financial periods) and who have sophisticated financial knowledge. However, self-savings is only suitable for a small number of individuals, and is not regulated by either the Pension Funds Act or Long-Term Insurance Act, and therefore is beyond the scope of this research.

2.10 CONCLUSION

This chapter discussed the current retirement savings options and vehicles that are available to South Africans, namely pension funds, pension preservation funds, provident funds, provident preservation funds, retirement annuity funds, living annuities, purchased annuities and self-savings. The advantages and disadvantages (where relevant) of each of these retirement savings options and vehicles were discussed. Certain retirement savings vehicles, such as pension funds, pension preservation funds, provident funds, provident preservation funds, and retirement annuity funds are governed by the Pension Funds Act which provides guidelines on the maximum fee charges and asset spread allocations. A living annuity can be created by any of the retirement savings vehicles governed by the Pension Funds Act when a member reaches retirement age or is over 55 years old. Once a living annuity is created, it is governed in terms of the Long-Term Insurance Act which does not provide guidelines for maximum fee charges and asset spread allocations. Furthermore, a living annuity places the investment and longevity risk in the hands of the annuitant. Annuities purchased from insurance companies do not cater exclusively for retirees, but they have a place within a retirement plan should the retiree wish to transfer the investment and longevity risk to the insurance company. It is noted that not every individual would save for their retirement using a retirement vehicle, and certain individuals may find that self-savings (without the use of a retirement vehicle) are appropriate for them. Purchased annuities and self-savings are not dealt with in the retirement reforms proposed by National Treasury, but they have been briefly mentioned as these are relevant retirement savings options.

The next chapter will discuss the current tax incentives and disincentives that are available for South Africans who are saving for their retirement. These are the incentives that are applicable under the current legislation. A number of amendments have been proposed with effect from the date of implementation of the change (possibly 1 March 2016 or 1 March 2017) and are discussed in chapter 4. It is necessary, in order to judge the extent and effect of the proposals, to first discuss the provisions of the Income Tax Act in relation to retirement as they stand for the 2014 and 2015 years of assessment.

CHAPTER 3: CURRENT TAX INCENTIVES AND DISINCENTIVES DURING THE ACCUMULATION PHASE OF RETIREMENT SAVINGS

3.1 INTRODUCTION

The goal of this research is to determine whether the retirement reform mechanisms outlined by National Treasury will encourage individual retirement savings. One of the sub-goals of this research is to analyse the current tax incentives and disincentives that are available for South Africans who are saving for their retirement. This chapter will discuss the tax incentives that are relevant for the 2014 and 2015 years of assessment, as well as the taxation of retirement fund withdrawals. A number of amendments have been proposed with effect from the date of implementation of the changes (possibly 1 March 2016 or 1 March 2017), and it is necessary, in order to judge the extent and effect of the proposals, to understand the provisions of the Income Tax Act in relation to retirement as it stands under its current form.

Chapter 2 discussed retirement plans and explained that in the case of a defined benefit fund, the risks of the benefit plan lie with the employer, whereas in the case of a defined contribution fund, the risks lie with the retiree. Pension and provident funds can be designed as either defined benefit or defined contribution funds, while retirement annuity funds are defined contribution funds. Two additional types of annuities that are available for retirees, namely living annuities and purchased annuities, were identified. The receipts from both of these types of annuities will fall within an individual's gross income in terms of paragraph (a) of the gross income definition in section 1 of the Income Tax Act. However, an exemption is available for those individuals who have purchased an annuity, as the annuity portion that represents a return of capital is exempt from taxation in terms of section 10A of the Income Tax Act.

This chapter will discuss the deduction that is allowed in terms of section 11(*l*) of the Income Tax Act for employers who make contributions to either a pension fund or provident fund or both. As employers are not parties to retirement annuity funds, no deduction would apply. Employees who contribute towards pension funds are able to deduct their pension fund contributions in terms of section 11(k) of the Income Tax Act. The Income Tax Act does not provide a deduction for employees who are members of a provident fund and who make contributions to the fund. For those individuals who are not in formal employment (either self-employed or unemployed) and who wish to save for their retirement, or for those individuals who are in formal employment and wish to supplement their pension fund or provident fund savings, a tax deduction is available to them in terms of section 11(n) of the Income Tax Act should they contribute towards a retirement annuity fund. Lastly, should an individual withdraw funds from a pension, provident, or retirement annuity fund either before or after they have reached retirement age, the lump sum withdrawal will be taxed in accordance with tax tables and tax rates that are applicable to such lump sum withdrawals. Section 11(*l*), (k) and (n) of the Income Tax Act provide tax incentives for retirement savings. These incentives, designed to encourage saving for retirement, are discussed in this chapter.

3.2 SECTION 11(*l*) EMPLOYER CONTRIBUTIONS TO PENSION, PROVIDENT AND BENEFIT FUNDS

Section 11(*l*) of the Income Tax Act refers to:

> any sum contributed by an employer during the year of assessment for the benefit of his employees to any pension fund, provident fund or benefit fund . . .

The benefit fund referred to in section 11(*l*) means:

> any medical scheme registered under the provisions of the Medical Schemes Act, 1998 (Act No. 131 of 1998)

This reference to medical scheme contributions is relevant, as the section 11(*l*) employer deductible contribution includes contributions to a medical scheme and this contribution does not provide any retirement benefit for an employee. The inclusion of the "benefit fund" in section 11(*l*) reduces the amount of the deductible employer contribution to pension and provident funds. This reduced deduction may have a negative long-term effect on the possible contributions that an employer can make to a pension or provident fund on behalf of an employee, if it is assumed that the employer will only contribute to the funds to the extent that contributions are deductible.

Section 11(*l*) allows contributions (including lump sum payments) to be deducted up to an amount that does not exceed 10 per cent of approved remuneration. However, in practice the restriction of 10 per cent is extended up to 20 percent. National Treasury (2012c: 9) clarifies this:

> Only where the employer's contribution exceeds 10% of the employee's remuneration may the deduction be restricted to what the Commissioner regards as reasonable. The Commissioner generally allows 20% in practice. Note however that this percentage factor is a cumulative percentage, covering contributions to both pension and provident funds and medical schemes.

The practice of the Commissioner for the South African Revenue Services doubles the potential section 11(*l*) deduction.

Section 11(*l*)(iii) defines "approved remuneration":

> **"approved remuneration",** in relation to any employee for any year of assessment, means so much of the total remuneration accrued to such employee during such year of assessment in respect of his employment by the employer concerned as the Commissioner considers to be fair and reasonable in relation to the value of the services rendered by such employee during such year of assessment to the employer and having regard to other benefits, if any, derived by him from his employment by the employer.

Normally partners in a partnership are not regarded as being in an employment relationship, but section 11(*l*) has been extended to allow the partnership to treat its partners as employees for the purposes of determining employer contributions.

Section 11(*l*) therefore provides a tax incentive for employers to contribute to their employees' pension, provident and benefit funds, as the employer is able to deduct its contributions to an employee's pension and provident fund. The employer contribution to an employee's pension and provident fund does not result in a corresponding inclusion in the employee's gross income as an employee benefit in terms of paragraph (i), even though the employee benefits by an increase in their retirement savings. In section 3.5 below, it is noted that the employer contributions to an employee's retirement annuity fund are included in the employee's gross income in terms of paragraph (i). It is submitted that the reason for the employer contributions to pension and provident funds not being included in the gross income of the employee in terms of paragraph (i) is that the employee derives no benefit from the contribution as the employer contributions are not available to the employee should he or she withdraw from the fund prior to retirement, retrenchment or death. From 1 March 2016 (or 1 March 2017 depending on the outcome of the negotiations with the National Economic Development and Labour Council), contributions to pension and provident funds are taxed as employment benefits and employer contributions are available to retirement fund members on withdrawal from the funds.

3.3 SECTION 11(k) EMPLOYEE CONTRIBUTIONS TO PENSION FUNDS

Section 11(k) of the Income Tax Act allows current contributions to pension funds (paid by an employed person or a partner in a partnership) to be deducted on the following basis:

> . . . that the total deduction to be allowed in respect of contributions by such person to any one or more pension fund or funds shall not in the year of assessment exceed the greater of R1 750 or 7,5 per cent of the remuneration (being the income or part thereof referred to in the definition of "retirement-funding employment" in section 1) derived by such person during the year in respect of his or her retirement-funding employment.

Retirement-funding employment is defined in section 1 of the Income Tax Act and in the case of an employee, includes remuneration (as defined in paragraph 1 of the Fourth Schedule to the Income Tax Act), but excludes allowances that are granted to the holder of a public office and allowances in respect of transport expenses.

Paragraph 1 of the Fourth Schedule to the Income Tax Act defines remuneration as:

> **"remuneration"** means any amount of income which is paid or is payable to any person by way of any salary, leave pay, wage, overtime pay, bonus, gratuity, commission, fee, emolument, pension, superannuation allowance, retiring allowance or stipend, whether in cash or otherwise and whether or not in respect of services rendered.

The definition of remuneration includes annuities, amounts received for services rendered, restraint of trade, amounts received owing to a change of employment, retirement lump sum benefits, amounts received owing to a commutation of amounts due under any contract of employment or service, fringe benefits, as well as any allowances received for accommodation, meals and other incidental costs, allowances for holding a public office (excluded from retirement-funding employment), travel allowances (excluded from retirement-funding employment) as well as any gains received from share options.

For individuals who are holders of an office, retirement-funding employment means income (excluding a retirement lump sum benefit) derived by an employee by way of a salary, emolument, fees or other remuneration in respect of their employment.

Partners of a partnership are deemed to be an employee and partnership "retirement-funding employment" is defined in paragraph (b) of the definition of "retirement-funding employment" as follows:

> (i) in relation to a partner in a partnership who was an employee of the partnership and who on becoming a partner retained membership of the pension fund of the partnership as if he or she had not ceased to be an employee, as respects the part of the partner's income from the partnership in the form of the partner's share of profits as does not exceed an amount equal to the partner's pensionable emoluments during the 12 months which ended on the day on which the partner ceased to be an employee; or
>
> (ii) in relation to a partner in a partnership (other than a partner contemplated in subparagraph (i)) the part of the partner's income from the partnership in the form of the partner's share of the profits.

Section 11(k) also provides tax incentives for those employees who make current and arrear pension fund contributions. Should an employee, partner or holder of office make arrear contributions to a pension fund, then the provisions of section 11(k)(ii) will apply:

> any sum paid during the year of assessment to any pension fund by any person, who as a member of such fund, has in terms of the rules governing such fund undertaken to pay such sum in respect of any past period which is to be reckoned as pensionable service of that member . . .

Arrear pension contributions will only be allowed should the rules of the pension fund allow such contributions. The deduction available for arrear contributions is limited to a maximum amount of R1 800 per year. Should the arrear pension contribution exceed R1 800 for the year, then the excess of R1 800 may be carried forward to the following year of assessment, and the arrear contribution may be claimed using the R1 800 limitation.

The arrear contributions may not be deducted in terms of section 11(k)(ii) where the arrear contribution carried forward (the excess of R1 800) has been accounted for in terms of paragraph 5(1)(a) or 6(1)(b)(i) of the Second Schedule to the Income Tax Act. Paragraph

5(1)(a) refers to those arrear contributions to retirement funds that would not have been deductible in terms of section 11(k) and (n) to the member's retirement fund before their retirement or death. Paragraph 6(1)(b)(i) applies the same principle as paragraph 5(1)(a) but refers to those contributions as the member's arrear contributions to retirement funds before the member withdrew or resigned from the retirement fund.

Where an employee has contributed to a pension fund in excess of the maximum section 11(k) deduction, the excess contributions (that were disallowed for tax) are deducted from the taxable portion of the lump sum when the employee retires and commutes part of the retirement interest to a lump sum of up to one-third of his or her retirement interest or withdraws from the fund.

3.4 EMPLOYEE CONTRIBUTIONS TO PROVIDENT FUNDS

The Income Tax Act does not make any provision for a deduction for those employees who contribute towards provident funds. This is a tax disincentive for those employees who make contributions towards provident funds.

However, the Income Tax Act does provide some parity for disallowed deductions. Where an employee has contributed to a provident fund, the amount of the contributions that were disallowed for tax are deducted from the taxable portion of the lump sum when the employee retires and withdraws the total retirement interest in the form of a lump sum. The only drawback of the disallowed deductions being deducted from the provident lump sum is that the time value of money erodes the absolute amount of the deductions.

3.5 SECTION 11(n) RETIREMENT ANNUITY FUND CONTRIBUTIONS

Unlike section 11(k) which is linked to an employment relationship, section 11(n) falls within the category of voluntary savings. This means that an employed, a self-employed or an unemployed individual may voluntarily contribute towards a retirement annuity fund.

Section 11(n) caters for the deduction of current and arrear retirement annuity fund contributions. The tax deduction for the current retirement annuity fund contributions is based on the greater of:

- 15 per cent of an amount equal to the amount remaining after deducting the retirement-funding employment income and any retirement fund lump sum benefit, retirement fund lump sum withdrawal benefit and severance benefit received or accrued by the taxpayer in the current year of assessment;

- the excess of R3 500 over the allowable section 11(k) deduction; or
- R1 750.

Should an individual make arrear retirement fund contributions, then a deduction of R1 800 per year is allowed. It is submitted that the monetary values relating to current retirement annuity fund contributions (of R3 500 and R1 750) and arrear retirement annuity fund contributions (of R1 800) have fallen prey to the effects of inflation.

Section 11(n)(ii) stipulates that should an employer make retirement annuity fund contributions on behalf of an employee, then the amount of the employer contributions are included in the employee's gross income as a fringe benefit in terms of paragraph (i) of the gross income definition. It appears that the provisions of the Income Tax Act are punitive to employees whose employer makes retirement annuity fund contributions on their behalf, which are then taxed as "fringe benefits", as prior to 1 March 2016 (or 1 March 2017 depending on the outcome of the negotiations with National Economic Development and Labour Council), employer contributions to pension and provident funds do not constitute a "fringe benefit". The section 11(*l*) deduction is only available to employers who contribute towards their employees' pension and provident funds. Employer-contributions on behalf of employees to retirement annuity funds are not deductible in terms of section 11(*l*), but are deductible in terms of the section 11(a) general deduction formula. Section 11(a) would not impose a restriction on the amount of the deduction.

3.6 DISPARITY BETWEEN DEDUCTIONS FOR PENSION, PROVIDENT AND RETIREMENT ANNUITY FUND CONTRIBUTIONS

There is a difference in the deduction that can be claimed by an employer, depending on whether a contribution is made to a pension or provident fund versus the retirement annuity fund. This difference results in a tax disadvantage to the employee (who gains no immediate benefit from employer contributions to retirement annuity funds).

The Income Tax Act provides tax incentives for those employees who contribute towards pension and retirement annuity funds. However, a deduction is not allowed for those employees who make additional contributions towards a provident fund.

As discussed in section 3.3 and 3.5 above, the deductions that are allowed for pension funds and retirement annuity funds are different, even though both vehicles are intended to encourage individuals to save for their retirement. The section 11(k) percentage deduction is based on 7.5 per cent of "remuneration" as defined, and the section 11(n) deduction is based on 15 per cent of the amount equal to the amount remaining after deducting "retirement-funding employment" income, retirement lump sum benefits, retirement withdrawal benefits and severance benefits. Even the basis of the deduction is different for a pension fund (which uses "remuneration" which is qualified by the rules of the pension fund that stipulate the basis on which the contributions by both the employer and employee would be made and is usually only the basic salary) and a retirement annuity fund (which uses non-"retirement-funding employment" income).

3.7 TAXATION OF ANNUITIES

All annuities (whether purchased annuities or living annuities) are included in gross income in terms of paragraph (a) of the definition. The return of the capital element of a purchased annuity is exempt in terms of section 10A of the Income Tax Act. It is justifiable that a purchased annuity should have a partial exemption since the owners of the purchased annuity used their capital when purchasing the annuity. Section 10A provides a formula to determine the capital element of the annuity that is exempt. Section 10A(3)(a) provides the formula as follows:

$$Y = {}^{A}/_{B} \times C$$

In this formula:

Y is the capital element to be determined

A is the amount of the total consideration paid by the purchaser of the annuity

B represents the total "expected return" of all the annuities provided for in the annuity contract

C is the annuity amount received of which the exempt capital portion must be calculated

The expected return is the sum of all the annuity amounts that are expected to become payable by way of the annuity from the commencement of the annuity contract (section 10A(1)).

The calculation of the capital portion of all annuity amounts to be paid under an annuity contract must be made by the insurer before the payment of the first annuity amount. When a determination has to be made of the life expectancy of the person for the purpose of the calculation of the expected return of an annuity or the probable number of years during which annuity amounts will be paid under an annuity contract, the mortality tables must be used.

A living annuity is defined in section 1 of the Income Tax Act and means:

> a right of a member or former member of a pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund, or his or her dependant or nominee, or any subsequent nominee, to an annuity purchased from a person or provided by that fund on or after the retirement date of that member or former member . . .

As the living annuity may only be created when a member of a retirement fund retires, the seed capital for the living annuity arises from a number of recognised retirement vehicles, such as a pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund, most of which (excluding provident funds and provident preservation funds) have enjoyed employee tax incentives throughout their existence. An indirect tax incentive is available for living annuities, as "the investment returns within the living annuity vehicle itself are tax exempt" (Netto-Jonker: 2007). The section 10A exemption is not available to living annuities.

3.8 PENSION PRESERVATION FUNDS AND PROVIDENT PRESERVATION FUNDS

A pension preservation fund and provident preservation fund arise when an individual ceases to be a member of a pension or provident fund, and the member chooses not to "cash out" or redeem his or her pension or provident fund benefit, but instead opts to preserve the benefit. The transfer of an individual's pension fund benefit to a pension preservation fund and a provident fund benefit to a provident preservation fund does not trigger an immediate tax implication for the individual. The transfer to a pension or provident preservation fund allows the individual to defer the payment (if any) of tax to a later date when the individual accesses the benefit in the pension or provident preservation fund. Tax only becomes payable on the date when the pension or provident preservation fund is accessed by the individual, which will be either when the individual chooses to "cash out" of the pension or provident fund, retires, or dies. When the individual accesses these pension and provident preservation fund benefits, then the withdrawal benefits from the pension and provident preservation fund will be taxed according to the retirement lump sum withdrawal benefit table (for pre-retirement withdrawals) and the retirement lump sum benefit table for withdrawals upon retirement. The taxation of these retirement fund withdrawals is discussed in section 3.9 below.

3.9 TAXATION OF RETIREMENT FUND WITHDRAWALS

A retirement fund withdrawal occurs when funds are withdrawn from a retirement vehicle (a pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund). Once a living annuity has been created the capital amount may not be withdrawn, unless the capital amount remaining is R75 000, or less.

There are three events that may result in the payment of a lump sum by a retirement vehicle: withdrawing the entire interest in the retirement vehicle before reaching retirement age (referred to as a pre-retirement withdrawal); or commuting up to a maximum of one-third of the retirement vehicle value as a lump sum upon retirement (only applicable to a pension fund, pension preservation fund or a retirement annuity fund); or upon the death of a member of the retirement vehicle. Depending upon which event gives rise to a lump sum payment, the amount will be taxed at a different rate of tax than the normal tax rates. There are two different tax tables that are available for retirement withdrawals. Should an individual elect to make a pre-retirement withdrawal, then their lump sum will be taxed using the following table:

Table 5: Tax table for retirement lump sum withdrawal benefits

RETIREMENT LUMP SUM WITHDRAWAL BENEFITS	
Year of assessment ending 28 February 2014	
Taxable income from benefits	**Rate of tax**
Not exceeding R22 500	0% of taxable income
Exceeds R22 500 but not R600 000	18% of taxable income exceeding R22 500
Exceeds R600 000 but not R900 000	R103 950 plus 27% of taxable income exceeding R600 000
Exceeds R900 000	R184 950 plus 36% of taxable income exceeding R900 000

The retirement lump sum withdrawal benefit table is aimed at discouraging members from making pre-retirement withdrawals, as once the lump sum benefit exceeds R22 500 it becomes taxable at a progressive rate. Pension and provident funds may only be accessed when there has been a change in the employment status of a member (the member becoming unemployed or changing employment, which results in a member changing pension or provident funds). Retirement annuity funds are voluntary savings that are not usually employer-linked and they may only be withdrawn when a member reaches 55 years old and they will be taxed using the retirement lump sum benefit table (Table 6 below).

All other retirement lump sum payments (where a member retires and commutes up to one-third of the retirement benefit of a lump sum on his or her retirement, or where a member dies and a lump sum is paid out upon his or her death) are taxed according to the table below:

Table 6: Tax table for retirement lump sum benefits

RETIREMENT LUMP SUM BENEFITS	
Year of assessment ending 28 February 2014	
Taxable income from benefits	**Rate of tax**
Not exceeding R315 000	0% of taxable income
Exceeds R315 000 but not R630 000	18% of taxable income exceeding R315 000
Exceeds R630 000 but not R945 000	R56 700 plus 27% of taxable income exceeding R630 000
Exceeds R945 000	R141 760 plus 36% of taxable income exceeding R945 000

The retirement lump sum benefit table taxes retirement lump sums once the lump sum benefit exceeds R315 000. This table is less punitive than the retirement lump sum withdrawal benefit table as the first R315 000 of the retirement lump sum benefit is tax-free compared to R22 500 in the retirement lump sum withdrawal benefit table. The retirement lump sum benefit table applies only to members of pension, pension preservation, provident, provident preservation and retirement annuity funds who make withdrawals from these funds upon their retirement or death. In most cases, members will not have further opportunities to earn money and save for their retirement. When a member retires or reaches retirement age, they have in all likelihood been working for a number of years and would have accumulated retirement savings. For this reason, the amount of the retirement benefit is taxed at a lower rate.

A further form of tax relief applies when comparing these tables to the normal tax table – both in relation to the income brackets and the maximum marginal rate. Natural persons are taxed according to the table below:

Table 7: Rates of tax applied to natural persons

NATURAL PERSONS			
Year of assessment ending 28 February 2014			
Taxable income		**Rates of tax**	
From	But does not exceed		
R	R	R	R
0	165 600	0 + 18% of each R1	
165 601	258 750	29 808 + 25% of the amount above	165 600
258 751	358 110	53 096 + 30% of the amount above	258 750
358 111	500 940	82 904 + 35% of the amount above	358 110
500 941	638 600	132 894 + 38% of the amount above	500 940
638 601		185 205+ 40% of the amount above	638 600

When comparing the natural persons tax table to the retirement lump sum withdrawal benefits and retirement lump sum benefits tax tables, it is noted that the maximum marginal tax rate for the retirement lump sum withdrawal benefit is reached when the withdrawal exceeds R900 000 and the retirement lump sum exceeds R945 000, and the maximum marginal tax rate that applies to both lump sums is 36 per cent. The maximum marginal tax rate of 40 per cent for an individual is reached when the taxable income exceeds R638 601. It is reasonable that the retirement lump sum withdrawal benefits and retirement lump sum benefits are taxed at a lower rate, since these lump sum receipts are not regular receipts throughout an individual’s life, and the lump sum is used to finance their retirement years when in all likelihood most individuals will not have further opportunities to earn money and save for their retirement.

The rates reflected in a retirement lump sum benefit table taxes lump sum benefits on a cumulative basis. This means that all of the lump sum benefits received by a taxpayer during his or her lifetime are added together and taxed using the same table and tax levied on the lump sum benefits in earlier years of assessment is deducted. A member of a retirement vehicle who receives multiple lump sums over multiple retirement years must use the same retirement lump sum benefit table when calculating the tax that should be paid on the lump sums. This is best illustrated by the use of an example:

Table 8: Example illustrating tax to be paid on retirement lump sum at retirement

Mr A is 62 years old and is a resident of South Africa. For the past 25 years Mr A had been working for DEF Limited. On 31 December 2013 Mr A retired from DEF Limited and received the following as a result of his retirement:

- R800 000 as a lump sum from the DEF Pension Fund (DEF Limited requires that all of its employees must be members of the DEF Pension Fund and DEF Limited contributes all pension fund contributions on behalf of all its employees); and
- R12 000 per month as an annuity from the DEF Pension Fund with effect from 1 January 2014.

Since 1 March 2013 Mr A received cash salary of R24 000 per month from DEF Limited. Mr A owns an investment property which he leased for R8 000 per month for 11 months during the 2014 year of assessment.

Mr A did not receive any other income or incur any deductions during the 2014 year of assessment.

During the 2012 year of assessment, Mr A received a lump sum of R320 000 from his retirement annuity fund.

The normal tax liability for Mr A for the 2014 year of assessment is shown below:

	R	**R**
	Retirement lump sum benefit	**Other**
Salary (R24 000 x 10 months)		240 000
Retirement lump sum benefit	800 000	
Rental income (R8 000 x 11 months)		88 000
Annuity from DEF Pension Fund (R12 000 x 2 months)		24 000
Taxable income	800 000	352 000
Tax payable in terms of the retirement lump sum benefit table		
Lump sum received during the 2012 year of assessment	320 000	
Lump sum received from the DEF Pension Fund during the 2014 year of assessment	800 000	
Cumulative lump sum received	1 120 000	

Tax on cumulative lump sum using the retirement lump sum benefit table calculated as follows: Tax on excess of R945 000 ((R1 120 000 – R945 000) x 36%) Tax on the R945 000 Total tax on cumulative lump sum Less: tax on lump sum received during the 2012 year of assessment Tax on excess of R320 000 ((R320 000 – R315 000) x 18%) Tax on the R315 000	 63 000 141 760 204 760 (900) 203 860	
Tax payable in terms of the natural persons tax table		81 071
Less: primary rebate		(12 080)
Tax on other taxable income		68 991
Tax on retirement lump sum benefit (in terms of the retirement lump sum benefit table as shown above)		203 860
Total tax payable by Mr A during the 2014 year of assessment		272 851

The retirement lump sum withdrawal benefit table and retirement lump sum benefit table are a disincentive for those individuals who access their retirement funds above the thresholds (R22 500 for a retirement lump sum withdrawal benefit (pre-retirement withdrawal) and R315 000 for a retirement lump sum benefit). A tax planning opportunity exists to withdraw lump sums without paying tax, where the withdrawal amount from a retirement lump sum withdrawal benefit is less than R22 500 and the retirement lump sum benefit is less than R315 000. The remaining retirement savings within the pension fund that are not withdrawn remain within the pension fund and result in the member earning a higher monthly pension than would have been the case had a greater lump sum amount been withdrawn. The retirement lump sum benefit table is not favourable for those individuals who are members of provident funds and whose lump sum benefit exceeds R315 000 and who withdraw their entire provident fund balance upon retirement, unlike a pension fund where up to one-third may be withdrawn. A member of a provident fund may be able to reduce or postpone his or her tax liability by withdrawing R315 000 from his or her provident fund (and thereby not paying tax on this amount), and using the balance in their provident fund to buy a retirement annuity or a living annuity. This will avoid having to pay tax on the entire provident fund lump sum.

Section 3.7 above discussed the taxation of purchased annuities and the exempt capital element that is exclusive to a purchased annuity structure. All other annuities that are paid from the non-withdrawn portion of a pension fund, retirement annuity fund or living annuity are included in the individual's gross income in terms of paragraph (a). These other annuities do not enjoy any tax exemptions and are taxed according to the normal tax tables for natural persons.

3.10 CONCLUSION

This chapter discussed the tax incentives and disincentives of saving for retirement for all retirement vehicles (pension funds, pension preservation funds, provident funds, provident preservation funds and retirement annuity funds) that are relevant for the 2014 and 2015 years of assessment. The taxation of retirement lump sum withdrawal benefits and retirement lump sum benefits was discussed. There is a difference in the tax treatment of pre-retirement withdrawals versus post-retirement withdrawals. The taxation of pre-retirement withdrawals is more punitive than post-retirement withdrawals, however this is reasonable since members of pension and provident funds should be discouraged from pre-retirement withdrawals in order to save for their retirement and have a more favourable income replacement ratio. The income that is received by the individual after retirement depends on the retirement vehicle to which the individual belongs. Should the individual retire from a pension fund or a retirement annuity fund or elect to invest the retirement benefit in a living annuity, the income received by the individual in the form of an annuity will be included in the individual's gross income in terms of paragraph (a) and will be taxed according to the normal tax tables that apply to natural persons. Should an individual have retired from a provident fund and chooses to redeem the full lump sum on retirement and uses it to purchase an annuity, then the annuity will be included in the individual's gross income in terms of paragraph (a) but the capital element of the annuity will be exempt from tax in terms of section 10A.

Based on the tax incentives and disincentives available for saving in a retirement vehicle, it was noted that there is a disparity between the deductions available for contributions to the various retirement funds. These tax deduction differences are illogical as the tax consequences of retirement savings, irrespective of the retirement vehicle chosen, should be consistent across all retirement vehicles. It is against this backdrop of inconsistent tax incentives and disincentives across retirement vehicles that a number of amendments to the Income Tax Act have been proposed with effect from the date of implementation of the changes (possibly 1 March 2016 or 1 March 2017).

The next chapter will discuss the proposed changes aimed at achieving retirement reform. During 2004 National Treasury issued *Retirement Fund Reform: a discussion paper* and this paper has been under discussion since it was issued. During 2012, National Treasury issued further discussion papers that augment and clarify the original discussion paper that was issued in 2004 (National Treasury, 2012a; National Treasury, 2012b; National Treasury 2012c; National Treasury, 2012d; National Treasury, 2012e & National Treasury, 2012f). In addition to the discussion papers, certain changes to the Income Tax Act have been proposed with effect from 1 March 2016 (or 1 March 2017 depending on the outcome of the negotiations with the National Economic Development and Labour Council. The next chapter will incorporate a discussion of these proposed changes to the Income Tax Act.

CHAPTER 4: PROPOSED CHANGES TO TAX INCENTIVES DURING THE ACCUMULATION PHASE OF RETIREMENT SAVINGS

4.1 INTRODUCTION

The goal of this research is to determine whether the retirement reform mechanisms outlined by National Treasury will encourage individual retirement savings. One of the sub-goals of this research is to review the proposed changes to the Income Tax Act that have been tabled by National Treasury in order to achieve retirement reform. This chapter will discuss the harmonisation of retirement savings deductions. This is relevant as chapter 3 identified the tax differences that exist between the various retirement vehicles (pension, provident and retirement annuity funds). These tax differences will exist up until the date of the implementation of the changes. Based on proposed changes to the Income Tax Act it appears that uniform deductions across all retirement vehicles will be available. Since National Treasury issued the *Retirement Fund Reform: a discussion paper* (National Treasury, 2004), the only changes that have been introduced are the proposed changes to section 11(*l*), 11(n) (which has been withdrawn) and 11(*k*) to the Income Tax Act. However, there are a number of other changes that were discussed and that are due for possible implementation in the future. These proposed changes will include offering accelerated retirement fund deductions for those individuals who are over 45 years old. National Treasury also proposed limiting the maximum deductions that will be allowed for retirement savings, proposed a monetary deduction of up to R20 000 per annum for contributions made by those individuals who are low-income earners and who contribute towards retirement savings in excess of the percentage limits, removing the age discrimination that exists in the retirement fund system and allowing a rollover dispensation for arrear retirement contributions made to all retirement vehicles, which will be beneficial for those individuals who have fluctuating incomes.

A comparison will be made between *The OECD roadmap for the design of defined contribution pension plans* (OECD, 2012)) and the South African National Treasury retirement reform proposals, to determine whether alignment exists between *The OECD roadmap for the design of defined contribution pension plans* (OECD, 2012) and the South African retirement reform.

4.2 HARMONISATION OF RETIREMENT SAVINGS DEDUCTIONS

A number of changes have been proposed to the Income Tax Act at the date of implementation of the changes. The existing legislation was discussed in chapter 3. The existing deduction that is available under the current legislation will be compared with the proposed changes, which take effect from the date of implementation of the changes.

4.2.1 SECTION 11(*l*) EMPLOYER CONTRIBUTIONS TO PENSION, PROVIDENT AND BENEFIT FUNDS

Chapter 3 discussed the section 11(*l*) employer contributions to pension, provident and benefit funds. It was noted that this deduction was only available to employers who required employees to be members of a pension or provident fund, and not to members of retirement annuity funds. With effect from the date of implementation of the changes (possibly 1 March 2016 or 1 March 2017), section 11(*l*) has been redrafted and now provides for a deduction for employer contributions to all retirement vehicles (pension, provident and retirement annuity funds). It is submitted that this proposed change to section 11(*l*) removes the tax discrimination for those employers who contribute towards a retirement annuity fund on behalf of their employees. This approach introduces parity of contribution deductions for all retirement vehicles. This has been clarified in the *Explanatory Memorandum on the Taxation Laws Amendment Bill, 2013* published by National Treasury (2013c: 9):

> Employer contributions to all approved retirement funds (South African) will be deductible against income under a specific deduction provision. The deduction will effectively be unlimited.

The existing section 11(*l*) deduction resulted in a difference between the Income Tax Act and the practice of the Commissioner for the South African Revenue Services. Section 11(*l*) of the Income Tax Act granted a deduction of 10 per cent of the “approved remuneration”, whereas the deduction in practice was granted up to 20 per cent of the “approved remuneration”. This will no longer apply.

The requirement that an employment relationship must be present is still included in the revised section 11(*l*) which reads as follows:

> any amount contributed by a person that is an employer during the year of assessment for the benefit of any employee or former employee of the employer or for any dependant or nominee

> of a deceased employee or former employee to any pension fund, provident fund or retirement annuity fund in terms of the rules of that fund: Provided for the purposes of this paragraph a partner in a partnership must be deemed to be an employee of the partnership and a partnership must be deemed to be the employer of the partners in that partnership.

The unlimited deduction for retirement fund contributions provides an opportunity for those employers who want to contribute a lump sum amount to an employee's retirement fund (perhaps in lieu of paying higher remuneration to an employee) in order for them to attain a higher income replacement ratio on retirement.

National Treasury (2013c: 9) summarises the employer deductions as follows:

> In certain cases (particularly in respect of defined benefit funds) employer contributions are allocable in the fund to both current and retired employees. The employer deduction will be available regardless of whether the fund allocates the contribution to a current or a retired employee. However, no fringe benefit will arise in the case of an employer contribution allocable by a retirement fund to a retired member of the fund.

The revised section 11(*l*) refers to both current and former employees and dependants of deceased employees. This inclusion allows the employer to continue to contribute to former employees' retirement savings. Employers may use this deduction should they want to encourage early retirement for their employees (without prejudicing those employees who would lose valuable years of further saving for their retirement). Since the proposed section 11(*l*) deduction applies to dependants of deceased employees, it allows those dependants to be catered for by the employer should the employee die before reaching retirement age.

The increase in the deduction for employer contributions may be seen as a benefit for the employees (as their retirement savings will benefit from increased employer contributions) and for the employer (as there is an unlimited employer deduction). It is submitted that in proposing this increased deduction limit, National Treasury may have reasoned that an employer would not make excessive deductions for former employees or dependants of deceased employees, as it would not be economically feasible for the employer to make excessive contributions for employees who are no longer in employment.

With regard to the current section 11(*l*) provisions, National Treasury (2013c: 8) indicated the following:

> Unlike other "in kind" benefits, employer contributions to pension and provident funds do not form part of the taxable income of employees. In short, employer contributions to a pension fund or provident fund do not lead to fringe benefit taxation for employees (regardless of whether the employer is a taxable or tax-exempt entity).

Based on the current version of the Income Tax Act, employer contributions to pension and provident funds are a cost of employment to the employer, and these expenses are deducted in terms of section 11(*l*). There is no corresponding inclusion in the gross income of the employee for employer contributions. According to the special inclusion paragraph (i) of the gross income definition in section 1 of the Income Tax Act:

> The cash equivalent, as determined under the provisions of the Seventh Schedule, of the value during the year of assessment of any benefit or advantage granted in respect of employment or to the holder of any office, being a taxable benefit as defined in the said Schedule, and any amount required to be included in the taxpayer's income under section 8A.

Furthermore, the Seventh Schedule does not include employer contributions to pension, provident and retirement benefits within the taxable benefits framework, and does not provide a method to determine the cash equivalent of retirement fund benefits. The Seventh Schedule will be amended with effect from the date of implementation of the changes (possibly 1 March 2016 or 1 March 2017) to incorporate definitions of "defined benefit component", "defined contribution component" and "retirement-funding income", include employer contributions to pension, provident and retirement benefits, and provide for the valuation of contributions made by employers to certain retirement funds.

Even though the proposed section 11(*l*) does not specifically state that employer contributions to a retirement fund are a fringe benefit in terms of special inclusion (i) of the gross income definition, National Treasury (2013c: 10) clarifies the tax implications for an employee:

> In future, any contributions made to an approved South African retirement fund for the benefit of an employee-member will be taxed as a fringe benefit in the hands of the member. The value

of the fringe benefit for tax purposes will depend on whether the contributions are made to a defined benefit fund or a defined contribution fund.

a. If the contributions are made to a defined contribution fund, the contribution allocable to the employee will be includible as a taxable fringe benefit for that employee as the cash value of the contribution.
b. If the contributions are made to a defined benefit fund, the value of the fringe benefit will be determined through a special formula . . .

The proposed changes to the section 11(*l*) deduction may result in a small loss to the fiscus in the short run as employers may take advantage of the more generous deductions, however in the long run it will be beneficial to enable South Africans to achieve greater income stability in their retirement.

The example below illustrates the difference in the deduction provided for in the current and the proposed section 11(*l*). The section 11(*l*) deduction is available in respect of contributions on behalf of all employees in the company who are members of the fund. However, in order to illustrate the effect on one employee, the example shows a deduction that applies to a company with only one employee.

Table 9: Example comparing the current and proposed section 11(*l*) deduction

ABC Limited has one employee. The approved remuneration of this employee is R165 000 for the year. Employee A earns R13 750 per month, and in addition to the monthly salary ABC Limited has a policy of contributing the equivalent of one month's salary to each of a pension fund, provident fund and a retirement annuity fund.		
		R
Employer contributions:		
Current contribution to pension fund		13 750
Current contribution to provident fund		13 750
Current contribution to retirement annuity fund		13 750
Total employer contributions		41 250
	Current section 11(*l*) deduction	**Proposed section 11(*l*) deduction**
	R	**R**
Approved remuneration is R165 000 for the year. The section 11(*l*) deduction allows a deduction of 10% of approved remuneration. The Commissioner for the South African Revenue Services allows a deduction of up to 20% of approved remuneration. The section 11(*l*) deduction is as follows: 20% of R165 000 = R33 000, limited to the contributions that have been made to the employee's pension (R13 750) and provident (R13 750) fund. No section 11(*l*) deduction is available for employer contributions made to a retirement annuity fund.	(27 500)	
The proposed section 11(*l*) will allow the deduction of all the amounts that the employer contributed towards any pension, provident or retirement annuity fund. The proposed section 11(*l*) deduction will be:		(41 250)

Based on the above example, it can be seen that the employer deduction will be increased by R13 750 (R41 250 – R27 500) through using the proposed section 11(*l*) deduction. The proposed section 11(*l*) deduction is beneficial for the employer as a greater deduction can be claimed. In the above example there is no direct benefit to the employee's retirement savings as the same amount will be contributed by the employer irrespective of the section 11(*l*) deduction. The current section 11(*l*) allows a smaller deduction for the employer when contributing to the employee's retirement funds, and should the proposed section 11(*l*) apply, then the employer may be tempted to contribute a larger amount towards the employee's retirement funds, and this may result in a benefit to the employee's retirement savings as a larger contribution to retirement savings may be made.

4.2.2 SECTION 11(k) EMPLOYEE CONTRIBUTIONS TO PENSION FUNDS

The current section 11(k) deductions are only available for the employee contributions to a pension fund. This is clarified by National Treasury (2013c: 10):

> In the main, member taxpayers may claim a tax deduction up to a maximum of 7.5 per cent of "retirement-funding employment" income in respect of contributions to a pension fund, commonly referred to as "pensionable income".

With effect from the date of implementation of the changes (possibly 1 March 2016 or 1 March 2017), the section 11(k) deduction has been re-drafted to include an employee deduction for all retirement funds (pension, provident and retirement annuity funds). The proposed section 11(k) reads as follows:

> any amount contributed during a year of assessment to any pension fund, provident fund or retirement annuity fund in terms of the rules of that fund by a person that is a member of that fund: Provided that –
>
> (i) the total deduction to be allowed in terms of this paragraph must not in the year of assessment exceed the lesser of –
>
> (*aa*) R350 000; or
>
> (*bb*) 27,5 per cent of the higher of the person's –
>
> (A) remuneration (other than in respect of any retirement fund lump sum benefit, retirement lump sum withdrawal benefit and severance benefit) as defined in paragraph 1 of the Fourth Schedule; or
>
> (B) taxable income (other than in respect of any retirement fund lump sum benefit, retirement fund lump sum withdrawal benefit and severance benefit) as determined before allowing any deduction under this paragraph;
>
> (ii) for the purposes of this paragraph, any amount so contributed in the previous year of assessment which has been disallowed solely by reason of the fact that it exceeds the amount of the deduction allowable in respect of that year of assessment is deemed to

be an amount so contributed in the current year of assessment, except to the extent that the amount so contributed has been –

(*aa*) allowed as a deduction against income in any year of assessment;

(*bb*) accounted for under paragraph 5(1)(a) or 6 (1)(b)(i) of the Second Schedule, or;

(*cc*) exempted under section 10C;

(iii) for the purposes of this paragraph, any amount so contributed by an employer of the person for the benefit of the person must, to the extent that the amount has been included in the income of that person as a taxable benefit in terms of the Seventh Schedule, be deemed to have been contributed by that person; and

(iv) for the purposes of this paragraph, a partner in a partnership must be deemed to be an employee of the partnership and a partnership must be deemed to be the employer of the partners in a partnership.

The proposed section 11(k)(i) is explained by National Treasury (2013c: 10) as follows:

. . . deductible contributions will be subject to an annual percentage limit and a monetary limit.

1. **Percentage limit**: Deductions in respect of contributions made by the member will be allowed up to 27.5 per cent on the greater of "remuneration" or "taxable income" (excluding retirement lump sums). Potential reliance on taxable income means that self-employed individuals can make deductible contributions (or that formerly employed individuals can make individual contributions based on amounts above remuneration of earning income from other sources).

2. **Monetary limit**: No member may deduct contributions in excess of an annual limit of R350 000. This limit ensures that wealthy individuals do not receive excessive deductions (*vis-à-vis* lower income individuals who do not have the means to contribute much to these funds).

It is submitted that the proposed section 11(k)(i) deduction is more favourable than the current section 11(k)(i) deduction, however the monetary limit of R350 000 places a restriction on the deduction that high income earners may claim for their retirement savings. High income earners earning in excess of R1 272 727 (R350 000 divided by 27.5 per cent) will be discouraged from contributing an additional amount to achieve an adequate income replacement ratio on retirement. It is noted that the purpose of the retirement reform provisions is not to benefit high income earners, who would retire owning assets and probably earning income from these assets. National Treasury (2010: 7) states that "the government has long encouraged South Africans to save for their retirement through tax incentives when making retirement contributions. In particular the aim of these incentives is to encourage income-earners to save for their retirement so as to reduce their vulnerability in old age".

The proposed section 11(k)(i) increases the deductible retirement fund deduction to a much larger percentage and the maximum amount that can be deducted is higher. The simplification of the proposed section 11(k)(i) deduction has provided fairness and uniformity for the retirement fund deduction for all retirement vehicles.

The proposed section 11(k)(iii) refers to employer contributions that have been included in the employee's income as a taxable benefit in terms of the Seventh Schedule. With effect from the date of implementation of the changes (possibly 1 March 2016 or 1 March 2017), a new definition of "retirement-funding income" has been included in the Seventh Schedule:

> "**retirement-funding income**" means –
>
> *(a)* in relation to any employee or the holder of an office (including a member of a body of persons whether or not established by or in terms of any law) who in respect of his or her employment derives any income constituting remuneration as defined in paragraph 1 of the Fourth Schedule and who is a member of or, as an employee, contributes to a pension fund or provident fund established for the benefit of employees of the employer from whom such income is derived, that part of the employee's said income as is taken into account in the determination of the contributions made by the employer for the benefit of the employee to such pension fund or provident fund in terms of the rules of the fund; or
>
> *(b)* in relation to a partner in a partnership (other than a partner contemplated in paragraph (*a*)) that part of the partner's income from the partnership of the partner's share of the profits as is taken into account in the determination of the contributions made by the partnership for the benefit of the partner to a pension fund or provident fund in terms of the rules of the fund: Provided that for the purposes of this definition a partner in a partnership must be deemed to be an employee of the partnership and a partnership must be deemed to be the employer of the partners in that partnership.

The inclusion of the definition of retirement-funding income in the Seventh Schedule has the effect of including employer contributions to pension and provident funds in the employee's gross income in terms of paragraph (i). Employer contributions to retirement annuity funds on behalf of the employer have always been included in gross income in terms of paragraph (i) and paragraph 13 of the Seventh Schedule.

The proposed section 11(k)(ii) allows for excess contributions made to retirement funds to be deductible in future years. National Treasury (2013c: 9) states: "However, as per existing legislation so as to avoid double taxation, if any contributions have not been deducted as at retirement, the nominal value will be available to set off against any lump sum income prior to the tax calculation, or will be available at assessment to reduce the tax payable in respect of compulsory annuities."

As mentioned in section 4.2.1 above, the proposed introduction of section 11(k)(iii) will include employer contributions in the employee's gross income in terms of special inclusion paragraph (i) for fringe benefits. The employee deduction in terms of section 11(k)(i) is limited to R350 000 and should the employer contribute more than R350 000 towards an employee's retirement savings, then the employee will not be able to claim a deduction for his or her employer's contributions in excess of R350 000.

The proposed section 11(k)(iv) still maintains the status quo of classifying a partner in a partnership as an employee.

4.2.3 EMPLOYEE CONTRIBUTIONS TO PROVIDENT FUNDS

Under the current tax legislation, provident fund members may not claim a tax deduction in respect of their own contributions (leaving only a 20 per cent employer contribution). The proposed section 11(k) deduction is available for employees who contribute towards a provident fund. Previously, employer contributions were not taxed as fringe benefits, and now they are. This is an equitable position.

4.2.4 SECTION 11(n) RETIREMENT ANNUITY FUND CONTRIBUTIONS

National Treasury (2013c: 8) provides the background on retirement annuity funds and the current section 11(n) deduction:

> Retirement annuity funds largely exist for separate individuals seeking to fund their own retirement. These individuals may be utilising these funds as a supplement to their employer-provided retirement savings or these funds may act as the chief form of retirement savings in the

> case of the self-employed, partners in a partnership (or joint venture), or a form of simplified fund on behalf of multiple persons associated with a small business.
>
> Members making contributions to these funds are generally eligible to deduct amounts up to 15 per cent of "non-retirement-funding-income", commonly referred to as "non-pensionable income". "Non-pensionable income" in general amounts to the individual's total income less any "pensionable income" and allowable deductions. Employers making contributions to these funds on behalf of an employee-member may also deduct these contributions, but these contributions are added to the employee-member's income. This additional employee-member income may also be deductible (as part of the overall 15 per cent limit as if the employee contributed these sums directly).

With effect from the date of implementation of the changes (possibly 1 March 2016 or 1 March 2017), the section 11(n) deduction will be deleted from the Income Tax Act, as section 11(k)(i) will provide for the deduction.

The broadening of the proposed section 11(k) and 11(*l*) deductions will be beneficial to those individuals who are members of a retirement annuity fund, as employers will be granted a deduction for their contributions to employee retirement annuity funds, and self-employed and unemployed individuals will be allowed a greater deduction (the maximum of R350 000 or 27.5 per cent of taxable income). Furthermore, those individuals who have chosen to make arrear contributions to retirement annuity funds are currently allowed a deduction of up to R1 800 per annum, and the proposed section 11(k)(ii) will allow excess contributions to be deducted in future years based on a more generous deduction structure as discussed in section 4.2.2 above. Under both dispensations, accumulated contributions in excess of the maximum are deductible from the lump sum benefit paid out on retirement, severance or death, in terms of paragraph 5(1)(a) of the Second Schedule to the Income Tax Act.

4.2.5 UNIFORM RETIREMENT CONTRIBUTION MODEL

Owing to the proposed section 11(k) deduction the disparity that existed between contributions to pension, provident and retirement annuity fund vehicles has been eliminated. The proposed changes to section 11(*l*) and 11(k) deductions give rise to a uniform retirement contribution model. The following example illustrates the effect of the taxable income on an employee using the existing tax incentives and the proposed tax incentives as they relate to section 11(k):

Table 10: Example comparing the current and proposed section 11(k) deduction

ABC Limited has one employee. The approved remuneration of this employee is R165 000 for the year. Employee A earns R13 750 per month, and in addition to the monthly salary that the employee earns ABC Limited has a policy of contributing the equivalent of one month of an employee's salary to each of a pension fund, provident fund and a retirement annuity fund. The employee does not make any contribution to a pension, provident or retirement annuity fund. Employee A does not earn any other income other than his salary.		
	Current section 11(k) and section 11(n) deduction	**Proposed section 11(k) deduction**
	R	**R**
Employee's salary (R13 750 x 12 months)	165 000	165 000
Employer's pension fund contribution (current legislation: not included in paragraph (i) of gross income; proposed legislation: included in "retirement-funding income" under the proposed changes at the date of implementation of the changes)	-	13 750
Employer's provident fund contribution (current legislation: not included in paragraph (i) of gross income; proposed legislation: included in "retirement-funding income" under the proposed changes with effect from the date of implementation of the changes)	-	13 750
Employer's retirement annuity fund contribution (current legislation: included in paragraph (i) of gross income as payment of an employee's debt under the current legislation and proposed legislation and included in "retirement-funding income" under the proposed changes with effect from the date of implementation of the changes)	13 750	13 750
Gross income	178 750	206 250
Less: exempt income	-	-
Income	178 750	206 250

Less: section 11(k) deductions Current legislation (no deduction since no employee contribution) Proposed legislation: Total contributions made (R13 750 (pension fund) + R13 750 (provident fund) + R13 750 (retirement annuity fund) = R41 250) Total deduction must not exceed the lesser of: - R350 000 - 27.5 per cent of remuneration of R206 250 = R56 719 The deduction will be R56 719, but limited to the actual contributions made of R41 250	-	(41 250)
Current legislation: section 11(n) retirement annuity fund contributions of R13 750 are limited to a deduction the greater of: - 15% of non-retirement funding employment income (RNil since the employee does not earn non-retirement funding employment income) - R3 500 less RNil (since the employee does not contribute towards the pension fund (as shown above)) - R1 750 Note: the unclaimed portion of the retirement annuity fund contributions of R10 250 (R13 750 – R3 500) is carried forward and set-off against the taxable portion of the retirement lump sum benefit) Proposed legislation: section 11(n) will have been withdrawn, so no deduction in terms of this section will be available. The deduction for the retirement annuity fund contributions is catered for in terms of the proposed section 11(k) deduction.	(3 500)	-
Taxable income	175 250	165 000

Based on the above example, it is noted that the employee will enjoy a greater deduction of his or her retirement funding under the proposed section 11(k), and this will have the effect of reducing the employee's taxable income. The proposed changes have the effect of reducing the taxable income of the employee, while their retirement fund contributions remain the same. The "saving" in taxable income may translate into increased retirement savings, but this is not certain.

4.3 ACCELERATED DEDUCTIONS AVAILABLE FOR OVER 45-YEAR OLDS

National Treasury (2012f: 13) proposed the following:

> Employer contributions to all types of funds will be included in the employee's remuneration as a fringe benefit, but individuals will be permitted a deduction of up to 22.5 per cent of their income if they are under 45 and 27.5 per cent if they are 45 and above. This will apply to both employer and employee contributions.

The rationale behind the accelerated deduction for over 45-year olds is explained by National Treasury (2012e: 9):

> Economists use a basic framework, the Life Cycle/Permanent Income Hypothesis, to understand individual savings across people's lives. The hypothesis states that because people prefer smooth consumption, though with fluctuating incomes, they choose to spend a constant proportion of their lifetime income, borrowing when actual income is below this level, and saving when it is higher.
>
> Typically, incomes are low when people are young, higher in middle age and low again when individuals retire and move out of the labour market. The lifecycle hypothesis predicts that the average tendency to consume out of income is greater for both young and aging individuals, since the young borrow against future income (often to buy homes), and the old use accumulated savings to finance consumption, thus reducing their pensions. Middle-aged people have a greater propensity to save and a lower propensity to consume out of income.

The rationale behind the accelerated deduction for over-45 year olds was to encourage those individuals to increase their retirement savings when they have more disposable income. It was considered that over-45 year olds will have a larger disposable income that could be channelled into increasing their retirement savings. It is submitted that it is more beneficial to save smaller amounts over a longer period of time. Kennon (2014) states:

> Albert Einstein once noted that the most powerful force in the universe was the principle of compounding. In investing, this manifests itself through something called compound interest. Put in its simplest terms, the phrase compound interest means that you begin to earn interest income *on* interest income, resulting in your money growing at an ever-accelerating rate.

It is noted that this progressive deduction based on age has not been included in the proposed section 11(k) deduction. Possibly this can be linked to the fact that one of the other proposed changes to retirement reform relates to the removal of age discrimination from retirement benefits (discussed in section 4.6 below). National Treasury must have decided that the accelerated deduction for over-45 year olds would not be consistent with the uniform deductions that are proposed for all retirement vehicles.

4.4 CAPPING OF MAXIMUM DEDUCTIONS AVAILABLE AGAINST RETIREMENT SAVINGS

National Treasury (2012f: 14) further proposed:

> To improve equity in the tax system, and to enable lower income individuals and those with variable incomes to contribute more, it is proposed that the maximum permitted deduction will be greater than R20 000 and less than R250 000 (R300 000 for those of 45 [years old] and above), regardless of income. The higher limits for older workers make allowance for those who did not save earlier in their lives.

As indicated in section 4.3 above, the proposed section 11(k) deduction does not cater for age discrimination and as a result all individuals (irrespective of their age) are subject to the same maximum deduction of the lesser of R350 000 or 27.5 per cent of taxable income.

National Treasury (2012c: 4) indicated the need for a monetary cap on retirement saving contributions:

> Further, the tax exemption has no nominal monetary cap in the case of higher income employees, allowing them to make tax-exempt contributions way in excess of the amount required to maintain a reasonable standard of living in retirement.
>
> . . .

> The effect of caps on national savings . . . was raised. It is found that since relatively few individuals contribute above the proposed caps, there were unlikely to be any significant effects.

It appears that National Treasury has considered the R350 000 cap carefully and concluded that the cap is reasonable. It is submitted that National Treasury should revisit this cap of R350 000 each year to determine whether the monetary cap is reasonable or whether it should be increased to cater for inflation.

4.5 MINIMUM MONETARY DEDUCTION OF R20 000 FOR LOW-INCOME EARNERS WHO CONTRIBUTE IN EXCESS OF PERCENTAGE LIMITS

National Treasury (2012c: 4) indicated the need to incentivise those low-income individuals to contribute as much as possible to their retirement savings:

> A minimum monetary deduction of R20 000 will apply to allow low-income earners to contribute in excess of the above percentage limits (*22.5 per cent for under 45 year-olds and 27.5 per cent for 45-year olds and above*).

This minimum deduction of R20 000 was considered by National Treasury, but it was not incorporated into the proposed section 11(k) deduction (which takes effect from the date of implementation of the changes (possibly 1 March 2016 or 1 March 2017). One reason for not implementing this change may be that low-income earners may not be able to afford to save R20 000 towards their retirement savings. The R20 000 minimum deduction may be introduced at a later date.

4.6 REMOVAL OF AGE DISCRIMINATION FROM RETIREMENT FUNDS

The definitions of "retirement date" and "normal retirement age" were set out in section 2.7 of chapter 2. Normal retirement age refers to the date on which a member of a pension or provident fund is entitled to retire in terms of the rules of the fund, or in the case of a retirement annuity fund where the member reaches 55 years of age, or where a member of a retirement fund is incapacitated through infirmity of mind or body.

The age caps on pension and provident funds result in employee-members being unable to make further contributions to their pension and provident funds after they have reached normal retirement age. Fin24 (2013) indicates that members may only withdraw retirement annuity funds once they are 55 years old (or are incapacitated through infirmity of mind or body). Previously, the maximum contribution age for a retirement annuity fund was 70 years old. However, in 2008 the rules for retirement annuity funds changed and this had the effect of removing the upper age limit for contributions to a retirement annuity fund.

National Treasury (2013a: 3) states:

> Any biases in retirement funds which discourage individuals from working past the retirement age of their funds will be identified and removed.

It appears that it is still National Treasury's intention to remove the member-contribution age discrimination limits for pension and provident funds. However, these proposed changes have not been effected in the *Explanatory Memorandum on the Taxation Laws Amendment Bill, 2013* (National Treasury, 2013c). The rules of the funds are applicable and an amendment to the Income Tax Act cannot achieve this. It is hoped that the age discrimination will be addressed in the future.

4.7 ROLLOVER DISPENSATION FOR ARREAR CONTRIBUTIONS MADE TO ALL RETIREMENT VEHICLES

National Treasury (2004: 35) states the following:

> The revenue authorities currently require that the contribution paid by a member must be fixed in terms of the rules for the category of membership to which the person belongs. Variable contribution rates are not permitted. This constrains the payment of additional contributions by members to enhance their retirement savings.

National Treasury (2012c: 4) addresses this drawback as follows:

> A rollover dispensation similar to the one currently applying to retirement annuity contributions will be adopted to allow flexibility for those with fluctuating incomes.

National Treasury was referring to the current section 11(n)(i)(*bb*) arrear contribution deduction of R1 800 for individuals who belong to a retirement annuity fund. The current section 11(n) will be withdrawn from the Income Tax Act, and will be replaced by the proposed section 11(k)(ii) deduction. This deduction reads as follows:

> for the purposes of this paragraph, any amount so contributed in any previous year of assessment which has been disallowed solely by reason of the fact that it exceeds the amount of the deduction allowable in respect of that year of assessment is deemed to be an amount so contributed in the current year of assessment, except to the extent that the amount so contributed has been –
>
> (*aa*) allowed as a deduction against income in any year of assessment;
>
> (*bb*) accounted for under paragraph 5(1)(*a*) or 6 (1)(b)(i) of the Second Schedule; or
>
> (*cc*) exempted under section 10C . . .

The proposed section 11(k)(ii) deduction that will be effective from the date of implementation of the changes (possibly 1 March 2016 or 1 March 2017) allows a deduction for arrear contributions to all retirement vehicles. This proposed amendment to section 11(k)(ii) allows a uniform deduction for arrear contributions made to all retirement vehicles.

4.8 ALIGNMENT WITH THE OECD ROADMAP: INCENTIVES TO SAVE FOR RETIREMENT

The OECD roadmap for the good design of defined contribution pension plans (OECD: 2012) makes two recommendations with which the National Treasury retirement reforms that have been discussed in this chapter are in alignment.

One of the OECD (2012: 1) recommendations is as follows:

> **Encourage people to enrol, to contribute and contribute for long periods**. Where mandatory enrolment is not considered opportune, mechanisms such as automatic enrolment, with the possibility for individuals to opt out, are particularly useful, together with setting adequate default contribution rates. Making sure people contribute for long periods with sufficiently high contribution rates is the most effective way to improve their chances of obtaining an adequate replacement ratio from DC [defined contribution] pension plans. This goal needs to be complemented with "work longer" policies.

The National Treasury retirement reform does not mirror exactly the goal outlined in *The OECD roadmap for the good design of defined contribution pension plans* (OECD: 2012). No recommendation is made regarding automatic enrolment, but most employment contracts make membership of a retirement fund mandatory. The proposal to remove age discrimination from retirement funds (discussed in section 4.6 above) does encourage individuals to contribute to retirement funds for a longer period.

A further recommendation made by the OECD (2012: 1) is as follows:

> **Improve the design of incentives to save for retirement, particularly where participation and contributions to DC [defined contributions] pension plans are voluntary**. An appropriate structure of incentives (including financial subsidies for those who pay low or no income taxes) and/or matching contributions can both be efficient mechanisms to encourage participation and increase contributions.

Chapter 3 set out the current tax incentives that are available across different retirement vehicles. It was noted that there was non-uniformity of deductions across retirement vehicles. This chapter discussed the proposed changes to the tax incentives, and how these proposed changes allow for uniformity of deductions irrespective of the retirement vehicle used. The fact that tax incentives will be uniform across all retirement vehicles with effect from the date of implementation of the changes (possibly 1 March 2016 or 1 March 2017) is a design incentive and may result in individuals increasing their retirement contributions.

The OECD roadmap for the good design of defined contribution pension plans (OECD: 2012) recommendations and the National Treasury retirement reform proposals are not identical, but there are certain similarities.

4.9 CONCLUSION

This chapter discussed the harmonisation of the proposed retirement savings deductions that have been proposed as amendments to the Income Tax Act with effect from the date of implementation of the changes. Retirement fund deductions for both the employer (in terms of the proposed section 11(*l*) deduction) and the employee (in terms of the proposed section 11(k) deduction) have aimed to provide uniform deductions across all retirement vehicles.

There are still a number of proposals that were raised in the *Retirement Fund Reform: a discussion paper* (National Treasury: 2004) that have not yet been adopted. The accelerated retirement fund deductions for those individuals who are over 45 years of age have not been addressed. It is submitted that this accelerated allowance will in all likelihood not be introduced as it lends itself to age discrimination, which is one of the aspects that the retirement reform aims to remove. The proposed section 11(k) caps the maximum contribution to retirement annuity funds at R350 000 per annum. The National Treasury proposal was to allow a minimum monetary deduction of R20 000 per annum for those individuals who are low-income earners and who contribute towards retirement savings in excess of the percentage limits. This R20 000 minimum monetary deduction has not been addressed in the proposed changes to the Income Tax Act. The proposed amendment to the "retirement date" and "normal retirement age" has not yet been addressed. During 2008, retirement annuity funds removed the upper age limit of 70 years for contributions to a retirement annuity fund. However, no changes to the age limits have been made to the Income Tax Act for pension and provident funds. It is submitted that this will be addressed at a later stage. The proposed section 11(k)(iii) allows arrear contributions to be made to all retirement funds and this has had the effect of providing members of retirement funds with an incentive to make arrear contributions.

Finally, there are similarities between *The OECD roadmap for the good design of defined contribution pension plans* (OECD: 2012) and the South African National Treasury retirement reforms. The main similarity is the alignment and parity of tax deductions for contributions made to all retirement vehicles. These changes have been proposed in terms of section 11(*l*) employer contributions and section 11(k) for pension, provident and retirement annuity fund contributions which will become effective from the date of implementation of the changes (possibly 1 March 2016 or 1 March 2017). *The OECD roadmap for the good design of defined contribution pension plans* (OECD: 2012) proposes improving incentives to save for retirement. The proposed amendments to section 11(*l*) and section 11(k) allow uniform tax deductions across all retirement funds, and this is in agreement with *The OECD roadmap for the good design of defined contribution pension plans* (OECD: 2012) guidelines.

The next chapter will discuss the proposed limitations on pre-retirement withdrawals. One of the reasons that individuals may not have an adequate income replacement ratio on retirement is owing to withdrawals that are made from pension and provident funds when individuals change their employment. National Treasury (2012e) has provided guidelines on the limitation of pre-retirement withdrawals, but these guidelines have not yet been enacted and are still under discussion by various stakeholders.

CHAPTER 5: LIMITATION OF PRE-RETIREMENT WITHDRAWALS

5.1 INTRODUCTION

The goal of this research is to determine whether retirement reform mechanisms outlined by National Treasury will encourage individual retirement savings. One of the sub-goals of this research is to review the proposed changes that have been tabled by National Treasury to achieve retirement reform. Chapter 3 of this research outlined the current taxation incentives and disincentives available to individuals who are saving for their retirement. It was noted that tax deductions available are not uniform across all retirement vehicles. Chapter 4 of this research outlined the changes that National Treasury has proposed in order to ensure uniform tax deductions for retirement savings across all retirement vehicles. Chapters 3 and 4 focussed on the accumulation phase of retirement savings. It is submitted that National Treasury will have achieved parity with regard to tax deductions in the accumulation phase of retirement savings once these changes are effected from the date of implementation of the changes (possibly 1 March 2016 or 1 March 2017).

The changes proposed by National Treasury which encourage uniform tax incentives for the accumulation phase of retirement savings are to be commended. However, these changes will not benefit those individuals who are saving for their retirement and who then withdraw their retirement savings prematurely (known as "pre-retirement leakage").

National Treasury (2004: 38) discussed pre-retirement leakage:

> 3.9 **Leakage**
>
> 3.9.1 An analysis of benefit payments and anecdotal evidence strongly suggests that the primary causes of poverty in old age, of people who have worked in the formal sector throughout their careers and who have been a member of one or other occupational or individual retirement fund, are:
>
> 3.9.1.1 the failure of many retirement funds in the past to pay adequate early withdrawal benefits; and
>
> 3.9.1.2 the drawing of benefits in cash when changing jobs and the failure to invest this money for their retirement.

> Such leakage from the retirement funding system has detrimental effects on the replacement ratio on retirement.

National Treasury has issued a paper that deals with the *Preservation, portability and governance for retirement funds* (National Treasury: 2012e). National Treasury (2012e: 7) is considering the following:

> . . . a system of portability and various options to increase the rate of preservation and reduce pre-retirement leakages (i.e. pension funds diminishing before retirement) and therefore enhance retirement savings. Preservation keeps intact pension and other retirement savings. Portability enables employees changing jobs to transfer accumulated pension benefits to the prospective employer's plan or to a preservation fund, or to leave retirement savings with their former employer.

National Treasury is not in a position to correct the past, and therefore pre-retirement leakages that have already occurred cannot be reversed. However, National Treasury is in a position to influence the accessibility of benefits of pre-retirement withdrawals in the future. This chapter will discuss the proposals made by National Treasury to discourage individuals from accessing their retirement savings prematurely.

5.2 DISPARITY BETWEEN WITHDRAWALS FROM THE DIFFERENT RETIREMENT VEHICLES

In chapter 3 (section 3.6) it was noted that there was disparity between deductions for pension, provident and retirement annuity funds. Chapter 4 outlined the changes that have been proposed to section 11(*l*) and section 11(k) of the Income Tax Act which will result in a uniform deduction across all retirement vehicles.

Not only is there disparity in deductions across the retirement vehicles (which is being addressed with effect from the date of implementation of the changes (possibly 1 March 2016 or 1 March 2017), but there is also disparity in pre-retirement withdrawals between the different retirement vehicles. National Treasury (2012e: 15) has produced the following table outlining the differences between pre-retirement withdrawals in the different retirement vehicles:

Table 11: Differences between pre-retirement withdrawals in the different retirement vehicles

Retirement vehicle	**Pre-retirement withdrawal rules**
Retirement annuity fund	Before age 55, all retirement benefits must be preserved.
Pension fund	Before retirement, funds can be accessed when members change jobs, are retrenched, or in the case of divorce order. Members may also borrow, either from the fund or using the fund as collateral, to purchase a house.
Provident fund	Before retirement, funds can be accessed when members change jobs, are retrenched, or in the case of divorce order. Members may also borrow, either from the fund or using the fund as collateral, to purchase a house.
Preservation fund (applicable to both pension and provident funds)	Individuals are permitted one cash withdrawal pre-retirement. Exceptions are if this is not permitted by the prior Fund rules, or if a prior withdrawal was made (such as in the case of a divorce order).

Based on the above table, it is noted that compulsory preservation only applies to retirement annuity funds. All other retirement vehicles (pension, provident, and pension and provident preservation funds) allow members to access their retirement savings should certain conditions be met.

National Treasury has recognised the disparity that exists between accessing retirement savings from the different retirement vehicles. The section below discusses National Treasury's position on preserving retirement savings and the rest of the chapter outlines the different options that National Treasury is considering for the preservation of retirement savings.

5.3 PRE-RETIREMENT WITHDRAWALS

When National Treasury (2004) issued its *Retirement Fund Reform: a discussion paper*, its main focus was to discourage leakage by forcing preservation of retirement benefits. National Treasury (2012e) states that mandatory preservation is very common throughout the world, particularly in countries such as Australia, Chile, Switzerland and Germany. National Treasury (2004: 39) made the following recommendations for employees who changed jobs and ceased to be eligible to belong to their old retirement fund:

> The benefit payable from the old retirement fund must not be available in cash but must be transferred to the employee's new occupational retirement fund, an individual retirement fund of the employee's choice, or the National Savings Fund, with the choice of transferee fund being made by the member.
>
> . . .
>
> If the member has not informed the old retirement fund of his/her election of receiving fund within a reasonable period, the old retirement fund may transfer the money to an individual retirement fund selected by the board of trustees of the old retirement fund and inform the member accordingly. [As the member has the option to transfer between individual retirement funds without charge, the member may move this money at any time thereafter.]
>
> . . .
>
> The whole, or portion, of the benefit may be paid in cash under one, or both, of the following circumstances:
>
> (a) where the amount involved is lower than a minimum amount determined by the regulator; and/or
>
> (b) where the fund has guaranteed a member's housing loan, and the member defaults, in which case the retirement fund must pay as much as possible of the outstanding loan (after the deduction of tax), and pay any residual amount (after the deduction of tax, if appropriate) to the National Savings Fund on behalf of the member.

The taxation of retirement lump sum withdrawal benefits (referred to as pre-retirement withdrawals or pre-retirement leakage) was discussed in section 3.9 of chapter 3. Based on the current legislation, certain tax disincentives exist for those individuals who, on withdrawing from the fund, access their retirement savings in excess of R22 500. However, these disincentives are not a strong enough deterrent for those individuals who prematurely access their retirement savings. National Treasury (2012e: 3) outlined the importance of retirement fund preservation:

> Retirement savings, for the average worker, are the single largest source of income post retirement. However, rates of preservation are very low. Cashing out accumulated retirement savings prematurely erodes security in old age, undermines the alleviation of chronic poverty and increases reliance on others. This paper proposes various options to increase rates of

> preservation in recognition of the need to protect retirement savings from being misused due to lack of foresight and long term planning when members leave employers prior to retirement, or when a non-member spouses receive cash pay-outs at the instance of divorce order settlements.

5.4 PROSPECTIVE RESTRICTION OF PRE-RETIREMENT WITHDRAWALS

Between 2004 and 2012, National Treasury engaged with a number of stakeholders and as a result changed some of its initial thinking regarding preservation of pre-retirement withdrawals. National Treasury softened its approach of not allowing any pre-retirement withdrawals, and this is indicated by National Treasury (2012e: 16):

> The 2012 Budget moots the introduction of preservation. Preservation would be triggered when pension and provident fund members leave their funds by changing jobs. To lessen the impact on current workers who may view their retirement savings as precautionary or medium-term consumption smoothing, and to prevent any short-term disruption to retirement savings, vested rights of workers will be protected.
>
> There is no intention to alter the provisions that currently allow individuals to borrow from their retirement funds or to use them as collateral for a loan that they might use to buy a house.

National Treasury supports the view that proposed changes to pre-retirement withdrawals may not be back-dated, and this means that on the date of implementation of the legislation, all balances accrued in retirement funds will be subject to the current rules of the retirement fund. National Treasury (2102e: 16) states:

> This will apply regardless of whether these balances remain in the current fund, or are transferred to new occupational funds. This means that existing employees changing jobs will thus have access to the nominal value of retirement savings accumulated on the date of implementation of the legislation.
>
> However, growth on these assets, new contributions by existing members and contributions of new members will be subject to the new dispensation. A number of options are presented for further consultation with key stakeholders on the treatment of these contributions and growth.

Based on the guidance provided by National Treasury, once legislation has been passed, pre-retirement withdrawals on new contributions and growth in the fund will be limited and new entrants will not be able to make pre-retirement withdrawals.

Although National Treasury initially contemplated mandatory preservation of retirement savings, it is clear that after consultation with various stakeholders it was recognised that there might be a need to allow access to accumulated retirement savings in certain limited instances. This is particularly important for South Africa, where a social safety net is not yet in place for formally employed middle-income employees.

National Treasury (2012e: 17) provides the reasoning for the non-mandatory preservation of retirement savings:

> Leakage is particularly difficult to address given the South African economy's structural problems. South Africa has a high unemployment rate, at present 25.2 per cent if narrowly defined. Unemployment benefits through the Unemployment Insurance Fund (UIF) are restricted to those previously employed, and are payable for up to eight months only. Consequently, the retrenched typically rely on pension funds to survive until they find another job. A withdrawal mechanism could still apply to retrenched individuals, who will be allowed to withdraw sufficient funds. This provision could be extended to pre-retirement access to savings in retirement annuity and preservation funds.

National Treasury recognises the need for all pension funds to create a preservation portion within the fund and, as the default option, transfer funds to a preservation fund when a member leaves employment, unless the member has indicated otherwise (for example, to withdraw their pension in cash). National Treasury proposes that members who opt to withdraw funds should be required first to seek advice.

5.5 REQUIREMENTS APPLIED TO A PRE-RETIREMENT WITHDRAWAL

Based on the unique economic situation that South Africa finds itself in, National Treasury has proposed a number of options to allow access to retirement funding savings prospectively. These options will only be available prospectively for new employees, new contributions and growth on existing retirement savings. National Treasury is considering five different approaches to prospective pre-retirement withdrawals:

1. Full withdrawal with an adjusted tax threshold

   This option entails allowing full access to funds when leaving employment, however a tax will be levied on a withdrawal in excess of a certain amount. This tax should act as a disincentive for pre-retirement withdrawals. It is submitted that this will maintain the status quo of the current pre-retirement withdrawals, and defeats the purpose of mandatory preservation. The only difference to the current pre-retirement withdrawal is that the taxation rate may be set at a higher rate than those currently reflected on the retirement withdrawal benefit tables discussed in chapter 3 (section 3.9).

2. Three-to-five year default monitoring period

   National Treasury could adopt a "wait-and-see" approach and obtain information on the "take-up" by individuals of pre-retirement withdrawals under the proposed tax changes which would have been implemented in terms of option 1 discussed above. National Treasury will only allow the full withdrawal after an individual has sought advice. The monitoring period requires a stricter approach, which could include implementing new legislation should there be no noticeable change in behaviour through increased preservation. It is submitted that the three-to-five year default monitoring period may not be a robust way of determining the effect on retirement saving preservation because the "take-up" of pre-retirement withdrawals may be affected by the state of the economy of South Africa.

3. Partial withdrawal

   The partial withdrawal option will entail the member of the retirement vehicle being able to withdraw up to one-third of the value of their retirement savings as a lump sum before they reach retirement age. The non-withdrawn portion will remain in the retirement savings and will be preserved. The withdrawal will be subject to the retirement withdrawal benefit tax tables. The benefit of the partial withdrawal is that the whole amount will not be withdrawn by the member. The drawback of the partial withdrawal is that it will erode certain of the member's retirement savings which may result in them not achieving an adequate income replacement ratio upon their retirement.

4. A maximum income per month

   This option will allow a member to withdraw a certain amount each month should the member be unable to find new employment. National Treasury had indicated that possible withdrawal amounts will be the lesser of R5 000 or three per cent of the fund's accumulated balance per month. This maximum income per month option is still a pre-retirement withdrawal, and therefore the same result as with option 3 above will occur – the member will erode their retirement savings.

5. Full preservation

   The last option for retirement withdrawals identified by National Treasury is still the most robust option that will result in full preservation of retirement savings and members will only be allowed to access their retirement savings upon their retirement. This is not an unusual approach as mandatory preservation is recommended in other parts of the world.

National Treasury invited comments from various stakeholders on the five different approaches to prospective pre-retirement withdrawals and reported on these comments in *2013 Retirement reform proposals for further consultation* (National Treasury, 2013a).

Based on the comments received, National Treasury (2103a: 4) reported that most commentators "agreed that the current system of paying cash withdrawal benefits virtually automatically when individuals leave employment is inappropriate. Yet few commentators supported the option of full preservation". National Treasury has noted that unemployed individuals may have difficulty in finding and retaining full-time employment and by imposing mandatory preservation individuals could be placed under financial distress should they be unable to access their retirement savings. It has been proposed that individuals may only access their retirement savings once they have depleted their unemployment insurance fund benefits and have obtained financial advice about the long-term effects of pre-retirement withdrawals. National Treasury has proposed that the rules on preservation will all change on a particular day, to be determined by legislation. This day will be called P-day. It is anticipated that P-day will occur during or after 2015.

National Treasury (2013a: 5) outlines the main elements of its proposal as follows:

- Vested rights will be protected on the balance that individuals have in their pension or provident fund on P-day, including growth on the balance up to the date when they leave the fund. Individuals will be able to access this amount, in cash, at any time after they leave the fund.

- From P-day, other than the *de minimis* provision (currently R75 000, which will be increased to R150 000 with effect from the date of implementation of the changes (possibly 1 March 2016 or 1 March 2017)), pension and provident funds will not be permitted to pay cash withdrawal benefits to any member who withdraws from the fund before retirement. This will prevent individuals from redeeming their retirement funds when they change their employment. Furthermore, individuals must have their entire balance paid either into a preservation fund or into their new employer's fund. This requirement will apply to all benefits, including those to which vested rights apply. To prevent tax arbitrage, benefits may not be split, so the member's entire balance must be paid into a single fund.

- On P-day, the rules on preservation funds will change. The restriction on the maximum number of withdrawals will be removed. At any time, individuals will be able to withdraw each year the greater of the state old age grant or 10 per cent of their initial deposit, excluding any portion to which vested rights apply. Any unused withdrawals may be carried forward, but to reduce administrative costs, individuals will be limited to one withdrawal per calendar year or part thereof.

- For individuals who are members of preservation funds on P-day, their initial deposit will be deemed to be equal to the value of their preservation fund on P-day, and vested rights will apply to this amount if they have not used their single withdrawal. If they have used their single withdrawal, vested rights will not apply.

- Consideration will be given to relaxing the preservation requirements of retirement annuity funds by allowing members to transfer their balances to preservation funds, under certain conditions aimed at preventing tax arbitrage. These conditions may include preventing individuals who have transferred funds out of a retirement annuity fund from re-joining that fund, or alternatively from receiving a tax deduction in respect of any retirement annuity fund contributions, for a period. National Treasury has not finalised its stance on retirement annuity funds, and has invited further comments from stakeholders. It is submitted that parity of preservation should be applied across all retirement funds. This would be in alignment with the proposed uniform retirement contribution model discussed in chapter 4 (section 4.2.5).

5.6 EXAMPLES OF THE APPLICATION OF PRE-RETIREMENT WITHDRAWALS

National Treasury (2013a: 5) provides examples of how they envisage pre-retirement preservation guidelines to work in practice. Two examples will be explained below.

EXAMPLE 1

This example illustrates how an existing member of a provident fund will be affected by the P-day proposals. A is a member of a provident fund. His balance on P-day is R400 000. The next day he resigns from his job. His balance of R400 000 is transferred to a provident preservation fund.

Table 12: Example illustrating how an existing member of a provident fund will be effected by the P-day proposals

Date	Balance *	Greater of old age grant or 10 per cent of the value of the fund *	Cumulative permitted maximum withdrawal	Actual withdrawal	Cumulative actual withdrawals	Unused withdrawals	Balance after withdrawal
	Column 1	Column 2	Column 3 (column 3 in the previous year + column 2 in the current year)	Column 4	Column 5 (column 5 in previous year + column 4 in current year)	Column 6 (column 6 in previous year + column 2 in current year – column 4 in the current year)	Column 7 (column 1 in the current year – column 4 in the current year)
P-day (leaves employment)	400 000	15 000	415 000	-	-	415 000	400 000
+ 1 year	450 000	16 000	431 000	-	-	431 000	450 000
+ 2 years	500 000	17 000	448 000	-	-	448 000	500 000
+ 3 years	500 000	18 000	466 000	-	-	466 000	500 000
+ 4 years	600 000	19 000	485 000	(485 000)	(485 000)	-	115 000
+ 5 years	140 000	20 000	505 000	-	(485 000)	20 000	140 000
+ 6 years	160 000	21 000	526 000	-	(485 000)	41 000	160 000
+ 7 years	150 000	22 000	548 000	(25 000)	(510 000)	38 000	125 000
* These values are illustrative and not intended to be indicative of future policy or market performance.							

EXAMPLE 2

This example illustrates how a member of a provident fund will be affected should he join a provident fund after P-day. B starts working (after P-day) and after five years he has accumulated R100 000 in a provident fund. Each year up to five years, his balance has grown by the amount of the old age grant.

After six years, his provident fund balance has grown to R130 000 and after seven years his provident fund balance has grown to R169 000.

He leaves his job, and transfers his fund to his new employer's fund. He leaves that job too, and his R200 000 is transferred to a preservation fund. At that point the old age grant is R23 000 per year.

Since he has no vested rights, in the eighth year he may withdraw the greater of R23 000 or 10 per cent of R200 000, which is R20 000. He cannot find another job, so he withdraws the R23 000 immediately. This leaves R177 000 in the preservation fund.

A year later this has grown to R190 000. The old age grant is R24 000 per year. He withdraws R24 000, leaving R166 000 in his account.

A year later this has grown to R185 000, and the old age grant is R25 000 per year. He withdraws R25 000, leaving R160 000 in his account. He finds another job, and makes no further withdrawals until four years later, when he chooses to withdraw the maximum permitted of R243 000 (but limited to the amount in his retirement savings).

Table 13: Example illustrating how a member of a provident fund will be affected should he join a provident fund after P-day

Date	Balance *	Greater of old age grant or 10 per cent of the value of the fund *	Cumulative permitted maximum withdrawal	Actual withdrawal	Cumulative actual withdrawals	Unused withdrawals	Balance after withdrawal
	Column 1	Column 2	Column 3 (column 3 in previous year + column 2 in current year)	Column 4	Column 5 (column 5 in previous year + column 4 in current year)	Column 6 (column 6 in previous year + column 2 in current year – column 4)	Column 7 (column 1 in the current year – column 4 in the current year)
P-day (starts employment)	-	-	-	-	-	-	-
+ 1 year	16 000	16 000	16 000	-	-	16 000	16 000
+ 2 years	33 000	17 000	33 000	-	-	33 000	33 000
+ 3 years	51 000	18 000	51 000	-	-	51 000	51 000
+ 4 years	70 000	19 000	70 000	-	-	70 000	70 000
+ 5 years	100 000	20 000	90 000	-	-	90 000	100 000
+ 6 years	130 000	21 000	111 000	-	-	111 000	130 000
+ 7 years	169 000	22 000	133 000	-	-	133 000	169 000
+ 8 years	200 000	23 000	156 000	(23 000)	(23 000)	133 000	177 000
+ 9 years	190 000	24 000	180 000	(24 000)	(47 000)	133 000	166 000
+ 10 years	185 000	25 000	205 000	(25 000)	(72 000)	133 000	160 000
+ 11 years	158 000	26 000	231 000	-	(72 000)	159 000	158 000
+ 12 years	170 000	27 000	258 000	-	(72 000)	186 000	170 000
+ 13 years	190 000	28 000	286 000	-	(72 000)	214 000	190 000
+ 14 years	200 000	29 000	315 000	(200 000)	(182 000)	43 000[1]	-
* These values are illustrative and not intended to be indicative of future policy or market performance.							

[1] Even though R43 000 is still available as an unused withdrawal, the member may not withdraw more than the balance in the fund. The unused portion is carried forward to later years should the member contribute more retirement savings to the fund.

Comments on example 2:

National Treasury has not issued guidelines on the earliest time when a retirement withdrawal should commence. However, the annual retirement withdrawal is limited to the greater of the old age grant or 10 per cent of the value of the fund. From the above example, it is noted that when an employee commences working, the growth of retirement savings in the formative years is slow because buy-in costs must be absorbed. A withdrawal from retirement funds in the formative years is detrimental to the long-term growth of retirement savings, as any withdrawal has the effect of diminishing the savings level. It is recommended that National Treasury considers placing a limit on the period before retirement savings may be accessed. For example, retirement savings may not be accessed within the first five years, and the cumulative permitted maximum withdrawal only starts to accrue after five years. This will be especially helpful to low income earners who may be tempted to access their pre-retirement savings, and by accessing these savings they are creating a retirement savings disadvantage for themselves.

In example 2, B was able to withdraw all of his retirement funds as his cumulative permitted maximum withdrawal exceeded the balance on his retirement savings. Furthermore he withdrew the retirement funds out of his own choice (not through the loss of employment). It is submitted that National Treasury should implement legislation that only allows pre-retirement withdrawals when a member has ceased to be employed, they have accessed all of their unemployment insurance fund benefits and the member has obtained financial advice on the long-term effects of withdrawing their retirement funds. The current proposal by National Treasury does not incorporate these three requirements.

Should National Treasury not implement legislation providing regulations on how a member may access their pre-retirement funding, members may be tempted to access their retirement savings when they become aware of the amount of their unused withdrawal balance. This will be especially tempting for individuals who do not have a good understanding of finance.

Even though example 2 does not allow members to withdraw their pre-retirement savings immediately when they change employment, it is submitted that the more measured withdrawal approach still encourages pre-retirement withdrawals and does not necessarily meet the goal of National Treasury which is to discourage pre-retirement withdrawals. The proposed National Treasury approach is still too generous on pre-retirement withdrawals.

5.7 ALIGNMENT WITH THE OECD ROADMAP: COHERENCE BETWEEN ACCUMULATION AND PAYOUT PHASES

The first recommendation of *The OECD roadmap for the good design of defined contribution pension plans* (OECD, 2012: 1) states:

> **Ensure the design of DC [defined contribution] pension plans is internally coherent between the accumulation and payout phases and within the overall pension system.** Consequently, the target retirement income in DC plans should be determined consistently with benefits provided by other components of the pension system. To define and achieve this target, all possible risks (*i.e.*, labour, financial and demographic risks) affecting retirement income of DC pension plans should be monitored.

It is submitted that pre-retirement withdrawals do not provide support for the accumulation phase of retirement savings. However, in section 5.4 the unique economic challenges facing South Africa were mentioned, and for this reason measured pre-retirement withdrawals have been considered by National Treasury and these were discussed in sections 5.5 and 5.6. Even though mandatory retirement savings preservation is common throughout the world as discussed in section 5.3 above, full preservation of retirement savings was not considered appropriate for South Africa. The pre-retirement withdrawals model that South Africa intends to adopt is not in alignment with the accumulation phase as proposed by *The OECD roadmap for the good design of defined contribution pension plans* (OECD: 2012).

5.8 CONCLUSION

This chapter discussed pre-retirement withdrawals (also known as pre-retirement leakage). National Treasury identified the disparity that exists between pre-retirement withdrawals in different retirement vehicles. National Treasury has recognised that pre-retirement withdrawals erode retirement savings, which has the effect of reducing the income replacement ratio upon retirement. Even though tax incentives for retirement savings will be adjusted and will allow for uniform deductions (with effect from the date of implementation of the changes (possibly 1 March 2016 or 1 March 2017)) throughout the accumulation phase of retirement, pre-retirement withdrawals are counter-productive for retirement savings. For this reason National Treasury proposed five different approaches to pre-retirement withdrawals. National Treasury elicited responses on these five approaches to pre-retirement withdrawals from the various stakeholders. Most stakeholders agreed that pre-retirement withdrawal benefits should not be automatically redeemed when an employee changes employment, but most stakeholders did not support full preservation of retirement savings. National Treasury proposed guidelines for pre-retirement withdrawals and issued a further paper: *2013 Retirement reform proposals for further consultation* (National Treasury, 2013a). National Treasury called for further comments which were to be submitted by 31 May 2013. To date no further reports have been tabled by National Treasury on the comments received from the public.

Examples of the application of pre-retirement withdrawals as proposed by National Treasury (2013a) were discussed and commented upon. It is submitted that there are a number of issues regarding pre-retirement withdrawals that need clarification. These are: placing a limit on the period before pre-retirement savings may be accessed and only allowing access to pre-retirement withdrawals when the member has ceased to be employed, after the member has accessed all of the unemployment insurance fund benefits and after the member has obtained financial advice on the long-term effect of withdrawing his or her retirement funds.

The pre-retirement withdrawals model that South African intends to adopt is not fully in alignment with the accumulation phase as proposed by *The OECD roadmap for the good design of defined contribution pension plans* (OECD: 2012).

The next chapter will discuss the post-retirement benefits that are available when a member retires. There are a number of retirement options available for members when they have reached retirement and these options will be discussed. One of the salient aspects of retirement is the annuitisation of post-retirement benefits, and the next chapter will discuss the importance of the annuitisation of post-retirement benefits. National Treasury (2012e) issued a discussion paper on post-retirement leakages and annuitisation.

CHAPTER 6: ANNUITISATION OF POST-RETIREMENT BENEFITS

6.1 INTRODUCTION

The goal of this research is to determine whether the retirement reform mechanisms outlined by National Treasury will encourage individual retirement savings. One of the sub-goals of this research is to review the proposed changes that have been tabled by National Treasury to achieve retirement reform. Chapter 3 outlined the current retirement savings deductions and chapter 4 outlined the changes that National Treasury has proposed in order to ensure uniform tax deductions for retirement savings across all retirement vehicles. Chapter 5 outlined the changes that National Treasury has proposed to limit pre-retirement withdrawals during the accumulation phase of retirement savings. This chapter will discuss National Treasury's proposals for post-retirement savings.

When the original *Retirement Fund Reform: a discussion paper* (National Treasury: 2004) was issued, no mention was made regarding post-retirement savings. National Treasury's focus in 2004 was to encourage retirement savings up until retirement date.

Post-retirement savings were first mentioned in the paper entitled: *Strengthening retirement savings: An overview of proposals announced in the 2012 Budget* (National Treasury, 2012f: 9). The problem of post-retirement savings erosion was described as follows:

> In addition, the system stops protecting most workers after retirement. Members of provident funds can withdraw all of their accumulated benefits in cash, which is often used quickly. Members of pension funds and holders of retirement annuities are required to annuitise two-thirds of their assets when they retire. Many purchase living annuities with their retirement funds, rather than conventional annuities – which are the only products that protect them against outliving their assets – and spend their assets too rapidly or make inappropriate investment decisions. This increases the risk of poverty in old age.

This chapter will discuss the current options for post-retirement savings as well as the proposals that have been made by National Treasury for the annuitisation of all post-retirement savings. A comparison will be made between National Treasury's proposals and *The OECD roadmap for the good design of defined contribution pension plans* (OECD: 2012), to assess whether there is alignment for the annuitisation of post-retirement benefits.

6.2 DISPARITY BETWEEN POST-RETIREMENT WITHDRAWALS FROM THE DIFFERENT RETIREMENT VEHICLES

Chapters 3 and 4 outlined the disparity in deductions and the proposed alignment across the different retirement vehicles (which will be addressed with effect from the date of implementation of the changes (possibly 1 March 2016 or 1 March 2017)) and chapter 5 highlighted the disparity in permitted pre-retirement withdrawals between the different retirement vehicles (discussed in section 5.2). There is also disparity between the different retirement vehicles in terms of post-retirement withdrawals. National Treasury (2012e: 15) has produced the following table outlining the differences between post-retirement withdrawals in the different retirement vehicles:

Table 14: Differences between post-retirement withdrawals in the different retirement vehicles

Retirement vehicle	**Post-retirement withdrawal rules**
Retirement annuity fund	After age 55, at least $^2/_3$ of the retirement benefit must be annuitised, and the balance can be taken as a lump sum.
Pension fund	After retirement, at least $^2/_3$ of the retirement benefit must be annuitised, and the balance can be taken as a lump sum.
Provident fund	After retirement, annuitisation is completely voluntary.
Preservation fund (applicable to both pension and provident preservation funds)	At retirement, the pension fund or provident fund rules apply, according to which type of fund the assets originally derived from.

It is clear from the above table that only provident funds do not cater for annuitisation. Furthermore, retirement annuity funds and pension funds only require up to two-thirds of the retirement benefit to be annuitised, which means that up to one-third may be accessed as a lump sum. This lump sum will be taxed in accordance with the table applicable to retirement lump sum benefits (discussed in section 3.9 of chapter 3). The lump sum or annuity that is available from a preservation fund upon retirement depends on the type of preservation fund: pension preservation funds allow for up to two-thirds to be annuitised and one-third can be commuted as a lump sum, whilst provident preservation funds allow for the full balance to be taken as a lump sum.

National Treasury (2012f: 8) explained as follows:

> Despite high participation rates, high contribution rates and significant assets under management, only about 10% of South Africans are able to maintain their pre-retirement level of consumption after they stop working – primarily because preservation rates are low. In recent years, the aggregate rand value of flows out of retirement funds – both pre- and post-retirement – appears to have been greater than total new contributions. The overall appreciation in value of fund assets has largely been a consequence of the general rise in asset prices.
>
> . . .
>
> The consequences of low retirement income are serious: in addition to increasing the burden on public finances, it increases the financial vulnerability of the elderly population, leaving many dependent on family for support. This in turn lowers the ability of many young families to save for their own future.

National Treasury is concerned about post-retirement withdrawals and the effect that these withdrawals will have on the ability of the retired person to manage their post-retirement withdrawal benefits to last for their lifetime.

6.3 PROSPECTIVE APPLICATION OF POST-RETIREMENT BENEFITS

The section above identified that the annuitisation requirements only apply to members of pension funds and retirement annuity funds. National Treasury has considered how the annuitisation requirements could be extended to provident funds.

National Treasury (2012e: 22) provides a background to the non-annuitisation of provident fund withdrawals:

> The choice is also a consequence of labour struggles in the 1980s, as many workers were denied adequate retirement options as part of their remuneration package. The choice is also one between low-income and higher-income employees, with low-income employees joining provident funds and high-income employees joining pension funds.

National Treasury (2012e) questions whether, in a post-apartheid democratic South Africa, it is still necessary to differentiate between the two different types of retirement funds and whether the system should be harmonised into one type of retirement fund. National Treasury proposes the vested rights approach to post-retirement withdrawals (also applied to pre-retirement withdrawals discussed in section 5.5 of chapter 5). This means that there is a need to protect the vested rights of provident fund members by allowing balances accrued at the date of implementation of the legislation to be taken as lump sums on retirement.

Two options for the alignment of provident to pension and retirement annuity funds have been proposed:

1. Individuals who are retiring from provident funds may access their funds under the current dispensation, so no new changes are adopted, and the status quo continues.

2. Growth on provident fund assets and new contributions post-implementation of legislation will be subject to the rules applicable to pension funds and retirement annuities. The *de minimus* rule could also be increased from the current R75 000 to accommodate those retiring with small balances as well as growth amounts that are not feasible to annuitise. National Treasury proposes a phased-in approach to the withdrawal of provident fund benefits which seeks to protect the vested rights of members of provident funds who are over 50 years old when the legislation is introduced. To this end, a sliding scale allows such members to take a larger portion of their retirement savings as a lump sum on retirement should they be older than 50 years when the legislative changes occur. The following table shows the proposed "years to retirement" approach to the annuitisation requirement for provident funds (National Treasury, 2012e: 23):

Table 15: Proposed "years to retirement" approach to the annuitisation requirement for provident funds

Years to retirement	**Cash: $^{1}/_{3}$ +**	**Annuity**
10	0% of $^{2}/_{3}$ full cash	100% of $^{2}/_{3}$rds
9	10% of $^{2}/_{3}$ full cash	90% of $^{2}/_{3}$rds
8	20% of $^{2}/_{3}$ full cash	80% of $^{2}/_{3}$rds
7	30% of $^{2}/_{3}$ full cash	70% of $^{2}/_{3}$rds
6	40% of $^{2}/_{3}$ full cash	60% of $^{2}/_{3}$rds
5	50% of $^{2}/_{3}$ full cash	50% of $^{2}/_{3}$rds
4	60% of $^{2}/_{3}$ full cash	40% of $^{2}/_{3}$rds

Years to retirement	**Cash: $^{1}/_{3}$ +**	**Annuity**
3	70% of $^{2}/_{3}$ full cash	30% of $^{2}/_{3}$rds
2	80% of $^{2}/_{3}$ full cash	20% of $^{2}/_{3}$rds
1	90% of $^{2}/_{3}$ full cash	10% of $^{2}/_{3}$rds
0	100% of $^{2}/_{3}$ full cash	0% of $^{2}/_{3}$rds

The vested right to access the provident fund in cash favours those members who are over 50 years old as those members may have reasonably firm plans for retirement and the regulatory change should not disrupt sound retirement planning already made. Furthermore, introducing the change to members who are younger than 50 years old is reasonable since these members have sufficient time to modify their retirement plans.

National Treasury (2012e: 24) provides three different examples of how it envisages the implementation of the prospective application of post-retirement benefits using the "years to retirement" approach:

Table 16: Examples illustrating the application of the "years to retirement" approach

Examples of the applicability of the proposed scales
Scenario 1:
Using 60 as a retirement age, a provident fund member <u>aged 50 at the date of implementation of legislative changes</u> would be 10 years from retirement. Upon retirement such a member would be entitled to the one-third cash lump sum and zero per cent of the remaining two-thirds in cash, meaning that the two-thirds will have to be annuitised. If the same member leaves the provident fund prior to retirement age (reaching the age of 60), for whatever reason, he/she will be able to withdraw up to one-third in cash and have the remaining two-thirds preserved or transferred to a prospective employer.
Scenario 2:
Using 60 as a retirement age, a provident fund member <u>aged 45 at the date of implementation of legislative changes</u> falls outside the additional cash benefit proposed in the "years to retirement" table. Upon retirement, that is on reaching the age 60, such member will only be entitled to the one-third cash lump sum and annuitisation of the remaining two-thirds. The 45-year-old, however, is allowed withdrawals of up to one-third of accumulated retirement savings prior to retirement without having to fulfil the conditions set for pre-retirement withdrawals for pension and retirement annuity funds. The allowed one-third pre-retirement withdrawal does, however, reduce the one-third cash lump sum available upon retirement.

Examples of the applicability of the proposed scales
Scenario 3:
A person who is <u>60 years old at the date of the implementation of the legislative changes</u> is entitled to the whole fund credit as a lump sum upon retirement (one-third cash lump sum plus 100 per cent full cash of the remaining two-thirds). This means that the current provident fund status quo of taking everything as a full cash lump sum benefit would be maintained for those already retiring by the time the legislative changes become effective.

National Treasury (2012e) invited comments from the public by no later than 16 November 2012. Following comments received, National Treasury issued a further paper in February 2013 entitled *2013 Retirement reform proposals for further consultation* (National Treasury: 2013a). Most commentators agreed with the principle of harmonisation of post-retirement benefits. However, responses differed on the timing and extent of the changes to annuitisation requirements for provident fund members. When National Treasury (2103a: 8) formulated its policy the following issues were taken account of:

> - Requiring members of provident funds to annuitise their balances without altering the means test of the OAG [old age grant] would result in significant numbers of low-income workers facing implicit marginal tax rates on their retirement income equal to 40%. This is the same marginal tax rate paid by the highest income earners in South Africa.
> - Many individuals near retirement age may be counting on receiving a large cash lump sum from their provident funds when they retire. Some of these workers will be adversely affected by annuitisation requirements which did not respect their vested rights.
> - The importance of avoiding tax arbitrage between different types of retirement fund.
> - Concurrent reforms to the market for retirement income products would be required to ensure that the market functions better than currently for low-income individuals.
>
> It is proposed that the rules on annuitisation of retirement fund contributions will change on a particular day, to be determined by legislation. This day will be called T-day. The tax treatment of retirement fund contributions will also change on T-day.

National Treasury (2013a) recommended that the means test of the old age grant should be phased out by 2016. The secondary rebate (R6 750 for the 2014 year of assessment for those individuals who are older than 65 years on the last day of the year of assessment) and the tertiary rebate (R2 250 for the 2014 year of assessment for those individuals who are older than 75 years on the last day of the year of assessment) will be adjusted over the same period to preserve equity.

Furthermore, contributions made to provident funds after T-day, and growth on these contributions will be subject to the same annuitisation requirements that are applicable to pension and retirement annuity funds. This means that an individual's accumulated funds in provident funds at T-day, plus any growth on that amount after that time, will be not be subject to the annuitisation requirements. It is submitted that this is a simpler approach than the "years to retirement" approach discussed above. The annuitisation rules will be subject to two limitations. Firstly, those individuals who are older than 55 years will not be subject to the annuitisation even on their new contributions. This is intended to ease the transition into retirement for those who are already eligible for early retirement. Secondly, the *de minimus* threshold, which is currently set at retirement balances equal to or lower than R75 000 which need not be annuitised, will be increased to R150 000.

For those individuals who are younger than 55 years old, National Treasury has indicated that there is sufficient time for these individuals to plan for the effect of annuitisation of provident funds on their retirement.

National Treasury (2013a: 8) has provided three examples of how it envisages the annuitisation of post-retirement benefits. These three examples are explained below:

EXAMPLE 1

This example applies to a provident fund member who is over 55 years old on T-day. Her balance is R400 000 on T-day and she is 56 years old. She continues to contribute to the provident fund until she is 64 years old, when she retires. When she retires her provident fund lump sum is R750 000. She will be able to take the entire lump sum at retirement, which will be subject to taxation applying the retirement lump sum benefit table. She will not have her old age grant reduced due to means testing, and will receive the full old age grant, currently set at R1 260 per month.

EXAMPLE 2

This example applies to a provident fund member who is younger than 55 years old on T-day. On T-day the balance in his fund is R450 000. He is 54 years old. He continues contributing to the provident fund. Six years later, the R450 000 has grown to R600 000. The increase in the provident fund after T-day is R100 000 and comprises contributions made to the fund and growth on these contributions.

Vested rights apply to R600 000, so he can take this as a cash lump sum. The additional R100 000 is subject to annuitisation under the new rules, however since the value is less than R150 000 the *de minimus* rule applies. He can therefore take the full R700 000 as a cash lump sum when he retires, which will be subject to taxation applying the retirement lump sum benefit table. Furthermore, he will receive the full old age grant, currently set at R1 260 per month for those individuals who are under the age of 75 years.

This is demonstrated in the following table:

Table 17: Example illustrating the application of the T-day method of the annuitisation of post-retirement benefits

	R	
Initial balance on T-day	450 000	Vested rights on R600 000
Growth on initial balance after T-day	150 000	
Contributions and growth after T-day	100 000	Subject to annuitisation, but less than R150 000 so this does not apply
Cash on retirement	700 000	Subject to tax applying the retirement lump sum benefit table

EXAMPLE 3

This example applies to a provident fund member who changes his provident fund before retirement. G is 29 years old and on T-day the balance in his provident fund is R1 000 000. He continues contributing to the provident fund and six years later he leaves his job. At this point the R1 000 000 has grown to R2 000 000, and new contributions and growth on these new contributions make up a further R500 000. He transfers his R2 500 000 balance to a provident preservation fund.

Many years later, when he turns 70 years old, the T-day balance has grown to R10 000 000. The rest of his retirement funds are R50 000 000. He is eligible to take R10 000 000 plus one-third of R50 000 000, which is R16 666 667 as a cash lump sum, which will be subject to taxation applying the retirement lump sum benefit table. The rest of his retirement balances must be annuitised.

In addition to this, he will be eligible to receive the full old age grant, currently set at R1 260 per month for those individuals who are under the age of 75 years.

This is demonstrated in the following table:

Table 18: Example illustrating the application of the T-day method of annuitisation of post-retirement benefits where a provident fund member changes his provident fund before retirement

	R	**R**	**R**	
	Value at 29 years old	Value at 70 years old	Lump sum and annuity component when he retires	
Initial balance on T-day	1 000 000			
Growth on initial balance after T-day	1 000 000			
	2 000 000	10 000 000	10 000 000	Vested portion
Contributions after T-day	500 000	50 000 000	16 666 667	Commuted portion ($^{1}/_{3}$ x R50 000 000)
			26 666 667	Lump sum (which is subject to the retirement lump sum benefit table)
			33 333 333	Balance available for annuitisation[2]
Value when he leaves his job	2 500 000	60 000 000	60 000 000	

[2] This balance will be paid as an annuity, and will be subject to the normal tax tables. In addition, a full old age grant (currently set at R1 260 per month) will be received by G.

It is submitted that the method proposed by National Treasury (2013a) is comparable with the method applied to pre-retirement withdrawals discussed in section 5.5 and 5.6 of chapter 5. The "years to retirement" approach has merits as it allows a measured approach to post-retirement annuitisation. However, the "years to retirement" approach is not as simple as the T-day method. The T-day method is consistent with the pre-retirement withdrawal approach.

6.4 CONVENTIONAL ANNUITIES

Purchased annuities were defined in section 2.8 of chapter 2. Purchased annuities may be referred to as conventional annuities or conventional life annuities.

The primary benefit of a conventional life annuity is that it protects individuals against the risk of outliving their assets by pooling mortality risk. Individuals who buy conventional life annuities face low levels of risk, since the insurance company guarantees a fixed or contractually increasing payment stream regardless of the future economic conditions (although with-profits life annuities might offer an increase partially dependent on investment returns). However, even though the Financial Services Board closely monitors solvency and capital adequacy, annuity holders bear the risk of potential insurer insolvency.

Besides risk pooling, there are other advantages to conventional annuities. National Treasury (2012b: 28) states that "there is evidence that a person's ability to manage their financial affairs declines with age. By paying a regular income, conventional life annuities remove the need for the elderly to make financial decisions that might become increasingly difficult".

There are a wide range of conventional annuities which allow for varying levels of payment increases, guarantee terms and level of income for spouses after holders have died. National Treasury (2012b: 26) provides a background on conventional annuities:

> Although there is no industry-wide breakdown of the market by product type, evidence suggests that about 90% of conventional life annuities sold are "level" annuities where payments do not increase over time. "With-profits" annuities, which make payments linked to investment returns on an underlying portfolio, are available, but these have fallen out of favour, perhaps as a result of poor transparency and high capital costs for insurers.

"Level" annuities (referred to as "fixed payment products") are heavily exposed to inflation risk. According to the Actuarial Society of South Africa tables, by the time an individual reaches the age of 90 (about 20 per cent of men who retire at 65 years old should reach this age), their purchasing power will be one-quarter of what it was when they retired. Should inflation be higher than expected, then purchasing power might well be much lower.

A drawback of a conventional life annuity is unintended bequests which occur when an individual dies before consuming all of their assets. An unintended bequest is best described using an example, as follows:

Table 19: Example illustrating a purchased annuity with an unintended bequest

<table>
<tr><td colspan="2">Mr X was 55 years old when he retired. He received a lump sum from his provident fund of R1 300 000 (after tax), and he purchased a level life annuity from an insurer that pays an annuity of R180 000 per annum (comprised of 12 payments of R15 000 per month). Mr X purchased the annuity on 1 March when he retired, so the full annual annuity of R180 000 is received in each year of assessment. This annuity amount was determined using a present value amount of R1 300 000, a life expectancy of 17.18 years (which is Mr X's life expectancy at his age next birthday of 56 years) and using a discount rate of 12 per cent. The calculation gives rise to an annuity value of R181 967 and this was rounded down to R180 000 per annum.</td></tr>
<tr><td></td><td>R</td></tr>
<tr><td>Each year Mr X will receive</td><td>180 000</td></tr>
<tr><td>The section 10A purchased annuity exemption will be:
$^{\text{Annual annuity amount}}/_{\text{Amount paid for level life annuity}}$ x annuity received during the year
= $^{\text{R180 000}}/_{\text{R1 300 000}}$ x R180 000</td><td>

(24 923)</td></tr>
<tr><td>Purchased annuity subject to taxation</td><td>155 077</td></tr>
<tr><td></td><td></td></tr>
<tr><td colspan="2">Based on the above Mr X expects to receive a gross amount R180 000 per year for the rest of his life. However, Mr X dies after 5 years. This means he has received R900 000 (R180 000 for five years) for his investment in the purchased annuity that cost him R1 300 000. For this reason he has "lost" a gross amount R400 000 (R1 300 000 – R900 000). This loss of R400 000 is referred to as the unintended bequest.</td></tr>
</table>

A further drawback is that the holder of the conventional life annuity bears the risk of potential insurer solvency. The insurance company that guarantees the conventional life annuity may become insolvent, and the holder of the conventional annuity has no recourse and loses his or her original investment amount in the conventional life annuity and the life annuity amount from the date that the insurance company is no longer able to pay the annuity (which can occur before the official insolvency).

The demand for conventional annuities is probably reduced by the protection afforded by public old age pensions. In South Africa, state old age support is limited to a means tested grant that is paid from age 60. For example, Mrs A retires and receives a lump sum from her provident fund, she chooses to spend the lump sum by giving money to her children and going on holiday. She uses her provident lump sum rapidly knowing that once she has spent her lump sum she may apply for the old age grant. Another individual, Mrs B, chooses to use her lump sum to purchase an annuity. Once Mrs A has spent all of her money, she will qualify for the old age grant. However, Mrs B may not qualify for the old age grant as she has an income which she receives from her purchased annuity. In this example, Mrs B will be disadvantaged by not receiving the old age grant, even though she made a sound decision to purchase an annuity with her provident fund lump sum. These two examples illustrate that the means test could discourage people from purchasing conventional annuities with provident fund money. With effect from 2016 the means test will be abolished and all individuals who are over 60 years old will qualify for the old age grant, although application details for the new old age grant have not yet been published by the South African Social Security Agency.

National Treasury (2012b: 29) provides other reasons why individuals may not purchase life annuities:

- If low-income workers expect to die soon after stopping work, they could perceive – correctly – that annuities represent poor value.
- Individuals could pool mortality risk privately, with their spouse and families, and other informal support networks.
- Retirement money from one family member could be used to invest in the education or health of younger members. Once they are earning, they would in turn support the retiree.
- In general, most people prefer liquid assets and are unwilling to lock their money with an insurance company for a long time.
- Many individuals prefer to take on investment risk when they retire in exchange for higher expected returns.
- Individuals may elect not to purchase a conventional annuity if interest rates are very low, preferring to wait until rates rise.

6.5 LIVING ANNUITIES

Living annuities were defined in section 2.7 of chapter 2. National Treasury (2012b: 11) indicates that:

> South Africa's living annuities market was worth an estimated R26.5 billion in 2011. Legally, these are life insurance policies and must be sold under life licenses, even though it is prohibited to provide guarantees. In the past they were mostly sold directly by life insurance companies, but in recent years investment service providers run by asset management firms under rented life licenses have come to dominate the market.
>
> Living annuities are tax-protected phased-withdrawal products. Each purchaser has a separate account, to which asset holdings and returns are allocated out of which benefits are paid. Purchasers must choose a drawdown rate between 2.5 per cent and 17.5 per cent out of the total assets, which is paid to them as income each year. When individuals die, any remaining balance reverts to their beneficiaries.
>
> Individuals have a wide range of choices for the underlying asset portfolio, and there are no individual or portfolio-level investment restrictions on the assets that may be held inside living annuities. Insurers that sell annuities, however, must abide by exchange control regulations set by the Reserve Bank, and broad prudential asset limits assessed at enterprise level.

From an insurer's perspective the living annuity poses few prudential difficulties as there is no mismatch between assets and liabilities, as the holder of the living annuity accepts all risk and can only draw on money that is available in the living annuity. The product design of a living annuity is transparent and the available balance and investment mix is visible at any time.

There are a number of advantages of living annuities. The living annuity structure is exempt from income tax in terms of section 10(1), proviso (b)(ii) of the Income Tax Act as it is "required to utilise its funds solely for investment or the object for which it has been established". This means that all capital gains, interest received and dividends received are free of tax. All reinvestments in the living annuity structure are tax protected, and the growth of living annuity assets versus conventional assets (outside the living annuity structure) should be greater as the growth reinvested has not been eroded by the payment of taxation.

PSG Online (2014) indicated that living annuities pass the capital remaining in policies to the owner's nominated beneficiaries when the owner dies. The living annuity differs from the conventional annuity as there is no unintended bequest when the owner dies. The remaining balance left in the living annuity may continue to be paid to the heirs in the form of an annuity (which will be taxed in their hands as an annuity), or the capital balance may be redeemed when the owner dies. Should the redemption option be chosen, then the balance that is left within the living annuity will be taxed in the deceased's hands according to the retirement lump sum benefit tax tables (discussed in section 3.9 of chapter 3).

When a living annuity is purchased the full purchase value becomes "trapped" in a living annuity structure and the balance in the living annuity grows within the living annuity free of tax. Fisher-French (2010) mentions that "living annuities fall outside your estate for estate duty and executor's fees purposes". For this reason a living annuity provides an alternative to the creation of a trust. When a trust is formed, assets are donated to a trust which gives rise to donations tax, as well as triggering a capital gains tax event that may give rise to capital gains tax. Any distributions from the trust will be taxed in the beneficiaries' hands, and any undistributed balance that remains in the trust will be taxed in the hands of the trust according to the Income Tax Act. The tax rate applicable to a trust is set at a flat rate of 40 per cent. Living annuities provide an attractive option for high net worth individuals, who have not created trusts in their earlier years whilst they were building their wealth, as they may enjoy growth in the living annuity structure without paying taxes on the growth and income received in the living annuity structure. For the above reasons, living annuities provide an attractive estate planning tool.

In the same way as there are advantages to living annuities, there are also a number of disadvantages. From the purchaser's perspective, living annuities are complex, especially when compared to a conventional life annuity, which functions automatically once purchased. Purchasers of living annuities must make or review several choices at least every year. The purchaser of the living annuity elects an investment mix from potentially thousands of options, chooses a drawdown rate (between 2.5 per cent and 17.5 per cent of the value of the assets) and may select a provider or change their existing provider (which may result in costs relating to changes in the asset allocations). National Treasury (2012b: 16) emphasises that the decisions made by the purchaser are dependent on a wide range of factors that vary from individual to individual, including:

- The level of support they can expect from family;
- Access to post-retirement medical aid cover;
- Risk aversion;
- Bequest motives; and
- Life expectancy.

These decisions may have serious consequences for the purchaser that only become apparent after many years.

Living annuities may not be jointly owned by individuals (for example a husband and wife cannot co-own a living annuity). Fisher-French (2010) indicates that the living annuity structure may be owned by one person who selects the beneficiaries of their living annuity when he or she dies. Even though not co-owned, a husband may appoint his wife as the sole beneficiary upon his death and in this way his wife's financial needs will be catered for (and his wife will not be at a financial disadvantage should he keep her as a sole beneficiary of the living annuity). The other option is that the living annuity may be owned by a trust (of which she is the sole beneficiary). There may be a number of taxes associated with the formation of the trust and these were mentioned above.

Once a living annuity contract is concluded, it cannot be broken, other than through death or the *de minimus* threshold (which is currently R75 000). According to PSG Online (2014), should the owner of a living annuity decide to emigrate, he or she may not cancel the living annuity. However, owners of the living annuity can increase their drawdown rate to the maximum amount possible (which is currently by drawing an annuity of 17.5 per cent of the total assets). This will allow the owner to erode the assets that are left in the living annuity until the assets are less than the *de minimus* threshold. However, the increase in the drawdown rate will not cancel the living annuity immediately. Upon emigration, the living annuity structure must remain in place, but the holder can remit the annuity abroad.

The living annuity market has an opaque financial advice fee structure as there may be charges when the investment is first made (initial charges) as well as recurring charges for the life of the investment. National Treasury (2012b: 17) identifies the types of fee charges that holders of living annuities are subject to, most of which are paid out of their fund balances:

- Costs of financial advice and brokerage fees;
- Platform fees to the provider;
- Asset management fees to the asset manager;
- Performance fees on investments to the asset manager; and
- Audit fees, trustee fees, brokerage, VAT, securities transfer taxes (usually these are not disclosed, but simply reduce the return on the underlying funds).

Recurring fees exert a substantial effect on the income that individuals can obtain from their living annuities. National Treasury (2013b: 17) elaborates on the charges for living annuities:

> There are no restrictions on the size or type of charges that may be levied although brokers may be subject to maximum commission scales. (In practice these can be evaded by labelling commission as 'fees for financial advice' or 'consulting fees'). Providers can choose how to balance initial and recurring fees. Fees are often negotiable, allowing individuals with larger balances to secure more favourable terms.

The table below has been prepared by the Association for Savings and Investments in South Africa and provides the annual living annuity charges as a percentage of assets under management from a large linked investment service provider (National Treasury, 2013b: 17):

Table 20: Annual living annuity charges as a percentage of assets under management

		Charge type				**Total charge (broker fee + platform fee + asset management fees)**	**Total charge (agent fee + platform fee + asset management fees)**
		Column 1 Broker fee *	Column 2 Agent fee *	Column 3 Platform fee	Column 4 Asset management fees	column 1 + column 3 + column 4	column 2 + column 3 + column 4
Annual charge	5th percentile	0.00%	0.00%	0.42%	0.00%	0.42%	0.42%
	25th percentile	0.00%	0.00%	0.66%	0.53%	1.19%	1.19%
	Median	0.50%	0.50%	0.81%	0.71%	2.02%	2.02%
	75th percentile	0.75%	0.50%	0.84%	1.03%	2.62%	2.37%
	95th percentile	1.00%	1.00%	0.84%	1.58%	3.42%	3.42%
	Average	0.53%	0.45%	0.48%	0.76%	1.77%	1.69%

* Individuals pay either the broker fee or the agent fee, but not both.

The table above illustrates a wide dispersion in each of these charges, although the data provided by the Association for Savings and Investments in South Africa does not indicate the dispersion in total charges. Two extra columns have been added to the above table to determine what the total charges will be under the various annual charge options.

National Treasury (2013b: 17) made the following comments on the table above:

> However, an average reduction in yield of 2 per cent to 2.5 per cent, and a range from 1 per cent to 3.5 per cent is not unreasonable based on the data. Initial fees are low, and falling, and might now be less than 1 per cent of the initial premium for most investors.
>
> As with charges on other types of financial products, individuals may be more sensitive to initial fees than to recurring fees. This would give providers, asset managers and brokers an incentive to reduce the former and increase the latter. Yet for long-term products, small recurring fees can add up dramatically and significantly reduce benefits.

It is noted that charges made against living annuities may result in a reduction in the yield that an investor receives. Living annuities do not fall within the ambit of the Pension Funds Act. The Financial Services Board regulates retirement funds in accordance with the Pension Funds Act which regulates each type of retirement vehicle (i.e. pension funds, pension preservation funds, provident funds, provident preservation funds and retirement annuity funds). According to National Treasury (2013b: 7): "In South Africa, besides maximum commission scales, there is no regulation on either the type or size of fees which may be charged by retirement funds". Furthermore, living annuities fall within the scope of the Long-Term Insurance Act, and are therefore not governed by the Pension Funds Act, which specifies maximum commission charges. National Treasury (2012b: 18) is of the opinion "that at current levels, living annuities fees significantly reduce the benefits that can be paid to retirees". Based on the comments made by National Treasury it appears that guidance will be issued regarding the regulation of charges by retirement funds and in respect of living annuities. It is outside the scope of this research to discuss the regulations on fee charges that are proposed by National Treasury, and it is submitted that this will take many years to finalise as National Treasury will solicit comments from the public and issue a number of discussion papers on how the fee charges may be regulated.

Following from the comment in the previous paragraph that living annuities are governed by the Long-Term Insurance Act, this implies that the Prudential Investment Guidelines outlined in Regulation 28 of the Pension Funds Act and discussed in section 2.3 of chapter 2 do not apply to living annuities. According to PSG Online (2014): "Current legislation does not include any restrictions on the underlying holdings of living annuity funds. However, proposed legislation currently in draft form proposes that living annuity funds should be managed in accordance with Regulation 28 of the Pension Funds Act". Prudential Investment Guidelines reflect a balanced investment risk profile, and the absence of these guidelines for living annuities may encourage owners of living annuities to select investments that may be more risky in order to generate a higher yield. Risky investments may be chosen at a time when the owner of the living annuity may not be in a strong position to withstand a loss of investment, for example should they realise that their life expectancy may be greater than they anticipated or their circumstances change which results in them having to bear greater financial costs than originally anticipated. This may result in owners of living annuities trying to maintain their drawdown rates at current levels and selecting more risky investments. This may work in their favour, but it can also work against them should their risky investment fail to deliver according to their expectations. It is submitted that all retirement funds (including living annuities) should have Prudential Investment Guidelines applicable to them. The Prudential Investment Guidelines need not be a blanket standard for all investments (irrespective of the size of the investments). National Treasury could propose different options for Prudential Investment Guidelines for different sizes of investments. For example, assets less than R5 million may have to comply with a standard Prudential Investment Guideline allocation, and all assets above R5 million may be managed on a discretionary basis depending on the choice made by the owner of the living annuity. This hybrid approach to Prudential Investment Guidelines will maintain the flexibility that makes a living annuity attractive whilst providing a safety net through a standard asset allocation for assets that are less than R5 million. At this stage, National Treasury has not issued any guidance on the approach that it will adopt in its Prudential Investment Guidelines for living annuities.

6.6 INDUSTRY STANDARDS ON LIVING ANNUITIES

Legislation permits the owner of a living annuity to draw an income of between 2.5 per cent and 17.5 per cent per annum of the capital value of their living annuity investment. Cameron (2013) states that if the owner of the living annuity bought the living annuity before 21 February 2007 and has not made any changes to their drawdown rate from this date, the drawdown percentage is between 5 per cent and 20 per cent. The reason for reducing the minimum drawdown percentage to 2.5 per cent was to discourage owners of living annuities from using their capital too rapidly.

The Association of Savings and Investments in South Africa (2010) has issued a Standard on Living Annuities which provides industry standards to ensure that living annuities are marketed, administered or underwritten responsibly. There are four living annuity product standards that have been formulated:

- Standard 1: Appropriate drawdown;
- Standard 2: Appropriate investments;
- Standard 3: Asset composition information; and
- Standard 4: Industry based analysis and monitoring.

Each of these standards will be discussed briefly. The first standard concerns the level of drawdown and the effect that this has on the reduction of the income level of the owner of the living annuity. The Association of Savings and Investments in South Africa (2010: 2) has provided the following table which illustrates the relationship between the annual income (drawdown) rate selected at the inception of the living annuity and the investment return per annum (before inflation and after all fees).

Table 21: Level of drawdown and the effect of the reduction on the income level of the owner of the living annuity

Years before your income will start to reduce						
		Investment return per annum (before inflation & after all fees)				
		2.50%	*5.00%*	*7.50%*	*10.00%*	*12.50%*
Annual income rate selected at inception	*2.50%*	21	30	50+	50+	50+
	5.00%	11	14	19	33	50+
	7.50%	6	8	10	13	22
	10.00%	4	5	6	7	9
	12.50%	2	3	3	4	5
	15.00%	1	1	2	2	2
	17.50%	1	1	1	1	1

Brink (2010: 1) explains the above table as follows:

> In practice the above table will show the client that if he/she selected an income of 7.5% at inception and the investment return is estimated at 10% per annum, the client should be able to maintain the selected level of income for approximately 13 years. It is therefore vitally important that the level of income, the estimated return on the investment and the client's financial situation is taken into account when deciding on whether the living annuity is the correct option for the client.

Alexander Forbes (2010: 1) commented that the Association of Savings and Investments in South Africa code on living annuities "included indicative pension withdrawal rates that were based on calculations used by long-term insurance companies to structure guaranteed annuities, with an initial maximum withdrawal rate of 5.5 per cent for men and 4.8 per cent for women rising in later years to 6.2 per cent for men and 5.4 per cent for women". According to Alexander Forbes (2010: 1):

> However, research papers presented at the convention of the Actuarial Society of South Africa suggest that it is unwise in most cases to withdraw more than 5.0% of the annual value of the residual capital if a [living annuity] pension is to be sustainable.

Even though there are many benefits of living annuities as discussed in section 6.5, the owner of the living annuity must be aware of the effects of the initial selection of a drawdown rate as well as any subsequent changes in the drawdown rate. It is submitted that owners of living annuities who do not have a sophisticated understanding of finance may not understand the effects of drawdown rates on their monthly income.

The second standard of the Standard on Living Annuities concerns appropriate investments. As mentioned in section 6.5 above, living annuities do not have to comply with the Prudential Investment Guidelines set out in Regulation 28 of the Pension Funds Act. Brink (2010: 3) mentions that the Standard on Living Annuities describes the following as an appropriate investment composition:

- A maximum exposure of 75 per cent to equity investment;
- A maximum exposure of 25 per cent to property investment;

- A maximum combined exposure of 90 per cent to equity and property investments; and
- A maximum exposure of 20 per cent to assets outside South Africa.

Brink (2010: 2) states that "the Financial Services Board is of the view that should your asset composition be at a variance with [the above guidelines], your annuity may be at risk".

The third standard of the Standard on Living Annuities concerns asset composition information. One of the benefits of a living annuity is that the owner is able to select the asset composition of the living annuity and the available balance and investment mix is visible at any time.

The final standard of the Standard on Living Annuities concerns industry-based analysis and monitoring. Alexander Forbes (2010: 3) explains:

> ASISA [Association of Savings and Investment in South Africa] member product providers are required to provide [living annuity] status reports to ASISA at the end of each year, who will in turn make them available to regulators, such as the FSB [Financial Services Board]. The reports will be used to draw up a consolidated report that will disclose the proportional split of [living annuity] pensioners categorised by age group and drawdown bands, the amount of money invested in the [living annuity], the number of [living annuity] policies, gross inflows into [living annuities] and average drawdown levels. This can then be used as a control mechanism.

The Association of Savings and Investments in South Africa (2010: 4) envisages the reporting table to be presented as follows:

Table 22: Proposed template for industry-based analysis and monitoring of drawdown rates per age category

	Income band							
Age band	**2.5% - 5.0%**	**> 5.0% - 7.5%**	**> 7.5% - 10.0%**	**> 10.0% - 12.5%**	**> 12.5% - 15.0%**	**> 15.0% - 17.5%**	**> 17.5% - 20.0%**	**Total**
< 55	2%	3%	2%	3%	5%	2%	3%	20%
55 – 59	2%	3%	2%	3%	5%	2%	3%	20%
60 – 64	2%	3%	2%	3%	5%	2%	3%	20%
65 – 69	2%	3%	2%	3%	5%	2%	3%	20%
70 – 74	-	2%	2%	2%	2%	2%	-	10%
≥ 75	-	2%	2%	2%	2%	2%	-	10%

The final standard is an interesting measure that can be used to assess whether owners of living annuities are utilising too much of their drawdown too soon. This measure will assist in the better regulation of living annuities. It is submitted that National Treasury's perspective with the mandatory annuitisation of post-retirement benefits is to assist retired persons to utilise their lump sum payments in such a way as to ensure a smooth flow of income for the rest of their life. The industry-based analysis and monitoring will provide useful information to assess whether the drawdown rates of living annuities are reasonable and, if not, to consider what measures should be introduced to ensure that drawdown rates of living annuities are realistic.

6.7 ALIGNMENT WITH THE OECD ROADMAP: ENCOURAGE ANNUITISATION AND FACILITATION OF DEALING WITH LONGEVITY RISK

The OECD roadmap for the good design of defined contribution pension plans (OECD, 2012: 2) makes the following recommendation with which the National Treasury retirement reforms that have been discussed in this chapter appear to be aligned:

> **For the payout phase, encourage annuitisation as a protection against longevity risk.** A certain level of annuitisation of balances accumulated in DC [defined contribution] pension plans should be set as a default mechanism for the payout phase, unless pay-as-you-go public pensions or the old-age safety net already provide for sufficient regular pension payments. A combination of programmed withdrawals with a deferred life annuity (e.g. starting payments at the age of 85) that offers protection against inflation could be seen as an appropriate default. The demand for annuities could also be promoted by financial education initiatives stressing

that they are insurance products designed to protect people from outliving their resources. Lump sum payments may have to be discouraged as a form of benefit pay-out, except for small DC account balances.

This chapter has specifically addressed National Treasury's approach to provident fund withdrawals and the need for these withdrawals to be annuitised. The rationale for annuitisation is two-fold: firstly, to ensure that lump sum benefits are not spent too rapidly owing to the retiree making poor financial decisions, which may result in old age poverty, and secondly, conventional annuities offer a regular income for the individual's entire life. The *de minimus* provision allows small balances (currently R75 000 and to be increased to R150 000) to be paid out to the retiree. It is clear that there is alignment between the OECD (2012) recommendations and the proposals of National Treasury with respect to the annuitisation of post-retirement benefits.

According to Brière and Signori (2013) developing countries have higher inflation rates than developed economies because of the greater uncertainty about real economic growth. South Africa is a developing economy and therefore faces a greater inflation risk than developed economies and the majority of the member OECD countries are developed economies. It is important that retirees build inflation risk into their retirement planning as high inflation erodes retirement benefits fairly rapidly and therefore underlying investments in retirement vehicles must grow at the same rate of inflation to ensure that annuitisation benefits grow in line with inflation. To some extent this may be achieved should the Association of Savings and Investments of South Africa issue projected inflation estimates that can be built into the expected returns of conventional annuities. This may discourage the purchase of level annuities that do not escalate to compensate for inflation.

Since South Africa does not have a pay-as-you-go public pension scheme, it is crucial that the annuitisation of post-retirement benefits becomes more closely regulated by the government. South Africa does have an old age safety net which is currently an amount of R1 260 per month. This provides some element of safety but it is a meagre amount and should not be viewed as the only option for retirement income.

Another area that was mentioned in section 6.5 relates to the fee charges for living annuities, and this is an area that is still under discussion by National Treasury. It is not within the scope of this research to discuss fee charges, other than to mention that National Treasury is in the process of investigating whether guidelines should be laid down for charges in South African retirement funds (National Treasury: 2013b). The fee charges are of interest to the OECD (2012) and these have been outlined in *The OECD roadmap for the good design of defined contribution pension plans* (OECD: 2012). The OECD (2012: 1) makes two recommendations regarding fee charges and these are:

> **Promote low-cost retirement savings instruments.** Policymakers need to ensure that there are incentives in place to improve efficiency and reduce costs in the pensions industry. Disclosure based incentives should be promoted, but need to be complemented with more effective solutions such as appropriate tender mechanisms or default allocation to low-cost providers, especially in compulsory or auto enrolment systems. In certain pension structures, costs issues can be addressed by establishing large pension schemes, run on a non-profit base.
>
> **Promote the supply of annuities and cost-efficient competition in the annuity market.** Different providers, such as public schemes, non-profit occupational plans, and insurance undertakings may provide different arrangements of risk-sharing in the payout phase that may help strengthen benefit adequacy and diversify risks in retirement income. Competition among different providers in the market for individual and group annuities should be promoted to ensure cost-efficient provision for plan members and to help develop the annuity sector as a whole.

National Treasury's focus going forward is on fee charges in retirement funds and this is in alignment with *The OECD roadmap for the good design of defined contribution pension plans* (OECD: 2012).

6.8 CONCLUSION

This chapter discussed the current options for post-retirement savings, as well as the proposals that have been suggested by National Treasury. Under the current options for post-retirement savings, individuals who are members of a pension fund, pension preservation fund and retirement annuity fund may only access up to one-third of their retirement savings as a lump sum, which will be taxed in accordance with the table applicable to retirement lump sum benefits (discussed in section 3.9 of chapter 3). The remaining balance in the pension fund, pension preservation fund and retirement annuity fund is paid to the member as an annuity. Should a member commute up to one-third of their retirement lump sum, the remaining two-thirds will be available for annuitisation. The larger the commutation amount, the less that is available for annuitisation which means that the annuity amount is reduced. It was noted that provident funds and provident preservation funds were not subject to annuitisation, and this resulted in many members of provident funds and provident preservation funds withdrawing the full lump sum on retirement (and this was subject to tax in accordance with the table applicable to retirement lump sum benefits). Furthermore, the withdrawal of the entire post-retirement lump sum may result in the retiree spending their lump sum too rapidly. National Treasury identified that the rules relating to provident funds and provident preservation funds are not aligned with other retirement vehicles, which require annuitisation of up to and above two-thirds of post-retirement savings. As retirement savings are a long-term saving strategy, National Treasury was not prepared to implement retrospective post-retirement benefit annuitisation in respect of accumulated benefits in the fund, and therefore it engaged with various stakeholders to determine the most appropriate method of implementing post-retirement annuitisation.

National Treasury considered two methods of post-retirement annuitisation, namely "years to retirement" and T-day. National Treasury settled on the T-day method, and the principle of this method is the same as the pre-retirement withdrawal approach discussed in section 5.4 of chapter 5.

Unlike pension funds and retirement annuity funds, provident funds and provident preservation funds may be withdrawn in full on reaching retirement age. Should members of provident funds and provident preservation funds choose to annuitise their lump sums, the two annuity options (which are also available to pension funds and retirement annuity funds) are also available for the post-retirement annuitisation of provident funds and provident preservation funds benefits: these are the purchase of a conventional annuity or life annuity. A conventional annuity prices in longevity risks, but these are level annuities and do not cater for inflation and they carry an unintended bequest risk. The other option for annuitisation is a living annuity. The growth and income of a living annuity (within the structure of a living annuity) is exempt from tax, and the living annuity vehicle allows the purchase value to be "trapped" within the living annuity structure. Living annuities do not have an unintended bequest risk. However, there are a number of drawbacks in owning a living annuity. Living annuities may be complex and require purchasers to make investment decisions on an annual basis, the purchaser bears the longevity risk, joint ownership is not allowed, there is no exit option for a living annuity (except when a member dies or resigns), and the fee structure for living annuities is opaque. The Association of Savings and Investments in South Africa has issued a Standard on Living Annuities and this aims to regulate drawdown rates, investments, asset composition information and industry based analysis and monitoring.

Finally, a comparison was made between National Treasury's approach to the annuitisation of post-retirement benefits and *The OECD roadmap for the good design of defined contribution pension plans* (OECD: 2012). The approach adopted by both National Treasury and the OECD (2012) are in alignment. National Treasury and the OECD (2012) also propose low-cost retirement savings instruments and the promotion of the supply of annuities and cost-efficient competition in the annuity market. National Treasury (2013b) is currently considering various ways of regulating fee charges in retirement funds but this process is still in its formative stages.

The next chapter will discuss the effectiveness of the retirement reform mechanisms outlined by National Treasury to assess whether they will achieve the goal of encouraging individual retirement savings in South Africa. This will be addressed by way of detailed comparative examples showing the position of an individual before and after the implementation of the retirement reform proposals.

CHAPTER 7: THE EFFECTS OF THE RETIREMENT REFORM PROPOSALS RECOMMENDED BY NATIONAL TREASURY

7.1 INTRODUCTION

The overarching research goal of this research is to determine whether the retirement reform proposals recommended by National Treasury would encourage individual retirement savings that would assist South Africans to achieve stability of income in their retirement. Chapter 2 provided an overview of the current retirement vehicles that are used by South Africans to save for their retirement. Chapter 3 outlined the current tax incentives and disincentives for the accumulation phase of retirement savings that are available to South Africans under the current tax legislation. It was noted that a disparity exists between deductions for both employers and employees who contribute towards pension funds, provident funds and retirement annuity funds. National Treasury recognised this disparity and is in the process of implementing a uniform contribution model for retirement savings which will be effective from the date of implementation of the changes (possibly 1 March 2016 or 1 March 2017). This model has aligned deductions available to both employers and employees across all retirement vehicles. Chapter 4 described the harmonisation of retirement savings deductions. Section 4.2.5 of chapter 4 contains an example that compares the taxable income of an individual taking into account the current tax deductions (available under the current section 11(k) and section 11(n)) and the proposed section 11(k) deduction. It was noted that the proposed uniform contribution model allowed an individual a greater deduction for their retirement savings and this had the effect of reducing the individual's taxable income. Chapter 5 discussed National Treasury's proposals to address pre-retirement leakage. Chapter 6 explained the need for annuitisation of post-retirement benefits. Pension funds, pension preservation funds and retirement funds cater for two-thirds or more of post-retirement benefits to be annuitised. However, provident funds and provident preservation funds may currently be paid entirely as a lump sum upon retirement.

This chapter attempts to measure the effects of the retirement reform proposals recommended by National Treasury. Section 7.2 of the present chapter uses two examples to illustrate the effect on the income replacement ratio of the current versus the proposed retirement savings options during the accumulation phase of retirement savings. Section 7.3 extends the examples introduced in section 7.2, and explains the effects of pre-retirement leakage and early retirement on the income replacement ratio. Section 7.4 outlines the effect of a full lump sum withdrawal on retirement, and section 7.5 shows the effects on the income replacement ratio of the annuitisation of post-retirement benefits. Section 7.6 describes the assumptions that were made in order to measure the effects of the retirement reform proposals recommended by National Treasury, as well as the limitations of these assumptions.

7.2 AN EXAMPLE SHOWING THE EFFECTS OF THE CURRENT VERSUS THE PROPOSED RETIREMENT SAVINGS OPTIONS DURING THE ACCUMULATION PHASE OF RETIREMENT SAVINGS

An assessment of the effect of the change in the tax incentives and disincentives relating to the proposals by National Treasury, during the accumulation phase of retirement savings is made using an example illustrating the results of the present provisions on the income replacement ratio and comparing these results to the proposed provisions and their effect on the income replacement ratio. A number of assumptions are made in order to arrive at a comparison. All of the examples assume that any lump sum withdrawal will not be invested to generate income or to purchase an annuity from an insurance company.

The particulars of the example are as follows: An office clerk started working on 1 April 1970 with a starting salary of R1 800 per annum. He was 20 years old when he started working, and he worked as an office clerk for 45 years, until retiring at the age of 65 years in 2014. It is assumed that he did not qualify for any promotions and the only increases that he earned throughout his working life were linked to the inflation rate. The inflation rate used was the average inflation rate per year for South Africa and was obtained from Worldwide Inflation Data (Inflation.eu: 2014). It is assumed that he contributed 7.5 per cent of his salary towards his employer's pension fund (the maximum amount that is allowed as a deduction in terms of the current section 11(k) deduction), and his employer matched the employee's contribution towards the employer's pension fund. Towers Watson (2014: 14) published the compound annual growth rates for a number of countries, and it highlighted that "South Africa has seen the fastest growth rate". Investopedia US (2014) defined the compound annual growth rate as the "year-over-year growth rate of an investment over a specified period of time. . . [The compound annual growth] rate isn't the actual return in reality. It's an imaginary number that described the rate an investment would have grown if it grew at a steady rate. You can think of [the compound annual growth rate] as a way to smooth out the returns". According to Towers Watson (2014: 14), South Africa's compound annual growth rate on pension fund investments for the five year period from 31 December 2008 to 31 December 2013 was 13.3 per cent, and for the ten year period from 31 December 2003 to 31 December 2013 was

14.1 per cent. As this example spans a 45 year period, it is assumed that the compound annual growth rate will be three per cent higher than inflation. This results in an average compound annual growth rate of 12.44 per cent over the 45 year period. The detailed calculation of this information is shown in Table 23 below:

Table 23: Income replacement ratio calculation using a 45-year contribution period and the current maximum income tax deduction of 7.5 per cent of salary and employer contributions of 7.5 per cent of the employee's salary

Individual works for 45 years, employee contributes maximum amount of 7.5 per cent of his salary to the pension fund under the current system and employer matches the employee's contribution to the pension fund, and the compound annual growth rate on pension fund investments is three per cent above inflation.

Number of working years	Year	Starting annual salary	Inflation rate (*)	Inflation-linked annual salary	Pension fund contribution (7.5% of salary)	Employer pension fund contributions (7.5% of employee salary)	Total contributions to pension fund	Compound annual growth rate on pension fund investments (3% above inflation)	Pension fund value	Notes
1	1970	1 800	4.98%	1 890	142	142	283	7.98%	283	(1)
2	1971	1 890	5.95%	2 002	150	150	300	8.95%	606	(2)
3	1972	2 002	6.42%	2 131	160	160	320	9.42%	980	(2)
4	1973	2 131	9.45%	2 332	175	175	350	12.45%	1 422	(2)
5	1974	2 332	11.70%	2 605	195	195	391	14.70%	1 990	(2)
6	1975	2 605	13.46%	2 955	222	222	443	16.46%	2 726	(2)
7	1976	2 955	11.03%	3 281	246	246	492	14.03%	3 667	(2)
8	1977	3 281	11.16%	3 648	274	274	547	14.16%	4 729	(2)
9	1978	3 648	11.11%	4 053	304	304	608	14.11%	6 006	(2)
10	1979	4 053	13.27%	4 591	344	344	689	16.27%	7 542	(2)
11	1980	4 591	13.65%	5 217	391	391	783	16.65%	9 552	(2)
12	1981	5 217	15.28%	6 014	451	451	902	18.28%	12 044	(2)
13	1982	6 014	14.67%	6 897	517	517	1 035	17.67%	15 281	(2)
14	1983	6 897	12.35%	7 749	581	581	1 162	15.35%	19 143	(2)
15	1984	7 749	11.50%	8 640	648	648	1 296	14.50%	23 377	(2)
16	1985	8 640	16.26%	10 044	753	753	1 507	19.26%	28 274	(2)
17	1986	10 044	18.66%	11 919	894	894	1 788	21.66%	35 507	(2)
18	1987	11 919	16.19%	13 848	1 039	1 039	2 077	19.19%	45 275	(2)
19	1988	13 848	12.80%	15 621	1 172	1 172	2 343	15.80%	56 306	(2)
20	1989	15 621	14.71%	17 919	1 344	1 344	2 688	17.71%	67 891	(2)
21	1990	17 919	14.33%	20 486	1 536	1 536	3 073	17.33%	82 987	(2)
22	1991	20 486	15.31%	23 623	1 772	1 772	3 543	18.31%	100 912	(2)
23	1992	23 623	13.96%	26 921	2 019	2 019	4 038	16.96%	123 427	(2)
24	1993	26 921	9.72%	29 537	2 215	2 215	4 431	12.72%	148 791	(2)
25	1994	29 537	8.94%	32 178	2 413	2 413	4 827	11.94%	172 544	(2)
26	1995	32 178	8.73%	34 987	2 624	2 624	5 248	11.73%	198 394	(2)
27	1996	34 987	7.34%	37 555	2 817	2 817	5 633	10.34%	227 298	(2)
28	1997	37 555	8.62%	40 793	3 059	3 059	6 119	11.62%	256 920	(2)
29	1998	40 793	6.86%	43 591	3 269	3 269	6 539	9.86%	293 313	(2)
30	1999	43 591	5.27%	45 888	3 442	3 442	6 883	8.27%	329 117	(2)
31	2000	45 888	5.33%	48 334	3 625	3 625	7 250	8.33%	363 585	(2)
32	2001	48 334	5.73%	51 103	3 833	3 833	7 666	8.73%	401 537	(2)
33	2002	51 103	9.47%	55 943	4 196	4 196	8 391	12.47%	444 982	(2)
34	2003	55 943	5.84%	59 210	4 441	4 441	8 882	8.84%	509 353	(2)
35	2004	59 210	-0.68%	58 807	4 411	4 411	8 821	2.32%	563 201	(2)
36	2005	58 807	2.06%	60 019	4 501	4 501	9 003	5.06%	585 270	(2)
37	2006	60 019	3.24%	61 963	4 647	4 647	9 295	6.24%	624 179	(2)
38	2007	61 963	6.17%	65 787	4 934	4 934	9 868	9.17%	672 996	(2)
39	2008	65 787	10.04%	72 392	5 429	5 429	10 859	13.04%	745 569	(2)
40	2009	72 392	7.26%	77 647	5 824	5 824	11 647	10.26%	854 438	(2)
41	2010	77 647	4.10%	80 831	6 062	6 062	12 125	7.10%	954 228	(2)
42	2011	80 831	5.01%	84 880	6 366	6 366	12 732	8.01%	1 034 710	(2)
43	2012	84 880	5.75%	89 761	6 732	6 732	13 464	8.75%	1 131 055	(2)
44	2013	89 761	5.77%	94 940	7 121	7 121	14 241	8.77%	1 244 263	(2)
45	2014	94 940	6.17%	100 798	7 560	7 560	15 120	9.17%	1 368 504	(2)
Total contributions made									229 700	
Total value (compound annual growth rate of return on pension fund investments of 3% above inflation)									1 368 504	
Retire (commute 1/3)									456 168	
Remain in fund (2/3)									912 336	
Assume 15 year retirement period (annuity per annum and 8.5% discount rate assumption)									109 864	
Percentage of final salary (adequate income replacement ratio)									109%	

(*) Inflation.eu (2014)

Notes:

(1) It is assumed that there will be no return on the pension fund investments, since this is the first year that contributions are made.

(2) In subsequent years the pension fund value is determined by taking the opening pension fund value and increasing this value by the return on pension fund investments and adding the current pension fund contributions (as zero growth is assumed in the first year that contributions are made).

From an analysis of Table 23, it is noted that the office clerk will have contributed R229 700 and his contributions will have grown to R1 368 504, taking the annual compound growth rate on pension fund investments into account. The office clerk opts to commute one-third of his lump sum (R456 168) and assuming that this is the only pension fund that he belonged to, he will pay tax of R25 410 on his pension fund lump sum (determined using the retirement lump sum benefit table for the 2014 year of assessment). The lump sum received, after tax, by the office clerk will be R430 758. The remaining two-thirds of pension savings will remain in the pension fund and will be paid as a pension. Although certain pension funds (defined benefit funds) bear the longevity risk and "guarantee" a pension, for the purposes of this example, the pension amount was determined. The following assumptions were made in order to calculate the pension that would be received by the office clerk:

- The present value of the investment is R912 336 which is the two-thirds that remain in the pension fund;
- It is difficult to estimate the retirement period, as each individual has a different life expectancy. The World Health Organisation (2014) has issued life expectancy tables in 2012 for South Africa, and it estimates that a 65 – 69 year old female has a life expectancy of 15 years, a male at the same age has a life expectancy of 11 years, and the combined life expectancy (for both males and females) is 13 years. The life expectancy tables used by the South African Revenue Services (2014) indicate that a 65 year old female (whose age next birthday is 66 years) has a life expectancy of 14.51 years and a male of the same age has a life expectancy of 11.26 years. It is submitted that the most prudent estimate of life expectancy for the purposes of this calculation would be 15 years.
- Aon plc (2013) in its *Global Report: Global Survey of Retirement Plan Accounting Assumptions* reported that the average discount rate for South Africa in the 2011 year was 8.75 per cent and the 2012 average discount rate was 8.86 per cent. It is submitted that a prudent estimate of a discount rate is 8.5 per cent and this is used in the calculation.

Based on these assumptions, the annual pension is calculated at R109 864. The income replacement ratio is calculated by taking the office clerk's annual pension (R109 864) and dividing this by his last annual salary (R100 798) when he retires. His income replacement ratio is 109 per cent. It may be concluded that under the current pension fund contribution arrangement, the office clerk who retires after 45 years of savings will have an income replacement ratio that will exceed his final salary by nine per cent.

In order to compare the effect of the proposed changes, another calculation using the same information as above was performed. The only difference is that the employee and employer contributions are removed, and replaced with pension contributions of 27.5 per cent of the office clerk's salary. This is in line with the proposed section 11(k) deductions which are effective from the date of implementation of the changes (possibly 1 March 2016 or 1 March 2017). The detailed calculation of this information is shown in Table 24.

Table 24: Income replacement ratio calculation using a 45-year contribution period and the proposed maximum income tax deduction of 27.5 per cent of remuneration

Individual works for 45 years, contributes maximum amount of 27.5 per cent of his salary to the pension fund under the proposed system, and the compound annual growth rate on pension fund investments is three per cent above inflation.

Number of working years	Year	Starting annual salary	Inflation rate (*)	Inflation-linked annual salary	Maximum contributions made per section 11(k)(27.5 % of remuneration)	Total contributions to pension fund	Compound annual growth rate on pension fund investments (3% above inflation)	Pension fund value	Notes
1	1970	1 800	4.98%	1 890	520	520	7.980%	520	(1)
2	1971	1 890	5.95%	2 002	551	551	8.950%	1 112	(2)
3	1972	2 002	6.42%	2 131	586	586	9.420%	1 797	(2)
4	1973	2 131	9.45%	2 332	641	641	12.450%	2 608	(2)
5	1974	2 332	11.70%	2 605	716	716	14.700%	3 649	(2)
6	1975	2 605	13.46%	2 955	813	813	16.460%	4 998	(2)
7	1976	2 955	11.03%	3 281	902	902	14.030%	6 723	(2)
8	1977	3 281	11.16%	3 648	1 003	1 003	14.160%	8 669	(2)
9	1978	3 648	11.11%	4 053	1 115	1 115	14.110%	11 011	(2)
10	1979	4 053	13.27%	4 591	1 262	1 262	16.270%	13 827	(2)
11	1980	4 591	13.65%	5 217	1 435	1 435	16.650%	17 512	(2)
12	1981	5 217	15.28%	6 014	1 654	1 654	18.280%	22 081	(2)
13	1982	6 014	14.67%	6 897	1 897	1 897	17.670%	28 014	(2)
14	1983	6 897	12.35%	7 749	2 131	2 131	15.350%	35 095	(2)
15	1984	7 749	11.50%	8 640	2 376	2 376	14.500%	42 858	(2)
16	1985	8 640	16.26%	10 044	2 762	2 762	19.260%	51 835	(2)
17	1986	10 044	18.66%	11 919	3 278	3 278	21.660%	65 096	(2)
18	1987	11 919	16.19%	13 848	3 808	3 808	19.190%	83 004	(2)
19	1988	13 848	12.80%	15 621	4 296	4 296	15.800%	103 228	(2)
20	1989	15 621	14.71%	17 919	4 928	4 928	17.710%	124 466	(2)
21	1990	17 919	14.33%	20 486	5 634	5 634	17.330%	152 143	(2)
22	1991	20 486	15.31%	23 623	6 496	6 496	18.310%	185 005	(2)
23	1992	23 623	13.96%	26 921	7 403	7 403	16.960%	226 283	(2)
24	1993	26 921	9.72%	29 537	8 123	8 123	12.720%	272 783	(2)
25	1994	29 537	8.94%	32 178	8 849	8 849	11.940%	316 330	(2)
26	1995	32 178	8.73%	34 987	9 621	9 621	11.730%	363 722	(2)
27	1996	34 987	7.34%	37 555	10 328	10 328	10.340%	416 714	(2)
28	1997	37 555	8.62%	40 793	11 218	11 218	11.620%	471 020	(2)
29	1998	40 793	6.86%	43 591	11 987	11 987	9.860%	537 740	(2)
30	1999	43 591	5.27%	45 888	12 619	12 619	8.270%	603 380	(2)
31	2000	45 888	5.33%	48 334	13 292	13 292	8.330%	666 572	(2)
32	2001	48 334	5.73%	51 103	14 053	14 053	8.730%	736 151	(2)
33	2002	51 103	9.47%	55 943	15 384	15 384	12.470%	815 801	(2)
34	2003	55 943	5.84%	59 210	16 283	16 283	8.840%	933 814	(2)
35	2004	59 210	-0.68%	58 807	16 172	16 172	2.320%	1 032 535	(2)
36	2005	58 807	2.06%	60 019	16 505	16 505	5.060%	1 072 995	(2)
37	2006	60 019	3.24%	61 963	17 040	17 040	6.240%	1 144 329	(2)
38	2007	61 963	6.17%	65 787	18 091	18 091	9.170%	1 233 826	(2)
39	2008	65 787	10.04%	72 392	19 908	19 908	13.040%	1 366 876	(2)
40	2009	72 392	7.26%	77 647	21 353	21 353	10.260%	1 566 470	(2)
41	2010	77 647	4.10%	80 831	22 228	22 228	7.100%	1 749 418	(2)
42	2011	80 831	5.01%	84 880	23 342	23 342	8.010%	1 896 969	(2)
43	2012	84 880	5.75%	89 761	24 684	24 684	8.750%	2 073 600	(2)
44	2013	89 761	5.77%	94 940	26 109	26 109	8.770%	2 281 149	(2)
45	2014	94 940	6.17%	100 798	27 719	27 719	9.170%	2 508 925	(2)
Total contributions made								421 116	
Total value (compound annual growth rate of return on pension fund investments of 3% above inflation)								2 508 925	
Retire (commute 1/3)								836 308	
Remain in fund (2/3)								1 672 617	
Assume 15 year retirement period (annuity per annum and 8.5% discount rate assumption)								201 417	
Percentage of final salary (income replacement ratio)								200%	

(*) Inflation.eu (2014)

Notes:

(1) It is assumed that there will be no return on the pension fund investments, since this is the first year that contributions are made.

(2) In subsequent years the pension fund value is determined by taking the opening pension fund value and increasing this value by the return on pension fund investments and adding the current pension fund contributions (as zero growth is assumed in the first year that contributions are made).

From an analysis of Table 24, it is noted that the office clerk will have contributed R421 116 and the value of his fund benefit has amounted to R2 508 925. The office clerk opts to commute one-third of his lump sum (R836 308) and assuming that this is only the pension fund that he belonged to, he will pay tax of R112 403 on his pension fund lump sum (using the retirement lump sum benefit table for the 2014 year of assessment). The lump sum received, after tax, by the office clerk will be R723 905. The remaining two-thirds (R1 672 617) of pension savings will remain in the pension fund and will be paid as a pension. The income replacement ratio is calculated by taking the office clerk's annual pension (R201 417) and dividing this by his last annual salary (R100 798) when he retires. His income replacement ratio is 200 per cent. It may be concluded that under the proposed pension fund contribution arrangement, an individual who retires after 45 years of savings will be able to exceed his final salary with an income replacement ratio of 200 per cent. The results presented in this table indicate the value of the increased allowable deduction proposed by National Treasury – an increase in the income replacement ratio of 91 per cent (200 per cent under the proposed section 11(k) deduction less 109 per cent under the current section 11(k) deduction). Based on the findings of the examples outlined in Tables 23 and 24 above, it has shown that the effect of the current versus the proposed retirement savings options during the accumulation phase of retirement savings will result in a greater income replacement ratio upon retirement.

The proposed change in the tax deduction will not necessarily result in all South Africans making use of the proposed incentives. As these tax incentives will only be introduced with effect from the date of implementation of the changes (possibly 1 March 2016 or 1 March 2017), there is no evidence to indicate that South African's retirement savings behaviour will change. However, research from the United States of America by Marr, Frentz and Chye Ching (2013) indicate that "Among workers who participate in retirement plans, only a small per cent are constrained by contribution limits. Only 5 per cent of participants contribute the maximum amount to a 401(k) [retirement plan], and those are primarily participants with higher incomes". Dolan (2013) confirms this: "Unfortunately, tax preferences do little to increase retirement saving". Topoleski (2013: 8) supports Marr *et al* (2013):

> Because higher-earners would save much of their income even without tax incentives to do so, a substantial share of tax revenue lost through the deduction for contributions to retirement plans does not result in a net increase in national saving. Consequently, some economists have

suggested that tax incentives for retirement saving are "upside down". Most of these tax breaks are enjoyed by higher-wage workers who would be likely to save part of their income even without a tax deduction, rather than by low-wage workers who might respond to an effective tax incentive with new saving.

South Africa cannot be directly compared to the United States, but it may be assumed that the behaviour of individuals saving for retirement throughout the world would be comparable. National Treasury implicitly understands that high-income earners are more likely to be able to save for retirement, irrespective of the tax incentives and for this reason the proposed section 11(k) deduction (effective from the date of implementation of the changes (possibly 1 March 2016 or 1 March 2017) imposes an annual limit of R350 000 on the retirement saving deduction.

Both of the scenarios represented in Table 23 and 24, assume that the employee has contributed the maximum amounts allowed to the pension fund under the current and proposed sections of the Income Tax Act. This may not be a realistic assumption. Research by Sanlam Employee Benefits (2014: 8) generated the following table showing the key indicators relating to the provision for retirement savings:

Table 25: Key indicators of retirement savings

	2014	**2013**	**2012**	**2011**	**2010**
Employer contributions	9.7	9.7	10.2	10.1	9.8
Employee contributions	6.4	5.9	6.0	6.1	5.8
Death benefit premiums	(1.6)	(1.6)	(1.6)	(1.6)	(1.7)
Disability benefit premiums	(1.0)	(1.1)	(1.1)	(1.2)	(1.3)
Administration and operating costs	(1.0)	(0.9)	(1.1)	(0.9)	(0.9)
Total provision for retirement	12.5	12.0	12.4	12.5	11.7

The table spans a five year period, and the average employee contributions over this five year period is 6.04 per cent of an employees' remuneration. The average employee contributions were calculated using the sum of employee contributions for five years divided by five years. The average employer contributions equate to 6.2 per cent of the employee's remuneration and were calculated as follows: the sum of (employer contributions less death benefit premiums, less disability benefit premiums, less administration and operating costs) for five years divided by five years. A sensitivity analysis was conducted using the same assumptions as before, except that the employee and employer contributions were replaced by the industry averages of 6.04 per cent and 6.2 per cent, respectively. The detail of this sensitivity analysis is shown in Table 26.

Table 26: Income replacement ratio calculation using a 45-year contribution period and the industry average employee and employer contributions based on an employee's salary

Individual works for 45 years, employee contributes 6.04% of his salary to the pension fund under the current system and employer contributes 6.2% of the employee salary to the pension fund, and compound annual growth rate on the pension fund investments is three per cent above inflation.

Number of working years	Year	Starting annual salary	Inflation rate (*)	Inflation-linked annual salary	Pension fund contribution (6.04 % of RFE)	Employer pension fund contributions (6.2 % of employee salary)	Total contributions to pension fund	Compound annual growth rate on pension fund investments (3% above inflation)	Pension fund value	Notes
1	1970	1 800	4.98%	1 890	114	117	231	7.98%	231	(1)
2	1971	1 890	5.95%	2 002	121	124	245	8.95%	495	(2)
3	1972	2 002	6.42%	2 131	129	132	261	9.42%	800	(2)
4	1973	2 131	9.45%	2 332	141	145	285	12.45%	1 161	(2)
5	1974	2 332	11.70%	2 605	157	161	319	14.70%	1 624	(2)
6	1975	2 605	13.46%	2 955	179	183	362	16.46%	2 224	(2)
7	1976	2 955	11.03%	3 281	198	203	402	14.03%	2 992	(2)
8	1977	3 281	11.16%	3 648	220	226	446	14.16%	3 859	(2)
9	1978	3 648	11.11%	4 053	245	251	496	14.11%	4 901	(2)
10	1979	4 053	13.27%	4 591	277	285	562	16.27%	6 154	(2)
11	1980	4 591	13.65%	5 217	315	323	639	16.65%	7 794	(2)
12	1981	5 217	15.28%	6 014	363	373	736	18.28%	9 828	(2)
13	1982	6 014	14.67%	6 897	417	428	844	17.67%	12 469	(2)
14	1983	6 897	12.35%	7 749	468	480	948	15.35%	15 621	(2)
15	1984	7 749	11.50%	8 640	522	536	1 057	14.50%	19 076	(2)
16	1985	8 640	16.26%	10 044	607	623	1 229	19.26%	23 071	(2)
17	1986	10 044	18.66%	11 919	720	739	1 459	21.66%	28 974	(2)
18	1987	11 919	16.19%	13 848	836	859	1 695	19.19%	36 944	(2)
19	1988	13 848	12.80%	15 621	944	968	1 912	15.80%	45 946	(2)
20	1989	15 621	14.71%	17 919	1 082	1 111	2 193	17.71%	55 399	(2)
21	1990	17 919	14.33%	20 486	1 237	1 270	2 508	17.33%	67 717	(2)
22	1991	20 486	15.31%	23 623	1 427	1 465	2 891	18.31%	82 344	(2)
23	1992	23 623	13.96%	26 921	1 626	1 669	3 295	16.96%	100 716	(2)
24	1993	26 921	9.72%	29 537	1 784	1 831	3 615	12.72%	121 413	(2)
25	1994	29 537	8.94%	32 178	1 944	1 995	3 939	11.94%	140 796	(2)
26	1995	32 178	8.73%	34 987	2 113	2 169	4 282	11.73%	161 889	(2)
27	1996	34 987	7.34%	37 555	2 268	2 328	4 597	10.34%	185 476	(2)
28	1997	37 555	8.62%	40 793	2 464	2 529	4 993	11.62%	209 647	(2)
29	1998	40 793	6.86%	43 591	2 633	2 703	5 336	9.86%	239 343	(2)
30	1999	43 591	5.27%	45 888	2 772	2 845	5 617	8.27%	268 559	(2)
31	2000	45 888	5.33%	48 334	2 919	2 997	5 916	8.33%	296 685	(2)
32	2001	48 334	5.73%	51 103	3 087	3 168	6 255	8.73%	327 654	(2)
33	2002	51 103	9.47%	55 943	3 379	3 468	6 847	12.47%	363 106	(2)
34	2003	55 943	5.84%	59 210	3 576	3 671	7 247	8.84%	415 632	(2)
35	2004	59 210	-0.68%	58 807	3 552	3 646	7 198	2.32%	459 572	(2)
36	2005	58 807	2.06%	60 019	3 625	3 721	7 346	5.06%	477 580	(2)
37	2006	60 019	3.24%	61 963	3 743	3 842	7 584	6.24%	509 330	(2)
38	2007	61 963	6.17%	65 787	3 974	4 079	8 052	9.17%	549 165	(2)
39	2008	65 787	10.04%	72 392	4 372	4 488	8 861	13.04%	608 384	(2)
40	2009	72 392	7.26%	77 647	4 690	4 814	9 504	10.26%	697 221	(2)
41	2010	77 647	4.10%	80 831	4 882	5 012	9 894	7.10%	778 650	(2)
42	2011	80 831	5.01%	84 880	5 127	5 263	10 389	8.01%	844 323	(2)
43	2012	84 880	5.75%	89 761	5 422	5 565	10 987	8.75%	922 941	(2)
44	2013	89 761	5.77%	94 940	5 734	5 886	11 621	8.77%	1 015 318	(2)
45	2014	94 940	6.17%	100 798	6 088	6 249	12 338	9.17%	1 116 700	(2)

Average of the compound annual growth rate over the 45- year period	12.44%
Total contributions made	187 435
Total value (compound annual growth rate of return on pension fund investments of 3% above inflation)	1 116 700
Retire (commute 1/3)	372 233
Remain in fund (2/3)	744 466
Assume 15 year retirement period (annuity per annum and 8.5% discount rate assumption)	89 649
Percentage of final salary (income replacement ratio)	89%

(*) Inflation.eu (2014)

Notes:

(1) It is assumed that there will be no return on the pension fund investments, since this is the first year that contributions are made.

(2) In subsequent years the pension fund value is determined by taking the opening pension fund value and increasing this value by the return on pension fund investments and adding the current pension fund contributions (as zero growth is assumed in the first year that contributions are made).

From Table 26, it is noted that the total contributions (both employee and employer contributions) made to the pension fund were R187 435. When the compound annual growth rate of pension fund investments is applied, the value of the fund benefit amounts to R1 116 700. After the commutation of one-third, the value that remains in the pension fund is R744 466. Based on these assumptions, the annual pension is calculated at R89 649. The income replacement ratio is 89 per cent. This is 20 per cent less than the income replacement ratio calculated assuming that contributions are based on the current tax deduction allowed for retirement savings.

Based on the examples in Tables 23 and 24, it can be concluded that the change in the tax deductions proposed by National Treasury during the accumulation phase of retirement will result in an increase in the income replacement ratio of an individual upon retirement. Table 26 demonstrates the effect of the assumption that individuals may not always take full advantage of the tax incentives for retirement savings.

The above examples (set out in Tables 23, 24 and 26) have assumed that the office clerk works for 45 years, does not change his job, works until the age of 65 and does not make any pre-retirement withdrawals. The following section will illustrate the effects of pre-retirement leakage and early retirement.

7.3 EXAMPLES SHOWING THE EFFECT OF PRE-RETIREMENT LEAKAGE AND EARLY RETIREMENT ON THE INCOME REPLACEMENT RATIO

South Africa does not have detailed data on how often employees change jobs. In the United States of America, the Bureau of Labor Statistics (2012: 1) found that: "The average person born in the latter years of the baby boom (1957 – 1964) held 11.3 jobs from the age of 18 to age 46. . . Nearly half of these jobs were held between the ages of 18 to 24." South Africa cannot be directly compared to the United States, but it is fair to assume that not all individuals will work for the same employer for 45 years. In this section of the chapter, the same particulars (as were used in the previous section) will be used, but adjustments will be made to the number of working years during which an individual contributes to his retirement savings and the effect on the income replacement ratio of the reduction in the number of working years will be shown.

Table 27: Income replacement ratio calculation using a 30-year contribution period and the current maximum income tax incentives of 7.5 per cent of salary and employer contributions of 7.5 per cent of the employee's salary

Individual works for 30 years, employee contributes maximum amount of 7.5 per cent of his salary to the pension fund under the current system and employer matches the employee's contribution to the pension fund, and the compound annual growth rate on pension fund investments is three per cent above inflation.

Number of working years	Year	Starting annual salary	Inflation rate (*)	Inflation-linked annual salary	Pension fund contribution (7.5 % of RFE)	Employer pension fund contributions (7.5% of employee salary)	Total contributions to pension fund	Compound annual growth rate on pension fund investments (3% above inflation)	Pension fund value	Notes
1	1985	8 640	16.26%	10 045	753	753	1 507	19.26%	1 507	(1)
2	1986	10 045	18.66%	11 919	894	894	1 788	21.66%	3 585	(2)
3	1987	11 919	16.19%	13 849	1 039	1 039	2 077	19.19%	6 439	(2)
4	1988	13 849	12.80%	15 622	1 172	1 172	2 343	15.80%	10 017	(2)
5	1989	15 622	14.71%	17 920	1 344	1 344	2 688	17.71%	14 288	(2)
6	1990	17 920	14.33%	20 487	1 537	1 537	3 073	17.33%	19 892	(2)
7	1991	20 487	15.31%	23 624	1 772	1 772	3 544	18.31%	26 883	(2)
8	1992	23 624	13.96%	26 922	2 019	2 019	4 038	16.96%	35 843	(2)
9	1993	26 922	9.72%	29 539	2 215	2 215	4 431	12.72%	46 353	(2)
10	1994	29 539	8.94%	32 180	2 413	2 413	4 827	11.94%	57 076	(2)
11	1995	32 180	8.73%	34 989	2 624	2 624	5 248	11.73%	69 139	(2)
12	1996	34 989	7.34%	37 557	2 817	2 817	5 634	10.34%	82 883	(2)
13	1997	37 557	8.62%	40 794	3 060	3 060	6 119	11.62%	97 572	(2)
14	1998	40 794	6.86%	43 593	3 269	3 269	6 539	9.86%	115 449	(2)
15	1999	43 593	5.27%	45 890	3 442	3 442	6 884	8.27%	133 715	(2)
16	2000	45 890	5.33%	48 336	3 625	3 625	7 250	8.33%	152 024	(2)
17	2001	48 336	5.73%	51 106	3 833	3 833	7 666	8.73%	172 354	(2)
18	2002	51 106	9.47%	55 946	4 196	4 196	8 392	12.47%	195 792	(2)
19	2003	55 946	5.84%	59 213	4 441	4 441	8 882	8.84%	229 089	(2)
20	2004	59 213	-0.68%	58 810	4 411	4 411	8 822	2.32%	258 162	(2)
21	2005	58 810	2.06%	60 022	4 502	4 502	9 003	5.06%	273 155	(2)
22	2006	60 022	3.24%	61 966	4 647	4 647	9 295	6.24%	296 271	(2)
23	2007	61 966	6.17%	65 790	4 934	4 934	9 868	9.17%	324 627	(2)
24	2008	65 790	10.04%	72 395	5 430	5 430	10 859	13.04%	365 255	(2)
25	2009	72 395	7.26%	77 651	5 824	5 824	11 648	10.26%	424 531	(2)
26	2010	77 651	4.10%	80 835	6 063	6 063	12 125	7.10%	480 213	(2)
27	2011	80 835	5.01%	84 884	6 366	6 366	12 733	8.01%	527 041	(2)
28	2012	84 884	5.75%	89 765	6 732	6 732	13 465	8.75%	582 722	(2)
29	2013	89 765	5.77%	94 945	7 121	7 121	14 242	8.77%	647 952	(2)
30	2014	94 945	6.17%	100 803	7 560	7 560	15 120	9.17%	719 898	(2)

Total contributions made	220 109
Total value (compound annual growth rate of return on pension fund investments of 3% above inflation)	719 898
Retire (commute 1/3)	239 966
Remain in fund (2/3)	479 932
Assume 15 year retirement period (annuity per annum and 8.5% discount rate assumption)	57 794
Percentage of final salary (income replacement ratio lower than industry recommended, but higher than government recommendations)	57%
Assume no commutation of retirement benefit, which results in the full pension fund value being taken as an annuity. The annuity that will be received for a period of 15 years (and a discount rate of 8.5% is applied) will be:	86 690
Percentage of final salary	86%

(*) Inflation.eu (2014)

Notes:

(1) It is assumed that there will be no return on the pension fund investments, since this is the first year that contributions are made.

(2) In subsequent years the pension fund value is determined by taking the opening pension fund value and increasing this value by the return on pension fund investments and adding the current pension fund contributions (as zero growth is assumed in the first year that contributions are made).

In Table 27, an example using the same facts and assumptions that were used in section 7.2 above is presented, except that the office clerk contributed to his retirement savings for a period of only 30 years. There may be two reasons for the shorter contribution period, such as a pre-retirement withdrawal where, for example after 10 years of working, the office clerk decided to change employment, withdrew his pre-retirement savings in full and then entered the teaching profession and contributed for a further 30 years, or the office clerk may have started working at 25 years old and decided to retire early at 55 years old due to ill health.

Under the current retirement contribution legislation, the effect of the shorter retirement savings period has the effect of reducing the income replacement ratio from 109 per cent to 57 per cent. This is a reduction of 52 per cent is a substantial reduction in the individual's income replacement ratio. The income replacement ratio is still higher than the government recommendation of 40 per cent (referred to in section 1.2 of chapter 1). Should the office clerk/teacher decide not to commute any of his retirement savings, then he will receive an annuity of R86 690 which equates to an income replacement ratio of 86 per cent under the current legislation. This non-commutation income replacement ratio is slightly above the industry recommendation of between 70 and 79 per cent (referred to in section 1.2 of chapter 1). The income replacement ratio based on non-commutation is 29 per cent (86 per cent less 57 per cent) higher than had the office clerk/teacher commuted one-third of his retirement savings.

Table 28 illustrates the effect of the proposed deductible contribution of 27.5 per cent and a 30-year contribution period.

Table 28: Income replacement ratio calculation using a 30-year contribution period and the proposed maximum income tax deduction of 27.5 per cent of remuneration									
Individual works for 30 years, contributes maximum amount of 27.5 per cent of his salary to the pension fund under the proposed system, and the compound annual growth rate on pension fund investments is three per cent above inflation.									
Number of working years	Year	Starting annual salary	Inflation rate (*)	Inflation-linked annual salary	Maximum contributions made per section 11(k)(27.5 % of remuneration)	Total contributions to pension fund	Compound annual growth rate on pension fund investments (3% above inflation)	Pension fund value	Notes
1	1985	8 640	16.26%	10 045	2 762	2 762	19.260%	2 762	(1)
2	1986	10 045	18.66%	11 919	3 278	3 278	21.660%	6 572	(2)
3	1987	11 919	16.19%	13 849	3 808	3 808	19.190%	11 804	(2)
4	1988	13 849	12.80%	15 622	4 296	4 296	15.800%	18 365	(2)
5	1989	15 622	14.71%	17 920	4 928	4 928	17.710%	26 195	(2)
6	1990	17 920	14.33%	20 487	5 634	5 634	17.330%	36 468	(2)
7	1991	20 487	15.31%	23 624	6 497	6 497	18.310%	49 285	(2)
8	1992	23 624	13.96%	26 922	7 404	7 404	16.960%	65 712	(2)
9	1993	26 922	9.72%	29 539	8 123	8 123	12.720%	84 980	(2)
10	1994	29 539	8.94%	32 180	8 849	8 849	11.940%	104 639	(2)
11	1995	32 180	8.73%	34 989	9 622	9 622	11.730%	126 755	(2)
12	1996	34 989	7.34%	37 557	10 328	10 328	10.340%	151 951	(2)
13	1997	37 557	8.62%	40 794	11 218	11 218	11.620%	178 882	(2)
14	1998	40 794	6.86%	43 593	11 988	11 988	9.860%	211 656	(2)
15	1999	43 593	5.27%	45 890	12 620	12 620	8.270%	245 145	(2)
16	2000	45 890	5.33%	48 336	13 292	13 292	8.330%	278 711	(2)
17	2001	48 336	5.73%	51 106	14 054	14 054	8.730%	315 981	(2)
18	2002	51 106	9.47%	55 946	15 385	15 385	12.470%	358 952	(2)
19	2003	55 946	5.84%	59 213	16 284	16 284	8.840%	419 996	(2)
20	2004	59 213	-0.68%	58 810	16 173	16 173	2.320%	473 297	(2)
21	2005	58 810	2.06%	60 022	16 506	16 506	5.060%	500 783	(2)
22	2006	60 022	3.24%	61 966	17 041	17 041	6.240%	543 164	(2)
23	2007	61 966	6.17%	65 790	18 092	18 092	9.170%	595 149	(2)
24	2008	65 790	10.04%	72 395	19 909	19 909	13.040%	669 633	(2)
25	2009	72 395	7.26%	77 651	21 354	21 354	10.260%	778 307	(2)
26	2010	77 651	4.10%	80 835	22 230	22 230	7.100%	880 391	(2)
27	2011	80 835	5.01%	84 884	23 343	23 343	8.010%	966 242	(2)
28	2012	84 884	5.75%	89 765	24 685	24 685	8.750%	1 068 324	(2)
29	2013	89 765	5.77%	94 945	26 110	26 110	8.770%	1 187 912	(2)
30	2014	94 945	6.17%	100 803	27 721	27 721	9.170%	1 319 813	(2)
Total contributions made								403 534	
Total value (compound annual growth rate of return on pension fund investments of 3% above inflation)								1 319 813	
Retire (commute 1/3)								439 938	
Remain in fund (2/3)								879 875	
Assume 15 year retirement period (annuity per annum and 8.5% discount rate assumption)								105 955	
Percentage of final salary (income replacement ratio lower similar to saving for 45 years under the current retirement savings deductions)								105%	
Assume no commutation of retirement benefit, which results in the full pension fund value being taken as an annuity. The annuity that will be received for a period of 15 years (and a discount rate of 8.5% is applied) will be:								158 932	
Percentage of final salary								158%	
(*) Inflation.eu (2014)									
Notes:									
(1)	It is assumed that there will be no return on the pension fund investments, since this is the first year that contributions are made.								
(2)	In subsequent years the pension fund value is determined by taking the opening pension fund value and increasing this value by the return on pension fund investments and adding the current pension fund contributions (as zero growth is assumed in the first year that contributions are made).								

Table 28 shows that a shorter period of retirement savings results in an income replacement ratio of 105 per cent under the proposed legislation. An income replacement ratio of 105 per cent should be more than sufficient for the office clerk/teacher, and he may commute up to one-third of his retirement savings without any reduction in his standard of living. Should the office clerk/teacher decide not to commute any of his retirement savings, then he will receive an income replacement ratio of 158 per cent under the proposed legislation. This non-commutation option is not necessary since the office clerk/teacher will have more income on his retirement than before his retirement.

Based on the findings in Table 28, it can be concluded that the proposed legislation for an increased deduction in respect of retirement savings, results in an increase in the income replacement ratio on retirement. This is the goal that National Treasury had when they embarked on retirement reform in 2004.

A further analysis was conducted based on contributions to the pension fund for a period of 20 years. The same information as in the previous examples was assumed, with a contribution rate of 7.5 per cent by both the employee and the employer.

Table 29: Income replacement ratio calculation using a 20-year contribution period and the current maximum income tax deductions of 7.5 per cent of salary and employer contributions of 7.5 per cent of the employee's salary

Individual works for 20 years, employee contributes maximum amount of 7.5 per cent of his salary to the pension fund under the current system and employer matches the employee's contribution to the pension fund, and the compound annual growth rate on pension fund investments is three per cent above inflation.

Number of working years	Year	Starting annual salary	Inflation rate (*)	Inflation-linked annual salary	Pension fund contribution (7.5% of RFE)	Employer pension fund contributions (7.5% of employee salary)	Total contributions to pension fund	Compound annual growth rate on pension fund investments (3% above inflation)	Pension fund value	Notes
1	1995	32 180	8.73%	34 989	2 624	2 624	5 248	11.73%	5 248	(1)
2	1996	34 989	7.34%	37 558	2 817	2 817	5 634	10.34%	11 498	(2)
3	1997	37 558	8.62%	40 795	3 060	3 060	6 119	11.62%	18 806	(2)
4	1998	40 795	6.86%	43 594	3 270	3 270	6 539	9.86%	27 530	(2)
5	1999	43 594	5.27%	45 891	3 442	3 442	6 884	8.27%	37 128	(2)
6	2000	45 891	5.33%	48 337	3 625	3 625	7 251	8.33%	47 449	(2)
7	2001	48 337	5.73%	51 107	3 833	3 833	7 666	8.73%	59 068	(2)
8	2002	51 107	9.47%	55 946	4 196	4 196	8 392	12.47%	72 616	(2)
9	2003	55 946	5.84%	59 214	4 441	4 441	8 882	8.84%	90 554	(2)
10	2004	59 214	-0.68%	58 811	4 411	4 411	8 822	2.32%	107 380	(2)
11	2005	58 811	2.06%	60 023	4 502	4 502	9 003	5.06%	118 875	(2)
12	2006	60 023	3.24%	61 967	4 648	4 648	9 295	6.24%	134 185	(2)
13	2007	61 967	6.17%	65 791	4 934	4 934	9 869	9.17%	152 427	(2)
14	2008	65 791	10.04%	72 396	5 430	5 430	10 859	13.04%	177 263	(2)
15	2009	72 396	7.26%	77 652	5 824	5 824	11 648	10.26%	212 026	(2)
16	2010	77 652	4.10%	80 836	6 063	6 063	12 125	7.10%	245 906	(2)
17	2011	80 836	5.01%	84 886	6 366	6 366	12 733	8.01%	276 098	(2)
18	2012	84 886	5.75%	89 766	6 732	6 732	13 465	8.75%	311 678	(2)
19	2013	89 766	5.77%	94 946	7 121	7 121	14 242	8.77%	353 192	(2)
20	2014	94 946	6.17%	100 804	7 560	7 560	15 121	9.17%	399 288	(2)
Total contributions made									189 796	
Total value (compound annual growth rat of return on pension fund investments of 3% above inflation)									399 288	
Retire (commute 1/3)									133 096	
Remain in fund (2/3)									266 192	
Assume 15 year retirement period (annuity per annum and 8.5% discount rate assumption)									32 055	
Percentage of final salary (income replacement ratio lower than industry recommendations and government recommendations)									32%	
Assume no commutation of retirement benefit, which results in the full pension fund value being taken as an annuity. The annuity that will be received for a 15 year period (and a discount rate of 8.5% is applied) will be:									48 082	
Percentage of final salary (income replacement ratio lower than industry recommendations, but higher than government recommendations)									48%	
(*) Inflation.eu (2014)										
Notes:										
(1)	It is assumed that there will be no return on the pension fund investments, since this is the first year that contributions are made.									
(2)	In subsequent years the pension fund value is determined by taking the opening pension fund value and increasing this value by the return on pension fund investments and adding the current pension fund contributions (as zero growth is assumed in the first year that contributions are made).									

Table 29 shows that his income replacement ratio will be 32 per cent (and 48 per cent with no commutation).

Table 30 is based on the same assumptions, but a contribution rate of 27.5 per cent.

Table 30: Income replacement ratio calculation using a 20-year contribution period and the proposed maximum income tax deduction of 27.5 per cent of remuneration

Individual works for 20 years, contributes maximum amount of 27.5 per cent of his salary to the pension fund under the proposed system, and the compound annual growth rate on pension fund investments is three per cent above inflation.

Number of working years	Year	Starting annual salary	Inflation rate (*)	Inflation-linked annual salary	Maximum contributions made per section 11(k)(27.5 % of remuneration)	Total contributions to pension fund	Compound annual growth rate on pension fund investments (3% above inflation)	Pension fund value	Notes
1	1995	32 180	8.73%	34 989	9 622	9 622	11.730%	9 622	(1)
2	1996	34 989	7.34%	37 558	10 328	10 328	10.340%	21 079	(2)
3	1997	37 558	8.62%	40 795	11 219	11 219	11.620%	34 477	(2)
4	1998	40 795	6.86%	43 594	11 988	11 988	9.860%	50 472	(2)
5	1999	43 594	5.27%	45 891	12 620	12 620	8.270%	68 068	(2)
6	2000	45 891	5.33%	48 337	13 293	13 293	8.330%	86 990	(2)
7	2001	48 337	5.73%	51 107	14 054	14 054	8.730%	108 291	(2)
8	2002	51 107	9.47%	55 946	15 385	15 385	12.470%	133 130	(2)
9	2003	55 946	5.84%	59 214	16 284	16 284	8.840%	166 015	(2)
10	2004	59 214	-0.68%	58 811	16 173	16 173	2.320%	196 864	(2)
11	2005	58 811	2.06%	60 023	16 506	16 506	5.060%	217 937	(2)
12	2006	60 023	3.24%	61 967	17 041	17 041	6.240%	246 006	(2)
13	2007	61 967	6.17%	65 791	18 092	18 092	9.170%	279 449	(2)
14	2008	65 791	10.04%	72 396	19 909	19 909	13.040%	324 983	(2)
15	2009	72 396	7.26%	77 652	21 354	21 354	10.260%	388 715	(2)
16	2010	77 652	4.10%	80 836	22 230	22 230	7.100%	450 827	(2)
17	2011	80 836	5.01%	84 886	23 344	23 344	8.010%	506 179	(2)
18	2012	84 886	5.75%	89 766	24 686	24 686	8.750%	571 410	(2)
19	2013	89 766	5.77%	94 946	26 110	26 110	8.770%	647 519	(2)
20	2014	94 946	6.17%	100 804	27 721	27 721	9.170%	732 027	(2)
Total contributions made								347 959	
Total value (compound annual growth rate of return on pension fund investments of 3% above inflation)								732 027	
Retire (commute 1/3)								244 009	
Remain in fund (2/3)								488 018	
Assume 15 year retirement period (annuity per annum and 8.5% discount rate assumption)								58 767	
Percentage of final salary (income replacement ratio lower than industry recommendations, but higher than government recommendations)								58%	
Assume no commutation of retirement benefit, which results in the full pension fund value being taken as an annuity. The annuity that will be received for a 15 year period (and a discount rate of 8.5% is applied) will be:								88 151	
Percentage of final salary								87%	
(*) Inflation.eu (2014)									
Notes:									
(1)	It is assumed that there will be no return on the pension fund investments, since this is the first year that contributions are made.								
(2)	In subsequent years the pension fund value is determined by taking the opening pension fund value and increasing this value by the return on pension fund investments and adding the current pension fund contributions (as zero growth is assumed in the first year that contributions are made).								

Table 30 shows that his income replacement ratio will be 58 per cent (and 87 per cent with no commutation). Should the individual decide to annuitise his entire retirement savings, he will enjoy an income replacement ratio of 48 per cent based on the current system (referred to in Table 29) and 87 per cent based on the proposed system (referred to in Table 30). Based on this analysis, an individual who contributes to retirement savings for 20 years will achieve an income replacement ratio (with up to one-third being commuted) of less than Masilela's (2008) ideal income replacement ratio of 60 per cent (referred to in section 1.2 of chapter 1).

One of the ways in which to increase the income replacement ratio using the same savings levels is to discourage the individual from commuting one-third of his retirement savings. In chapter 6 it was explained that National Treasury recommended the annuitisation of two-thirds of post-retirement benefits in relation to provident funds. It is submitted that National Treasury should consider the annuitisation of all post-retirement benefits and this would mean a phasing-out of the commutation of up to one-third of the accumulated benefit in all funds. This phasing-out may be done on a similar method to the P-day approach discussed in section 5.5 of chapter 5 and the T-day approach discussed in section 6.3 of chapter 6. It is submitted that without at least a 20-year saving period (under the current retirement savings system) and the annuitisation of the total post-retirement benefits in all funds, pensioners may not be able to fund their living expenses and they will become dependent on the government.

It can be concluded that the income replacement ratio on retirement is dependent on the amount of annual retirement savings and the number of years of retirement savings. National Treasury's proposals that address increasing the amount of annual retirement savings will be effective from the date of implementation of the changes (possibly 1 March 2016 or 1 March 2017). A pre-retirement withdrawal has the same effect as a shorter retirement savings period (for instance the effect of 45 years of savings versus 20 years of savings), as the years of retirement savings are reduced. National Treasury (2012e) discussed the importance of the limitation of pre-retirements withdrawals, but a date has not yet been set for when the limitation of pre-retirement withdrawals will be effective. It is submitted that pre-retirement withdrawals should be prohibited as soon as possible.

7.4 THE TAX EFFECT WHEN ONE-THIRD OF THE PENSION FUND VALUE IS COMMUTED

Should an individual choose to commute one-third of the pension fund value, then the individual pays tax on the lump sum amount using the retirement lump sum benefit table referred to in section 3.9 of chapter 3.

Using the pension fund value in Tables 23, 24, 27, 28, 29 and 30 above, and assuming that the fund is a provident fund, the tax paid on the retirement benefits is calculated and the lump sum received net of tax is shown below:

Table 31: Lump sum received net of tax when one-third of the pension fund value is withdrawn

Table	Lump sum determined from pension fund value	Tax paid on lump sum	Lump sum received net of tax
23	R1 368 504	R294 211	R1 074 293
24	R2 058 925	R542 773	R1 516 152
27	R719 898	R80 972	R638 926
28	R1 319 813	R276 693	R1 043 312
29	R399 288	R15 172	R384 116
30	R732 027	R84 247	R647 780

7.5 THE EFFECT ON THE INCOME REPLACEMENT RATIO WHEN ONE-THIRD OF THE PENSION FUND VALUE IS COMMUTED

Should the retiree withdraw the full lump sum on retirement, he or she will be responsible for utilising the lump sum in such a way that it will last for his or her entire lifetime (which is assumed to be 15 years after retirement should the individual retirement at 65 years old). However, not every individual will have the discipline or financial restraint to invest the lump sum in an annuity, and many individuals may be tempted to spend their lump sum benefits too rapidly, or may invest their lump sums in an investment/(s) that does not keep pace with inflation and offers negative real growth (for example, investing money in a bank). Furthermore, individuals may not have the specialised knowledge to manage their lump sum to last for their lifetime. It is for this reason that National Treasury (2012e) proposed the annuitisation of provident fund lump sums. The effect of the annuitisation of the provident fund lump sum is illustrated in Table 32.

Table 32: Effect on income replacement ratio of commutation of one-third of pension fund value

Table	Total pension fund value (obtained from each of the tables):	Should the full pension fund value be taken as an annuity (i.e. no commutation of the pension fund value), the annuity amount will be:[3]	Income replacement ratio when the full pension fund value is taken as an annuity (Column 2 amount divided by final salary (R100 798)):		Should one-third of the pension fund value be withdrawn (commuted), then the remaining two-thirds that will remain the in the pension fund will be:[4]	Should the remaining two-thirds be taken as an annuity, then the annuity amount will be:[5]	Income replacement ratio resulting from the annuity which is received on the remaining two-thirds of the pension fund value (Column 5 amount divided by final salary (R100 798)):		Reduction in the income replacement ratio owing to the withdrawal (commutation) of one-third of the pension fund value:
	Column 1	Column 2	Column 3		Column 4	Column 5	Column 6		Column 7 ((3) – (6))
23	R1 368 504	R164 796	163%		R912 336	R109 864	109%		54%
24	R2 058 925	R247 937	246%		R1 672 617	R201 417	200%		46%
27	R719 898	R86 690	86%		R479 932	R57 794	57%		29%
28	R1 319 813	R158 932	158%		R879 875	R105 955	105%		54%
29	R399 288	R48 082	48%		R266 192	R32 055	32%		16%
30	R732 027	R88 151	87%		R488 018	R58 767	58%		29%

[3] The annuity amount is calculated using the following assumptions: the present value is the lump sum determined from the pension fund value (this is the gross amount and excludes taxation) (column 1), the discount period is 15 years, and the interest rate is 8.5 per cent per annum.
[4] The two-thirds lump sum pension value amount is calculated by: multiplying the lump sum from the pension fund value (column 1) by two-thirds.
[5] The annuity amount is calculated using the following assumptions: the present value of the remaining two-thirds lump sum of the pension fund value (this is the gross amount and excludes taxation) (column 4), the discount period is 15 years, and the interest rate is 8.5 per cent per annum.

Table 32 illustrates the effect on the income replacement ratio of the commutation of one-third of the pension fund value by showing the annuity that would result should the retiree not commute any of his pension fund value and the resulting income replacement ratio, and this is compared to the annuity that would result should the retiree commute one-third of the pension fund value and the resulting income replacement ratio, and finally the reduction in the income replacement ratio that arises as a result of the one-third commutation. Should the individual not commute one-third of the pension fund value then he will obtain a higher income replacement ratio on retirement.

Under the current legislation, provident fund members are able to withdraw their full lump sum on retirement, and the manner in which the retiree uses this lump sum is not subject to regulation. The proposed legislation will require provident fund members to annuitise two-thirds of the value of the provident fund. It is submitted that the annuitisation option provides a more stable income after retirement. It is further submitted that not every individual should be allowed to commute up to one-third of their retirement savings, as commutation reduces the income replacement ratio. National Treasury should ensure that legislation is passed that requires a minimum income replacement ratio to be maintained, and only the excess above this minimum income replacement ratio should be allowed to be commuted by the retiree. Based on Table 32 above, the cut-off commutation may possibly occur when the income replacement ratio exceeds 60 per cent. This will mean that the options under Tables 23, 24 and 28 will allow the retiree to commute up to one-third of his income replacement ratio, whereas the options under Tables 27, 29 and 30 (shorter contribution periods) will not allow him to commute up to one-third of retirement savings, as his income replacement ratio will be less than 60 per cent.

7.6 ASSUMPTIONS AND LIMITATIONS OF THE EXAMPLES

The measurement of the effects of the retirement reform proposals recommended by National Treasury required a number of assumptions to be made:

- The individual would not qualify for promotions during his working life;
- The only increases that the individual would receive would be inflation linked;
- The quantum (shown as a percentage of the individual’s salary) of employee and employer contributions that were made to the retirement savings vehicles;

- The fringe benefit component (and the resulting increase in gross income) of the increased employer contributions have not been factored into the employee's taxable income and the effect that this would have on the after tax cash flow of the employee was not accounted for in the calculations;
- The compound annual growth rate on the pension fund investments plus three per cent above inflation may exceed or be less than the actual growth in the pension fund investments;
- The life expectancy of the individual may be less than or exceed 15 years;
- The interest or discount rate of 8.5 per cent used to annuitise the pension fund value may be too conservative or too high;
- No other retirement savings were made by the individual.

These assumptions are in all likelihood not realistic, as one would expect individuals to qualify for promotions based on experience and additional skills acquired through their working life, and therefore they would earn a salary that is higher than the salary that is only linked to inflationary increases. Salary increases usually result in additional retirement savings should the same percentage of salary savings be maintained. The proposed legislation requires that employer contributions be included as employee benefits in gross income in terms of paragraph (i) of the Income Tax Act, and this will have the effect of increasing the taxable income (and tax payable) by the individual, and this effect has not been accounted for. The assumptions for the compound annual growth rate of three per cent above inflation have been estimated using available information published by Towers Watson (2014: 14) for the past five and ten years, and do not necessarily reflect the compound annual growth rate for the accumulation period of retirement savings. Depending on the state of the economy, the factor of three per cent above inflation used for the compound annual growth rate may be too conservative (during periods of economic booms) or too high (during periods of economic recession). The life expectancy varies for each individual depending on their physical health, income level, level of education and profession. A prudent life expectancy estimate was used based on the most recent information provided by the World Health Organisation. The interest or discount rate was estimated at 8.5 per cent based on the *Global Report: Global Survey of Retirement Plan Accounting Assumptions* (Aon plc, 2013) and information provided by private insurers may be biased.

Although the assumptions made limit the research, it is submitted that it is not possible to measure the effect of the proposals adopted by National Treasury with respect to the retirement reforms without using the assumptions. Had different assumptions been made, the results may have differed, but the underlying conclusions reached would in all likelihood be the same.

7.7 CONCLUSION

This chapter attempted to measure whether the retirement reform mechanisms outlined by National Treasury will have achieved the goal of encouraging individual retirement savings in South Africa. Section 7.2 demonstrated the effect of comparing the current retirement savings deductions and the proposed increase in deductions arising from a uniform contribution model for all retirement funds in the accumulation phase of retirement. Based on the calculations shown in Table 23 and Table 24, it was concluded that the proposed contribution model results in a higher income replacement ratio on retirement. It was noted that should an individual save for retirement for a period of 45 years, the current retirement contribution model will provide an adequate income replacement ratio. However, not all individuals save for 45 years for their retirement, and therefore shorter savings periods were considered in section 7.3. Table 27 demonstrated the effect of individuals not taking full advantage of the tax incentives for retirement savings. The question remains whether taxpayers will change their behaviour and make use of the proposed more generous tax incentives that have been harmonised across all retirement vehicles.

Section 7.3 demonstrated the effect on the income replacement ratio should an individual redeem his or her retirement savings before retirement date (referred to as pre-retirement leakage) or retire early. Two analyses were conducted using a retirement savings period of 30 years and 20 years. The reduction in retirement savings years had a negative impact on the individual’s income replacement ratio on retirement.

Section 7.4 presented the net cash position (after tax) that would arise when an individual commutes one-third of the pension fund value. Section 7.5 demonstrated the effect of the annuitisation of post-retirement benefits. The annuitisation of post-retirement benefits is in line with the recommendations made by National Treasury. It was recommended that National Treasury should consider limiting the right to commute up to one-third of retirement savings. The requirement for maintaining an income replacement ratio of 60 per cent or above was suggested, and commutation of only the excess benefit above that which provides a 60 per cent income replacement ratio should be allowed.

Based on the recommendations made by National Treasury, individuals should achieve a better income replacement ratio upon retirement. Whether the increase in the income replacement ratio is adequate, is still an open question. In order to ensure that an optimal income replacement ratio is achieved, National Treasury should require automatic enrolment in retirement savings for all individuals who are in employment, pre-retirement withdrawals should not permitted, and full post-retirement benefits should be annuitised. The *OECD roadmap for the good design of defined contribution pension plans* (OECD: 2012) does not recommend pre-retirement withdrawals and requires annuitisation of post-retirement benefits.

The next chapter will conclude on whether retirement reform recommendations outlined by National Treasury will have achieved the goal of encouraging retirement savings that should assist South Africans to achieve stability of income in their retirement.

CHAPTER 8: CONCLUSION

8.1 INTRODUCTION

The overarching research goal of this research was to determine whether the retirement reform mechanisms outlined by National Treasury would encourage individual retirement savings that should assist South Africans to achieve stability of income in their retirement.

The overarching research goal was addressed by the following sub-goals:

- Analysing current retirement savings options and vehicles available for South Africans;
- Analysing current tax incentives and disincentives available for South Africans;
- Reviewing proposed changes to tax incentives to encourage retirement savings during the accumulation phase of retirement savings;
- Reviewing proposed changes to discourage pre-retirement withdrawals (also known as pre-retirement leakage);
- Reviewing proposed changes for the annuitisation of post-retirement benefits; and
- Measuring the effects of the retirement reform proposals recommended by National Treasury.

Each of these research sub-goals were addressed in separate chapters in this research thesis. Throughout the research thesis, where possible, South Africa's retirement reform proposals were compared to *The OECD roadmap for the good design of defined contribution pension plans* (OECD: 2012).

Chapter 2 described the current retirement savings options and vehicles that are available to all South Africans, namely pension funds, pension preservation funds, provident funds, provident preservation funds, retirement annuity funds, conventional (purchased) annuities, living annuities and self-savings. The advantages and disadvantages of these retirement savings options were discussed. Certain retirement savings vehicles, such as pension funds, pension preservation funds, provident funds, provident preservation funds, and retirement annuity funds are governed by the Pension Funds Act which provides investment guidelines (referred to as the Prudential Investment Guidelines) on asset spread allocations and limits the maximum fee charges for investment services. Public pension funds are not governed by the Pension Funds Act and these funds include the Government Employees Pension Fund, Transnet, Telkom and the Post Office retirement funds. National Treasury aims to bring all pension funds within the purview of the Pension Funds Act, but National Treasury has not provided concrete guidance on how it will achieve this. A living annuity can be created from any of the retirement vehicles governed by the Pension Funds Act when a member reaches retirement age or in the case of a retirement annuity fund, is over 55 years old. Once a living annuity is created, it is governed by the Long-Term Insurance Act, which does not provide guidelines for maximum fee charges and asset spread allocations. Furthermore, the living annuity places the investment and longevity risk in the hands of the annuitant. Although conventional annuities do not cater exclusively for retirees, they do have a place within a retirement plan should the retiree want to transfer the investment and longevity risk to the insurance company. It was noted that not every individual would save for retirement using a retirement vehicle, and certain individuals may find that self-savings (without the use of a retirement vehicle) may be appropriate for them. Self-savings were not dealt with in the retirement reforms proposed by National Treasury, but they were briefly mentioned as it is a relevant retirement savings option.

Chapter 3 identified the tax incentives and disincentives of saving towards retirement using all retirement vehicles (pension funds, pension preservation funds, provident funds, provident preservation funds and retirement annuity funds) that are relevant for the 2014 and 2015 years of assessment. The taxation of retirement lump sum withdrawal benefits and retirement lump sum benefits were discussed. The taxation of pre-retirement withdrawals is more punitive than retirement withdrawals. This is appropriate since members of pension and provident funds should be discouraged from pre-retirement withdrawals in order to have a more favourable income replacement ratio upon retirement. The nature of the income that an individual receives after retirement depends on the retirement fund of which the individual is a member, or the self-saving vehicle used by the individual to save for retirement. Should the individual be a member of a pension fund, pension preservation fund or a retirement annuity fund, the income received by the individual will be in the form of an annuity and will be included in the individual’s gross income in terms of paragraph (a) of the Income Tax Act and will be taxed according to the normal tax tables that apply to natural persons. Should an individual have been a member of a provident fund or provident preservation fund and chose to redeem the full lump sum on retirement (which will be subject to tax using the retirement lump sum benefit table), or uses part of the lump sum benefit from a pension, pension preservation or retirement annuity fund and subsequently purchases an annuity, the annuity will be included in the individual’s gross income in terms of paragraph (a) but the capital element of the annuity will be exempt from tax in terms of section 10A of the Income Tax Act.

Based on the tax incentives and disincentives available for saving in a particular retirement vehicle, it was noted that there was a disparity between the deductions available for contributions to the various retirement vehicles. These tax deduction differences are illogical, as tax incentives to save for retirement, irrespective of the retirement vehicle chosen, should be neutral across all retirement vehicles. It is against this backdrop of inconsistent tax incentives and disincentives across retirement vehicles that a number of amendments to the Income Tax Act have been proposed with effect from the date of implementation of the changes (possibly 1 March 2016 or 1 March 2017).

Chapter 4 discussed the harmonisation of retirement savings deductions that have been proposed as amendments to the Income Tax Act with effect from the date of implementation of the changes (possibly 1 March 2016 or 1 March 2017). Retirement fund deductions for both the employer (in terms of the proposed section 11(*l*) deduction) and the employee (in terms of the proposed section 11(k) deduction) have aimed to provide uniform deductions across all retirement vehicles. There are still a number of proposals that were raised in the *Retirement Fund Reform: a discussion paper* (National Treasury: 2004) that have not yet been introduced. The accelerated retirement fund deductions for those individuals who are over 45 years of age have not been addressed. It is submitted that this accelerated allowance will in all likelihood not be introduced as it lends itself to age discrimination, which is one of the aspects that the retirement reform aims to remove. The National Treasury proposal allowed for a minimum monetary deduction of R20 000 per annum for those individuals who contribute towards retirement savings in excess of the percentage limits, and this deduction has not been incorporated in the proposed changes to the Income Tax Act. The proposed amendment to the "retirement date" and "normal retirement age" has not yet been introduced. During 2008, retirement annuity funds removed the upper age limit of 70 years for membership of a retirement annuity fund. The proposed section 11(k)(iii) allows arrear contributions to be made to all retirement funds which further encourages retirement savings. Chapter 4 highlighted similarities between *The OECD roadmap for the good design of defined contribution pension plans* (OECD, 2012) and the South African National Treasury retirement reforms. The main similarity is the alignment of tax deductions for contributions made to all retirement vehicles. These changes have been proposed in terms of the section 11(*l*) employer contribution deduction and the section 11(k) employee contribution deduction in respect of contributions to pension, provident and retirement annuity funds, which will become effective from the date of implementation of the changes (possibly 1 March 2016 or 1 March 2017). *The OECD roadmap for the good design of defined contribution pension plans* (OECD, 2012) proposes improving the design of incentives to save for retirement. The proposed amendments to sections 11(*l*) and 11(k) allow for uniform tax deductions across all retirement funds, and this is an improvement in the design of incentives to save for retirement, although changes in tax incentives will not necessarily result in additional retirement savings (as mentioned in section 8.2 below).

Chapter 5 explained how pre-retirement withdrawals from retirement funds erode retirement savings, which has the effect of reducing the income replacement ratio upon retirement. National Treasury identified a disparity between pre-retirement withdrawals in different retirement vehicles, as retirement annuity funds require preservation of pre-retirement savings until the individual reaches 55 years old, whereas pension, provident, pension preservation, and provident preservation funds may be accessed when a member changes employment, is retrenched or gets divorced, irrespective of the member's age. Even though tax incentives for retirement savings will be adjusted and will allow for uniform deductions throughout the accumulation phase of retirement savings (with effect from the date of implementation of the changes (possibly 1 March 2016 or 1 March 2017)), these incentives will not address the reduction of the income replacement ratio on retirement, should pre-retirement withdrawals continue to be allowed during the accumulation phase of retirement savings. For this reason National Treasury proposed five possible approaches to limiting pre-retirement withdrawals and solicited responses on these approaches from various stakeholders. Examples of the application of the proposals to limit pre-retirement withdrawals as proposed by National Treasury (2013a) were discussed and commented upon. Most stakeholders agreed that pre-retirement withdrawal benefits prevented the full preservation of retirement savings. After consultation with the various stakeholders, National Treasury proposed guidelines for the limitation of pre-retirement withdrawals and issued a further paper: *2013 Retirement reform proposals for further consultation* (National Treasury: 2013a). National Treasury called for further comments which were to be submitted by 31 May 2013. To date no further reports have been tabled by National Treasury on the comments received from the public. It was submitted that there are a number of issues regarding the limitation of pre-retirement withdrawals that need clarification. These are placing a limit on the period before pre-retirement savings may be accessed and only allowing pre-retirement withdrawals when a member has ceased to be employed, after a member has accessed all his or her unemployment insurance benefits, and after a member has obtained financial advice on the long-term effect of withdrawing his or her retirement funds. The limitation of the pre-retirement withdrawals model that South Africa intends to adopt is not fully in alignment with the accumulation phase as proposed by *The OECD roadmap for the good design of defined contribution pension plans* (OECD: 2012). The OECD (2012) proposes mandatory retirement savings preservation for all retirement vehicles and does not support pre-retirement withdrawals.

Chapter 6 examined the current options for post-retirement savings as well as the proposals that have been made by National Treasury. Under the current options for post-retirement savings, an individual who belongs to a pension fund, pension preservation fund and retirement annuity fund may only access up to one-third of his or her retirement savings as a lump sum, which will be taxed in accordance with the table applicable to retirement lump sum benefits (discussed in section 3.9 of chapter 3). The remaining balance in the pension fund, pension preservation fund and retirement annuity fund is paid to the member as an annuity. The annuity amount that is received (after the lump sum commutation) is reduced as the lump sum withdrawal results in a smaller preservation of retirement savings which are available for annuitisation. It was noted that provident funds and provident preservation funds were not subject to annuitisation and this resulted in members of provident funds and provident preservation funds withdrawing the full lump sum on retirement (subject to tax in accordance with the table applicable to retirement lump sum benefits). Furthermore, the withdrawal of the entire post-retirement lump sum may result in the retiree spending the lump sum too rapidly.

National Treasury identified that the provident fund and provident preservation fund full lump sum withdrawals were not aligned with other retirement vehicles, which required annuitisation of not less than two-thirds of post-retirement savings. As retirement savings are a long-term strategy, National Treasury does not wish to implement retrospective post-retirement benefit annuitisation, and therefore engaged with various stakeholders to determine the most appropriate method of implementing post-retirement annuitisation. Subsequently, National Treasury proposed the T-day method of post-retirement benefit annuitisation where, after a certain date, all contributions and the growth in contributions are subject to annuitisation.

Provident funds and provident preservation funds are usually withdrawn in full and not normally annuitised, unlike pension and retirement annuity funds. A member of a provident fund or provident preservation fund may choose to annuitise the provident fund balance in the form of a purchased annuity or a living annuity. A purchased life annuity prices in longevity risks, but sometimes these annuities do not cater for inflation and carry an unintended bequest risk (which means that the investment in the annuity is lost when the individual dies irrespective of whether they have utilised the investment in full or not). The other option for annuitisation is a living annuity (which is also available to a member of a retirement annuity fund). The living annuity vehicle allows the purchase value, as well as the growth and income flow from the underlying investments, to be "trapped" within the living annuity structure. Living annuities do not have an unintended bequest risk. However, there are a number of drawbacks in investing in a living annuity: living annuities may be complex and require purchasers to make investment decisions on an annual basis, the purchaser bears the longevity risk, joint ownership is not allowed, there is an no exit option for a living annuity (although this is the same for all other retirement vehicles, except when a member dies, resigns, or emigrates), and the fee structure for living annuities is opaque. The Association of Savings and Investments in South Africa has issued a standard on living annuities and this aims to regulate drawdown rates, investments, provision of information on asset composition, and industry-based analysis and monitoring.

Chapter 6 compared National Treasury's approach to the annuitisation of post-retirement benefits to the approach proposed by *The OECD roadmap for the good design of defined contribution pension plans* (OECD: 2012). The annuitisation approach adopted by both National Treasury and the OECD (2012) are in alignment, but the OECD (2012) proposed that all retirement savings are annuitised whereas National Treasury proposes that up to two-thirds of retirement savings are annuitised. National Treasury and the OECD (2012) also propose low-cost retirement savings instruments and the promotion of the supply of annuities and cost-efficient competition in the annuity market. National Treasury (2013b) is currently considering ways of regulating fee charges in retirement funds but this process is still in its early stages.

Chapter 7 attempted to measure the effects of the retirement reform proposals recommended by National Treasury, by means of examples. This meant that a number of assumptions needed to be made in drawing up these examples in order to determine whether the proposals by National Treasury would encourage South Africans to save for their retirement. The findings of this chapter will be discussed in the next section.

8.2 REVIEW OF FINDINGS OF THE RESEARCH

An example comparing the current retirement savings deductions and the proposed uniform contribution model in the accumulation phase of retirement savings demonstrated that the proposed uniform contribution model results in a higher income replacement ratio on retirement, simply because the tax deductions for saving for retirement have been increased. It was noted that should an individual save for retirement for a period of 45 years, the current retirement contribution model will provide an income replacement ratio of 109 per cent of his or her final salary, after the individual has commuted one-third of the retirement savings. The same individual, who would have saved for retirement for a period of 45 years using the proposed tax incentives, will have an income replacement ratio of 200 per cent of his or her final salary, after commuting one-third of the retirement savings.

It was noted, however, that the proposed change in tax incentives will not necessarily result in all South Africans making use of the proposed incentives. Based on international research by Marr *et al* (2013), Dolan (2013) and Topoleski (2103), it was noted that tax incentives do not necessarily lead to increases in retirement savings during the accumulation phase. A further calculation was performed for an individual who saved for retirement for a period of 45 years using industry averages for current retirement savings during the accumulation phase of retirement. This example indicated that an income replacement ratio of 89 per cent would be achieved by an individual who had retirement savings in line with industry averages. This example confirmed the findings of the international research by Marr *et al* (2013), Dolan (2013) and Topoleski (2013).

It was also noted that not all individuals save for their retirement for 45 years, and therefore sensitivity analyses were conducted using shorter savings periods, comparing the effect on the income replacement ratio between the current tax deductions and the proposed tax deductions during the accumulation phase of retirement savings. Retirement savings periods that are shorter than 45 years are more realistic. Two savings periods of 30 years and 20 years were used. The savings periods may have been shorter due to breaks in employment, early retirement or pre-retirement leakage. The shorter savings periods resulted in lower income replacement ratios and, depending on the optimal income replacement ratio, may result in an inadequate income replacement ratio. One of the ways of improving the income replacement ratio is for the individual not to commute one-third of the post-retirement savings, as this has a marked effect on increasing the income replacement ratio, particularly over a 30-year retirement savings accumulation period. The non-commutation of a 30-year post-retirement savings period may increase the income replacement ratio by 29 per cent under the current tax system and 53 per cent under the proposed tax system. The effect of non-commutation is not as marked over a shorter savings period of 20 years, but this makes sense as there is a smaller savings amount available for annuitisation. The non-commutation over a 20 year savings period results in an increase in the income replacement ratio of 16 per cent under the current tax system and 29 per cent under the proposed tax system.

Based on the research performed, it was found that the recommendations made by National Treasury with respect to harmonising the proposed tax incentives for the accumulation phase of retirement savings may have an effect on increasing retirement savings, but this may not be entirely realistic, based on the research findings of Marr *et al* (2013), Dolan (2013) and Topoleski (2013). However, the other two recommendations made by National Treasury, namely, the limitation of pre-retirement withdrawals and the annuitisation of the total post-retirement benefits do have a substantial and measurable effect on the income replacement ratio on retirement. For this reason, it is recommended that the limitation of pre-retirement withdrawals should be even more stringent than that proposed by National Treasury (for example, pre-retirement withdrawals should not be allowed at all and this will then be in alignment with *The OECD roadmap for the good design of defined contribution pension plans* (OECD: 2012)). It is further recommended that National Treasury should remove the option of commuting up to one-third of post-retirement savings for all retirement vehicles and this would also be in alignment with *The OECD roadmap for the good design of defined contribution pension plans* (OECD: 2012), or National Treasury should consider only allowing the commutation of post-retirement benefits where the income replacement ratio (after the one-third commutation) will be in excess of a certain per cent (for example, only where the income replacement ratio, after the one-third commutation, is greater than 60 per cent).

A summary of the findings based on the hypothetical examples illustrating the retirement savings during the accumulation phase of retirement, pre-retirement withdrawals and annuitisation of post-retirement benefits is shown in the table below:

Table 33: Summary of the findings on the income replacement ratio of different retirement savings periods during the accumulation phase of retirement, pre-retirement withdrawals and annuitisation of post-retirement benefits

	45 years savings – current tax deductions	45 years savings – proposed tax deductions	45 years savings – based on industry averages	30 years savings – current tax deductions	30 years savings – proposed tax deductions	20 years savings – current tax deductions	20 years savings – proposed tax deductions
Total contributions made	R229 700	R421 116	R187 435	R220 109	R403 534	R189 796	R347 959
Total contribution after calculating the compound annual growth rate	R1 368 504	R2 508 925	R1 116 700	R719 898	R1 319 813	R399 288	R732 027
Commutation ($^1/_3$)	R456 168	R836 308	R372 233	R239 966	R439 938	R133 096	R244 009
Remain in fund ($^2/_3$)	R912 336	R1 672 617	R744 466	R479 932	R879 875	R266 192	R488 018
Annuity per annum based on two-thirds remaining in fund	R109 864	R201 417	R89 649	R57 794	R105 955	R32 055	R58 767
Income replacement ratio on two-thirds remaining in fund	109%	200%	89%	57%	105%	32%	58%
Full annuity (no commutation)				R86 690	R158 932	R48 082	R88 151
Income replacement ratio on full annuity				86%	158%	48%	87%

8.3 LIMITATIONS OF THE RESEARCH EXAMPLES

Section 7.6 of chapter 7 outlined the limitations of the research examples, as a result of the assumptions made. These assumptions were as follows:

- The individual would not qualify for promotions during his or her working life;
- The only increases that the individual would receive would be inflation linked;
- The quantum (shown as a percentage of the individual's salary) of employee and employer contributions that were made to the retirement savings vehicles;
- The fringe benefit component (and the resulting increase in gross income) of the increased employer contributions was not factored into the employee's taxable income and the effect that this would have on the after tax cash flow of the employee was not accounted for in the calculations;
- The compound annual growth rate of the pension fund investments of the rate of inflation plus three per cent, may exceed or be less than the actual growth in the pension fund investments;
- The life expectancy of the individual may be less than or exceed 15 years post-retirement at 65 years of age;
- The interest or discount rate of 8.5 per cent used to annuitise the pension fund value may be too conservative or too high;
- No other retirement savings were made by the individual.

These assumptions may not be realistic, as one would expect an individual to qualify for promotions based on experience and additional skills acquired throughout his or her working life, and therefore earn a salary that is higher than a salary that is only linked to inflationary increases. Salary increases usually result in additional retirement savings. The amount of the savings made by an employee and an employer may not be as much or as little as assumed in the calculations. The fringe benefit component of the increased employer contributions has not been factored into the calculations. The assumed compound annual growth rate (inflation plus an assumed real rate of growth of three per cent) and the assumed life expectancy may not be accurate.

The assumptions made do limit the findings, but it is submitted that it is not possible to measure the effect of the proposals adopted by National Treasury with respect to the retirement reforms without using the assumptions in order to control the many potential variables that would influence the results in real life. Had different assumptions being made, the results may have differed, but the underlying conclusions reached would in all likelihood be the same.

8.4 RECOMMENDATIONS FOR FURTHER RESEARCH

Retirement savings and how these should be increased owing to the increase in the life expectancy of individuals (especially in developed countries) and the increase in the youth unemployment rate (which may have an effect of reducing the retirement age as older workers are retired from the work force to accommodate younger workers who are encouraged to enter the work force) has become a topical area of research. From a South African perspective, this was identified before 2004 and as a result of this National Treasury (2004) issued *Retirement Fund Reform: a discussion paper*. Globally, governments are considering or have implemented an increase in the retirement age due to longevity risks. From a South African perspective, not all employees or individuals are saving for retirement. It is submitted that research should be conducted on how to implement an automatic enrolment system for retirement savings in South Africa. Many other countries already have automatic enrolment systems, or have recently introduced automatic enrolment systems. In the same way that automatic enrolment should be introduced, so too should research be conducted into how pre-retirement withdrawals can be eliminated and how all post-retirement benefits should be annuitised.

National Treasury is currently engaged with regulating fees charged by retirement funds, and has issued *Charges in South African Retirement Funds* (National Treasury, 2013b). The greater the fees charged to retirement funds, the lower the growth rate that is attributable to the pension fund value. However, the financial services industry would be adversely affected by unrealistic regulations. Research could be conducted on how to reasonably regulate fee charges for different levels of retirement savings.

Furthermore, it was noted that the public pension funds in South Africa are not governed by the Pension Funds Act, and examples of such non-regulated public pension funds are the Government Employees Pension Fund, Transnet, Telkom and the Post Office retirement funds. Research could be conducted on how it would be possible to bring those non-regulated public pension funds under the purview of the Pension Funds Act. The Government Employees Pension Fund is managed by the Public Investment Corporation and the regulation of this pension fund would have implications for the Public Investment Corporation.

8.5 CONCLUSION

The proposals made by National Treasury, which will be effective from the date of implementation of the changes (possibly 1 March 2016 or 1 March 2017), to section 11(*l*) for employer contributions and section 11(k) for employee contributions have introduced uniform tax deductions for retirement savings that are far simpler to understand, much clearer and more transparent than the existing section 11(*l*), section 11(k) and section 11(n) deductions.

The limitation of pre-retirement withdrawals through the introduction of the P-day method would have the effect of encouraging individuals not to withdraw their entire pre-retirement lump sums when they change their employment. Although stricter regulation of not allowing any pre-retirement withdrawals would result in the most favourable outcome to the individual's income replacement ratio upon retirement, the regulations that National Treasury is recommending are not as effective, but are an improvement on the current situation that applies to pre-retirement withdrawals.

National Treasury's recommendation of annuitising at least two-thirds of post-retirement withdrawal benefits for members of provident funds and provident preservation funds will offer some protection to those individuals who are at risk of spending their retirement lump sums too rapidly. It is submitted that a better outcome would be achieved by not allowing any post-retirement withdrawals and therefore all retirement savings would be annuitised.

The recommendations made by National Treasury are still not optimal with respect to ensuring that individuals save the maximum amount for their retirement, but they are steps in the right direction to encourage South Africans to save for their retirement in order to achieve stability of income in their retirement. It is hoped that these recommendations by National Treasury are the starting point and that more stringent rules on retirement savings with respect to pre-retirement withdrawals and that the annuitisation of all post-retirement benefits will be considered in the near future.

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