ESTATE PLANNING ESSENTIALS

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Retirement Fund Deductions: One door closes, another opens

According to the 2011 Budget Review, 1 March 2012 will see the introduction of a new dispensation for permissible deductions towards retirement funds. There is a clear twofold message behind these changes, particularly when read together with the taxation of lump sum benefits:

- higher income earners will have to make additional provision for retirement outside of tax incentivised retirement funds; and
- retirement fund benefits are intended to provide annuities at retirement and not tax free lump sum benefits on withdrawal and retirement.

In this edition of Estate Planning Essentials we look at the proposed changes to the tax deductions in respect of contributions to retirement funds. In the next edition we will examine the taxation of lump sum benefits, as well as explore an interesting alternative for retirement saving for high income earners.

The tax treatment of contributions

According to the 2011 Budget Review the proposals in respect of contributions towards retirement funds include the following:

(a) Employer contributions to retirement funds on behalf of an employee will be deemed to be a taxable fringe benefit in the hands of the employee.

(b) Individuals will be allowed to deduct up to 22.5% of their taxable income for contributions to pension, provident and retirement annuity funds. (Individuals are currently not allowed to deduct their own contribution to a provident fund.)

(c) The deduction will be subject to two threshold amounts: A maximum of R200 000 and a minimum of R12 000.

(d) In future, lump sum benefits from a provident fund will be limited to the one third limit currently applicable to pension and retirement annuity funds. (This proposal is subject to the protection of vested rights and further consultation with unions and other interested parties.)

Practical examples

Example 1

Mr Green's income is R1 000 000 p.a. His employer contributes an amount equal to 15% of this income to a pension fund on his behalf. Mr Green contributes 7,5% based on the same amount.

The amount contributed to his fund is therefore:

Employer's contribution:	R 150 000
Own contribution:	R 75 000
Total:	R225 000

Ignoring all other deductions, Mr Green's taxable income for this year will be R925 000 (i.e. R1 000 000 – R75 000).

After 1 March 2012 his situation will change as follows:

Assuming that his earnings remain the same, his taxable income (before retirement fund contributions) will now increase from R1 000 000 to R1 150 000 due to the inclusion of the employer's contribution as a taxable fringe benefit.

A 22,5% deduction based on a taxable income of R1 150 000 will amount to R258 000. However, the deductibility of these contributions will be limited to R200 000 p.a.

Despite his contribution levels remaining the same (total R225 000), Mr Green's taxable income for the 2012 tax year will increase by R25 000 to R950 000 (R1 150 000 – R200 000) because of the loss of the deduction on the amount above R200 000.

It is assumed that the contribution above the threshold amount will be treated as a disallowed contribution which may be used to increase the tax free portion of any lump sum benefit taken at retirement.

NOTE: The existing difference in the treatment of disallowed contributions between pension and provident funds on the one hand and retirement annuities on the other will in all probability disappear.

At this stage, retirement annuity fund members are allowed to deduct excess contributions, which were not deductible against the lump sum at retirement, from their income after retirement, as if it were a current contribution (see section 11n(bb)(iii) in this regard). No similar provision exists for pension or provident funds. It is hoped that this is taken into consideration by the drafters.

Example 2

Mr Grey's income is R500 000 p.a. His employer contributes R75 000 - being 15% of this income - to a provident fund on his behalf. Mr Green makes no contribution to his provident fund (provident fund contributions not being deductible by members at this stage). In terms of the current retirement annuity deduction formula his income is treated as retirement funding and he can make a maximum deductible contribution to a retirement annuity fund of R3 500 p.a. in terms of the current (b)-leg of the formula.

After March 2012 he will be able to make the following additional contributions, either to the provident fund or to his retirement annuity fund:

Taxable income is R575 000 (before retirement fund contributions).

Twenty two comma five percent (22,5%) of this amount will be R129 375.

Assuming that he already makes the maximum contribution to a retirement annuity fund, he will be able to make an additional contribution as follows:

Employer contributions to the provident fund:	R75 000
Own contribution to his retirement annuity fund:	R 3 500
Amount available to make up the 22,5% maximum:	R50 875.

Example 3

For certain self-employed persons the new contribution limits will also provide an opportunity to make additional contributions to their retirement annuity funds.

Mr Mustard is self-employed and his taxable income before any retirement fund contributions is R1 000 000.

Currently his maximum deductible retirement annuity contribution is R150 000 p.a. (in terms of the 15% leg of the retirement annuity deduction formula).

In the proposed new dispensation, this limit will increase to 22,5% but will be limited by the annual maximum of R200 000. Thus, Mr Mustard will be able to make an additional tax deductible contribution of R50 000 p.a.

Example 4

It is not clear what the purpose of the R12 000 minimum deduction is. The minimum appears to affect persons with a taxable income of less than R53 334 p.a. only. (At this point a 22,5% contribution equals R12 000 p.a.)

The current income tax threshold for persons under the age of 65 is R59 750 and thus a person earning R53 333 is not subject to tax and will not benefit from any tax relief.

Despite not benefiting from any tax relief, their contribution will be deductible and because the entire contribution will be deducted it will not qualify as a disallowed contribution which can be taken into account at withdrawal or retirement from a fund.

Marketing message

For self-employed persons with an income of R888 889 or less the tax deductible contributions to retirement annuity funds will increase from 15% to 22,5% of income (not non-retirement funding income only).

Persons who are members of employer funds may also be provided with an opportunity to make additional tax deductible contributions to their retirement funds, depending on their current contribution limits.

The maximum tax saving on contributions will be reached when the person's taxable income, including the employer's contribution as a taxable fringe benefit, reaches R888 889.

Persons making contributions in excess of the R200 000 limit are reminded that:

- contributions are being made to an investment on which all growth takes place in a tax exempt environment;
- disallowed contributions may be used for additional tax relief on lump sums at retirement; and
- retirement fund benefits, be they in the form of lump sums or annuities, are not subject to estate duty.

Any queries may be directed to:

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