South Africa: The occupational pension scene

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Abstract This paper describes briefly the pensions legislation that governs occupational pension and provident funds in South Africa. Member-elected trustees and the establishment of the Pension Funds Adjudicator's office are examples of recent legislation. The South Africa tax relieves (in respect of pension and provident funds) are under siege and there are moves to rationalise the different retirement regimes.

Keywords: *defined benefit plans; defined contribution plans; preservation funds; elected trustees; pension funds adjudicator; Katz commission*

Introduction

According to the 1996 census, the population of the 'rainbow nation' numbers some 37.9m. It is, however, accepted that there was an undercount that will revise the final figure upwards. South Africa is aptly described as the rainbow nation on account of the mix of people of many different nationalities. For example, 3 per cent are Indians, 9 per cent are coloured, 13 per cent are white and the balance of the population is African.

The country covers 1,221,000 square km with the result that the population distribution is 31 persons per sq. km. In the UK the comparable figure is 241 persons per sq. km (58.6m people in 243,000 square km).

After Brazil, South Africa has the most skewed income distribution in the world. The poorest 10 per cent of the people receive 1.4 per cent of the total annual household income and the poorest half of the population receives about 15 per

cent of the total household income. At the other end of the spectrum, the top 10 per cent of households control 42 per cent of the income.

Background to pension and provident plans

In contrast to the slant in household incomes, the retirement plan business is more balanced — retirement plans being the generic term used to describe pension and provident plans. The 1997 report of the Financial Services Board (the FSB is the government body that supervises the financial sector, which includes retirement plans) provides the following information:

No. of registered funds	15,089
Membership	9.4m
Contribution income	R29.6bn
Benefit outgo	R39.7bn
Assets	R411.4bn

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Bearing in mind the high unemployment rate in the country and that approximately 50 per cent of South African people live in rural areas, the FSB's statistics indicate that a very substantial proportion of the working population is covered by either private or State occupational retirement arrangements.

State scheme

Perhaps it is not surprising that the retirement business is well developed; after all, there is no national social security system in place for the provision of State old-age social pensions. The State system is very underdeveloped; no contributions are paid by either the employer or employee towards the cost of pensions, with the result that there is no available fund from which to draw for the payment of pensions. To be eligible for a State old-age social pension a person must:

- either be a South African citizen or have been a resident in South Africa for five years preceding application and qualify under the immigration laws — this is very important on account of the substantial number of illegal immigrants from neighbouring countries; or
- submit to a means test and prove that their income does not exceed certain limits. If the applicant is married the spouse's income is halved to determine each spouse's income.

To be eligible for a State pension, a single person's income should not exceed R11,400 per annum nor should that person have assets of more than R180,000. For a married couple, the income and asset limits are R21,000 and R360,000 respectively. These limits are reviewed from time to time.

The pension age is 65 for men and 60 for women — there is no suggestion that the pension ages will be equalised. The present State old age social pension amounts to R510 per month and is reviewed periodically.

Occupational retirement plans

South Africa is part of the Commonwealth and, in the circumstances, it is not surprising that the occupational retirement plan legislation has many similarities with the fundamental pension legislation that is in place in the UK. There is no legal requirement for an employer to provide retirement benefits; however, bearing in mind the lack of a State retirement pension, most of the larger employers do provide either pensions or lump sums at retirement that are based on the years of employment with the company. Most employers make membership of the retirement arrangements a condition of employment.

During the past ten years there has been a move from defined benefit to defined contribution arrangements. This trend has been encouraged by the trade unions that perceive:

- defined contribution arrangements as being easier to understand. This is an important point in a country where the level of State education has been less than adequate
- that withdrawal benefits are, in the main, totally inadequate in defined benefit arrangements. There is no preservation legislation with the result that a member may leave a pension fund after, say, ten years and receive only a refund of their own contributions. It is worth noting that the government attempted to introduce preservation legislation in the early 1980s; however, strong

union pressure made the government withdraw it

- that on retirement, many members return to the family home in a rural area where there are no facilities to collect monthly pension payments. In this situation the unions prefer members to be in defined contribution provident arrangements.

The employers have been happy to support this move as it has released them from the open-ended liability of defined benefit plans. The end result is that defined benefit plans now constitute a small proportion of the overall number of retirement arrangements. Nevertheless, the larger employer has tended to retain defined benefit plans with the consequence that the number of employees covered by defined benefit plans still outnumbers those in defined contribution plans.

Defined benefit plans

A typical defined benefit pension plan will provide 1.75 per cent to 2.25 per cent of final pensionable salary for each year of service (there is no legislation that restricts the pension to being a function of salary at or near to retirement — any restriction is in the form of the maximum contributions paid into the plan). Final pensionable salary may be defined as the highest average of three consecutive salaries, salary in the last year or salary at the point of retirement.

At retirement a member may commute up to $\frac{1}{3}$ of the benefits for a cash lump sum: however, only part of the lump sum is tax free. The tax-free portion is calculated as $\frac{1}{10}$ of the highest average annual salary (maximum R60,000) over any consecutive five years multiplied by the number of years of completed plan membership (with a

maximum of 50 years) plus a return of the member's own contributions that have not been allowed as tax deductible.

In addition, there is an overall requirement that aggregates the tax-free lump sums from pension, provident and retirement annuity funds and stipulates that the maximum tax-free lump sum cannot exceed the greater of R120,000 or R4,500 multiplied by the number of completed years of membership. Any lump sum in excess of the tax-free element is taxed at the higher of the member's average rate of tax in the year of uplift and the preceding tax year.

In the case of death in service, a pension plan would normally provide a spouse's pension of 50 per cent of the pension that would have accrued by normal retirement age. Some retirement plans provide an annual pension of 50 per cent of the member's salary at the date of death.

In addition, a lump-sum death-in-service benefit would be provided — typically this benefit would be two to four times salary. Once again, only part of the lump sum is free of tax — the tax-free portion is the greater of R60,000 or two times salary (maximum salary R60,000) in the 12 months prior to death. Any lump sum in excess of the tax-free portion is taxed at the member's average rate of tax.

Defined contribution plans

In either a defined benefit or a defined contribution pension plan a member may contribute the greater of R1,750 or 7.5 per cent of earnings; the contribution is tax deductible before the member's tax is calculated. Consequently, many pension arrangements are designed around the principle of the member contributing 7.5 per cent of earnings towards the cost of the pension benefits.

In defined contribution pension plans

the employer will usually contribute a further 8 to 12 per cent of earnings. The cost of the risk benefits and the administration is usually included within this percentage. After deductions it means that there is usually 5 to 9 per cent of a member's earnings available for pension or to be accumulated as a cash lump sum.

Some employers stipulate that they will contribute a maximum amount towards the cost of the risk benefits. If the cost exceeds the stipulated sum then the benefits are reduced — a satisfactory arrangement if the member survives until normal retirement age — not so good if he passes away at an earlier age. It has been found necessary to include this provision on account of the increasing number of early deaths arising from HIV-related illnesses.

In line with defined benefit plans, up to $\frac{1}{3}$ of the accumulated benefits can be taken as a cash lump sum, subject to the same tax requirement regarding the tax-free element. The portion of the accumulated benefits not taken as cash must be used to purchase an annuity.

The employer may contribute in aggregate to pension, provident and benefit plans up to 20 per cent of remuneration for any one member; however, only 15 per cent of remuneration may be paid to either pension or provident plans. If, however, the retirement plan is underfunded and the Commissioner of the Revenue agrees, it is permissible to pay a higher rate of contribution into the plan. The employer's contributions are treated as a business expense for tax purposes.

Provident plans

Membership of a provident plan has the advantage that all the accumulated benefits can be taken as a cash lump sum

at retirement. When employees retire many of them return to rural areas where it is difficult to cash a monthly pension.

Furthermore, many South Africans have an inherent desire to take up farming and the cash lump sum at retirement enables them to purchase the farm and some livestock.

The tax-free portion of the lump sum is calculated in the same manner as that arising from a pension plan, namely: $\frac{1}{10}$ times the highest average annual salary (limited to a maximum salary of R60,000) over any consecutive five years multiplied by the number of completed years of plan membership. In addition, any contributions paid by the member may be returned. It is subject to the aggregate tax-free sums from pension, provident and benefit plans not exceeding the greater of:

- R120,000, or
- R4,500 times the number of years of completed membership.

If a member contributes to a provident plan the contributions are not tax deductible. Consequently, the majority of provident plans tend to be non-contributory. The employer may contribute in aggregate to pension, provident and benefit plans up to 20 per cent of remuneration for any one member. The employer's contributions are treated as a business expense for tax purposes.

Taxation

The underlying tenet is that contribution and investment income should be exempt from tax and that tax should be levied on the benefit outgo; however, in the quest for further sources of income, the government has started to levy tax on some aspects of investment income (see Recent Proposals below).

The member's pension that emerges from a pension plan is fully taxable and subject to Standard Income Tax on Employment (SITE). If a spouse's and/or dependent's pension becomes payable on the death of the member, it is also subject to SITE. As previously mentioned, part of the cash lump sum at retirement is tax free and the balance is taxable. Tax is levied at the higher of the member's average rate of tax in the year of accrual and the previous year.

On withdrawal from a pension plan a member can have a refund of contributions plus interest not exceeding R1,800 free of tax. However, a member may also receive free of tax any contributions that were not previously allowed as tax deductible if these exceed R1,800. Any refund in excess of the foregoing is taxed at the higher of the member's average rate of tax in the year of accrual and the previous year.

Retirement annuities

People who are self-employed, those not eligible to join their company's occupational retirement plan and those who have not reached their maximum benefits in their pension plans can take out a retirement annuity. A person may contribute each year the greater sum of:

- 15 per cent of non-retirement funding income
- R3,500 less current contributions to a pension plan, or
- R1,750.

The annuity may vest at any age between age 55 and age 70. On vesting the member has the option of taking up to $\frac{1}{3}$ as a cash lump sum — the same regulations apply to calculating the tax-free portion; the other $\frac{2}{3}$ must be used to purchase an annuity.

On withdrawal from an occupational pension plan a member may place the transfer value in a retirement annuity contract.

Preservation funds

Leading consultants and insurance companies have established preservation funds as the repository for the assets of members who change jobs and do not want to leave their preserved benefits in their previous company's pension or provident plans.

The legislation allows a member to make one withdrawal of funds (which will be taxed) from the preservation fund before retirement. A member may withdraw all his pension assets or only some of them; if, however, some funds are left it is not permissible to have another withdrawal before retirement.

On retirement, a member can uplift from a pension preservation fund $\frac{1}{3}$ of the assets as a cash lump sum (the same legislation applying to the tax computations as pension plans) and the balance used to purchase an annuity. If it is a provident preservation fund, all the assets can be uplifted as a cash sum (subject to tax). The assets must be uplifted from a preservation fund before attainment of age 70.

Housing loans

One of the unusual aspects of the South African pension legislation concerns investment in housing. The trustees of retirement plans may grant a loan to a member, if the rules of the particular plan allow it. The end result is that the member may:

- purchase a house or purchase land and erect a house on it
- make alterations to, or repair, the existing house

- redeem a mortgage previously granted by a third party.

One of the requirements is that the member or one of his dependents must occupy the house. Such loans can be made for periods of up to 30 years.

Pension funds adjudicator

Recent legislation has created the position of Pension Funds Adjudicator to ensure that pension and provident plans are managed in accordance with the rules. For example, a member may bring a complaint to the Adjudicator concerning:

- the administration of the plan
- the investment of the fund's money
- the interpretation and application of the rules of the plan.

The legislation is very specific and the complaint must relate to one of the following:

- that the plan made a decision outwith its power
- that the member has been prejudiced as a result of maladministration
- that the employer has not fulfilled its duty in terms of the fund's rules.

The first step is for the complainant to lodge the complaint with the administrator or trustees of the retirement fund or the employer and thereafter 30 days are allowed for a reply. It is only at this stage if either the member (or other beneficiary) is unhappy with the reply or there has been no reply that the process involves the Adjudicator, Professor John Murphy. A member is entitled to have legal representation at the adjudication meeting, which will also involve a representative from the retirement plan. The Adjudicator will consider all facets

of the case and subsequently make his decision; thereafter, either party has the right to take the case to the High Court on appeal within six weeks. If the case does not go to appeal the Adjudicator's decision carries the same authority as a court order.

Recent developments

Substantial amendments were made to the Pension Funds Act in 1996 and these became law on 15th December, 1998. Now, all pension and provident plans are required to have a board (of trustees) consisting of four or more trustees, at least half of whom have been elected by the members.

The legislation states that the rules of the plan must set out the procedures for appointing the trustees, the constitution of the board, the quorum for meetings and so on. In addition, the rules must set out the objects of the board; namely, to direct, control and oversee the operations of the plan in accordance with the Pension Act and the plan's own rules. Furthermore, the rules must set out the duties of the board such as the proper maintenance of registers, the timely payment of contributions to the fund and so forth.

Recent proposals

The government established the Katz Commission to look into and report on taxation in South Africa. According to Professor Katz, there is an apparent lack of consistency in the taxation of retirement funds with the consequence that it is possible to gain an unfair tax advantage by using one type of investment as distinct from another.

The Katz Commission has recommended that all retirement funds be taxed in a similar manner so that retirement funding should not be given

any tax advantage over any other form of savings. Consequently, the proposals are that all retirement plan legislation should be rationalised, with the result that all the benefits attributable to a member should be subject to a one-off tax at the time of retirement. This means that all retirement benefits are treated as lump sums and taxed fully at the time of retirement: his proposed tax incentive is that the rate of tax will be lower.

On the investment front, Katz recommended that interest, rental and other trading income should be taxed at 30 per cent on the proportion of the

assets corresponding to the ratio that non-pensioner liabilities bear to total liabilities. Tax at 17 per cent was introduced in 1996 and levied on interest, rental and trading income. This tax was increased to 25 per cent in the 1998–99 budget and became effective on 1st March, 1998.

Further reading

- 1 Infrastructure: A Foundation for Development — Development Bank of Southern Africa.
- 2 Financial Services Board — 1997 Report.
- 3 The Pension Funds Act 24 of 1956.
- 4 The Pension Funds Amendment Act 1996.
- 5 Professor M. Katz — Katz Commission Reports.