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Understanding the proposed retirement reform – “Two-pot retirement system”

Summary:

The two-pot retirement system will come into effect on the 1st of September 2024. The new system will allow retirement fund members to make partial withdrawals from their retirement savings while also protecting and preserving a greater proportion of savings until retirement.

Member’s pension contributions prior to the implementation date will be retained in the ***vested pot***, and no future retirement fund contributions will be made into this pot. Further, one-third (33%) of member’s pension contributions will be put into the ***savings pot***, while the remaining two-thirds (67%) will go into the ***retirement pot***. Under defined benefit funds such as the Government Employees Pension Fund (GEPF), this will be based on a member’s pensionable years of service.

Upon the implementation date, a once-off ***seeding capital of 10%*** or a capped amount of ***R30 000*** from the member’s existing retirement savings will be transferred to the savings pot. The defined benefit funds will calculate the seeding capital using 10% of the actuarial reserve value (ARV), considering a member’s pensionable years of service.

Members will still be able to access their pension savings stored in the vested pot upon resignation, retrenchment and retirement, subject to the current withdrawal and tax rules.

Members can withdraw a minimum of R2 000 up to the total value of their savings pot, limited to one withdrawal each tax year. Withdrawals from this pot will be taxed at the member’s marginal income tax rate in the year of withdrawal. The retirement pot will be preserved until retirement to purchase a compulsory income annuity that will be taxed at the corresponding marginal tax rate.

1. Overview of the South African pension system

The South African retirement savings system has aggregate pension assets amounting to approximately 50% of the national Gross Domestic Product (GDP)[1]. Like many countries across the globe, SA's retirement system adopted the World Bank's three-pillar framework, which postulates that pension systems exist to allow individuals, particularly the elderly and the disabled, to retire from employment comfortably with sufficient income.

The first pillar is a public benefit programme, funded from general government revenue, aimed at redistribution to prevent poverty in old age. Pillar one comprises the social old age grant, which is the main source of income of over 75% of women over 60 and men over 65, including many people with many years of formal or informal employment behind them.

The second pillar is typically privately managed, fully or partially funded, with mandatory participation, within which individuals save to provide themselves with an income during retirement. Under pillar 2 are the various pension and provident fund arrangements associated with formal employment in private or public sectors.

The third pillar comprises voluntary savings, permitting individuals to choose how they allocate income over their lifetime. In South Africa (SA), the self-employed may not participate in occupational retirement funds and are required to use the same vehicle as others to supplement the provision in pillar 2. Therefore, pillar 3 includes contractors, consultants, and other professional people who undertake retirement funding for themselves and individuals who supplement any provision made through occupational savings vehicles[2].

The South African pension system is mainly regulated by the Pension Funds Act (PFA) 24 of 1956[3] and the Income Tax Act 58 of 1962[4]. These two Acts regulate all retirement vehicles in the country, except for the pensions of people employed by the government and some state entities[5]. The public sector pensions are regulated by the Government Employees Pension Law Act 21 of 1996, which makes provisions for the payment of pensions and certain other benefits to persons employed by the government, certain bodies, and institutions.

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[1] SARB Working Paper WP/22/17 (2022). Retrieved online:

https://www.resbank.co.za/content/dam/sarb/publications/working-papers/2022/WP%202217.pdf. (Accessed: 13 May 2024).

[2] Retirement Fund Reform. A discussion paper, December 2004.
https://www.treasury.gov.za/public%20comments/Retirement%20Fund%20Reform%20A%20Discussion%20Paper.pdf

[3] Pension Funds Act (PFA) 24 of 1956 provides guidelines concerning the registration, incorporation, regulation and dissolution of pension funds and any matters related to pensions. It also sets out the duties and responsibilities of pension fund trustees and the rules for investing pension fund assets.

[4] Income Tax Act 58 of 1962 stipulates that all contributions towards pension funds are subject to tax deductions of up to a certain limit. It also details the tax treatment of pension fund benefits, including the tax-free lump sum that can be taken upon an individual's retirement.

[5] The proposed amendments to various pieces of legislation governing public sector pension funds include the following: Government Employees Pension Law, 1996 (Proclamation 21 of 1996), Post and Telecommunications-related Matters Act, 1958 (Act 44 of 1958), and the Transnet Pension Fund Act, 1990 (Act 62 of 1990).

In line with the pillars above and the legislative framework, SA has different retirement fund vehicles available to individuals who wish to save for retirement: ***pension funds, pension preservation funds, provident funds, provident preservation funds and retirement annuity funds.*** Besides retirement annuity and preservation funds, the retirement vehicles are provided on a condition of employment; as such, members enter savings contracts with these different retirement funds. According to Statistics South Africa (Stats SA), over 14.1 million people in SA are contributing to a retirement fund as a condition of employment[6].

2. Rationale for the two-pot retirement system

According to a retirement reality report, ***less than 6% of South African employees could afford to retire comfortably***.[7] As such, many retirees face the dilemma of outliving their retirement savings and ultimately must make other means to maintain their standard of living post-retirement. Notwithstanding the low retirement savings rate, concerns were raised regarding the design of the current retirement regime.

Firstly, households cannot access their retirement funds during financial hardships. This incentivises individuals to ***resign from their employment to access their retirement funds prematurely during times of financial difficulty***. This reality became evident during the Covid-19 pandemic as many individuals, especially employees, could not access their retirement savings to address living expenses, including medical and other health-related expenses due to ill health, and debt repayments such as mortgage bonds. Consequently, during times of financial distress, such as the Covid-19 pandemic, other people were forced to rely on debt as a short-term financial solution.

Secondly, there is a lack of preservation of retirement savings pre-retirement. This is caused by pension and provident fund members who terminate employment to gain access to retirement interest, thereby prematurely terminating the ability to preserve these funds until normal retirement age. Should these early retirees not find employment elsewhere, they risk retiring without adequate capital to buy a pension and maintain themselves.

Consequently, ***the two-pot retirement system aims to ensure that retirement fund members are allowed partial access to their assets within their retirement funds for emergencies while enforcing the compulsory saving of a portion of contributions made to the fund until retirement.***

3. The Two-pot retirement system

The two-pot retirement system will come into effect on 1st September 2024. It will apply to both private and public retirement funds, except for the old generation or legacy retirement annuity policies or funds with no active

[6] Stats SA (2024). Quarterly Labor Force Survey: May 2024. Statistical Release: P0211. Retrieved online: https://www.statssa.gov.za/publications/P0211/P02111stQuarter2024.pdf (Accessed 13 May 2024).

[7] Retirement reality report. Available online: https://assets.ctfassets.net/yqvz0zwovkbq/11ZwXfsfDb254lZAYol0oG/a712ba2c362773772e2bbcbef154aa57/10X_Retirement_Reality_Report_2023_2024.pdf (Accessed: 19 May 2023).

participating members. Furthermore, pensioners and provident fund ***members who were 55 years old and above on 1st March 2021 will have a choice to either continue with the current system or opt to participate in the reform.***

The reform creates ***three components (pots) within the retirement funds***: a ***savings pot,*** a ***retirement pot,*** and a ***vested pot.*** Only the savings and retirement pots will receive retirement contributions from the implementation date onwards. The retirement fund managers will split contributions between these two pots. The vested pot will not receive any retirement contributions after the implementation date but will keep member contributions made until the 31st of August 2024 and investment growth thereof.

3.1 Vested Pot

The new reform will call the existing retirement fund the vested pot. The vested pot constitutes the member's entire pension contributions before the implementation date of the two-pot system. The vested pot under the defined benefit funds will be based on a member's pensionable years of service before the new reform's implementation date. The vested pot will follow the existing pension system rules. Under the current rules, members of pension and provident funds are only allowed access to their retirement benefits in full as a cash lump sum, or they can transfer to the retirement pot upon resignation or retrenchment, subject to tax. However, if a member decides to transfer funds to the retirement pot, the vested pot will cease to exist.

Members of retirement funds may only transfer their retirement interest from the vested pot to the retirement pot. At retirement, a member's retirement interest in the vested pot will be subject to the current rules. ***The current rules stipulate that one-third (33%) of retirement interest can be accessed as cash lump-sum, and two-thirds (67%)*** must be annuitised, with corresponding tax implications as discussed below. However, provident fund members above 55 years of age, on the 1st of March 2021, will have a choice to take everything as a cash lump sum or annuitise their savings.

3.2 Savings Pot

33% of the pension contributions from 1 September 2024 will be stored in the savings pot. The purpose of the savings pot is to discourage over-reliance on debt and to provide members with financial means to handle "*rainy days*". The defined benefit funds[8] such as the Government Employees Pension Fund (GPEF), will calculate one-third of member's pension contributions to the savings pot with reference to one-third of the member's pensionable service.

[8] Defined benefit funds are retirement funds whose value of benefits at retirement is not determined by how much the member or employer has contributed but by a formula contained in the fund rules. The formula takes factors such as a member's pensionable years of service and final salary into account.

After implementing the new retirement system, a ***seeding capital of 10% or a capped amount of R30 000 from a member's pension contributions until 31st August 2024*** will be transferred to the savings pot. The seeding capital will be capped at a maximum of R30 000 to limit the adverse effects on liquidity.

For example, a member with a retirement fund value of R350 000 from which the seeding capital of either 10% or a capped amount of R30 000 should be calculated. In this scenario, R30 000 will be used as the seeding capital since ***10%*** ($\boldsymbol{R350\ 000 \times 10\% = R35\ 000}$) of the member's existing retirement interest exceeds the capped amount. However, ***if a member's 10% of the retirement interest is less than R30 000, the member will receive 10% as the seeding capital.***

The defined benefit funds will calculate the seeding capital using 10% of the actuarial reserve value (ARV), considering a member's pensionable years of service. For example, a member who has been in service for 30 months (2 and a half years) and has an ARV of R250 000 will have a seeding capital of ***R25 000*** $(\boldsymbol{R250\ 000 \times 10\% = R25\ 000})$***.*** The fund will then reduce the member's pensionable service because the pensionable service date will be moved forward by 3 months ($30\ months \times 10\% = 3$).

Also, provident fund members under 55 as of 01 March 2021 will have their seed capital taken proportionally from the pot that was vested in 2021 and the non-vested pots.

Savings withdrawal benefit

Members can withdraw the seeding capital and any future contributions made to the savings pot to manage financial emergencies. Members of all retirement funds will be allowed to withdraw a ***minimum of R2 000*** up to the full value of their retirement interest available in the savings pot at any time during a tax year. However, members will be restricted to one withdrawal each tax year. It is important to note that withdrawals from this pot will be subjected to tax, as discussed below, and may also be charged administration fees. Members who have multiple retirement fund contracts will be allowed one withdrawal from each contract per tax year.

While the savings pot will allow access to members at any time during each tax year, the withdrawal benefit will differ with retirement vehicles when a member is retrenched, resigns, and retires. For instance, members of the pension and provident funds can either continue with annual withdrawals subject to tax or choose to transfer funds to the retirement pot when they resign. On the other hand, retrenched pension and provident fund members will be allowed to make annual withdrawals subject to tax. At retirement, members of all retirement funds who still have savings remaining in the pot will access it as a cash lump sum, subject to the lump sum tax table.

Notably, if a member terminates membership from a retirement fund after making a withdrawal and the remaining balance is less than R2 000, the remaining balance can be withdrawn. Since the defined benefit funds use a formula to determine benefits, the new pension system will use a reduction in a member's years of service when a withdrawal is made.

Transfers to the savings pot

As discussed above, there will be no further transfers from the other pots into the savings pot except the seeding capital. However, members will be able to transfer from this pot into the retirement pot.

3.3 Retirement Pot

The retirement pot will constitute about two-thirds (67%) of a member's future contributions from the reform's effective date. The defined benefit funds will calculate two-thirds of the member's contributions to the retirement pot with reference to two-thirds of the member's pensionable service with effect from the implementation date. Retirement savings in this pot will be preserved until the official retirement age. ***Retirement interest in the retirement pot will not be accessible even when members resign or are retrenched.*** This will improve the retirement outcomes for retirement fund members.

Members can transfer their retirement interest from the savings pot to this pot if they choose to. However, no transfers out of the retirement pot to the savings pot can be made. At retirement, members of all retirement funds will be required to annuitise the full value of their retirement interest in this pot, provided it exceeds the current minimum threshold of R247 500 allowable for annuitization.

The amount in the retirement pot will only be accessible as a cash lump sum in three instances: (1) if the member has ceased to be a South African resident for a continuous period of three years; (2) if the member left South Africa on expiry of a work or visit visa; or (3) if the amount in the member's retirement and vested components in the fund are less than an amount prescribed by legislation, which is currently at R247 500.

Transfer of pots to across different retirement funds

Members of all retirement funds will be able to transfer the three pots from one fund to another only upon termination of membership in the respective fund. However, the pot cannot be separated when making a transfer to another fund; all funds must be transferred together as they are, that is, savings, retirement, and vested pots.

4. Tax treatment under the two-pot retirement system

4.1 Contributions to retirement funds

The current principle of exempting contributions and growth while taxing withdrawal of benefits will remain under the two-pot retirement system. This implies that members of retirement funds will be allowed a deduction for amounts contributed to retirement funds, either by themselves or their employer on their behalf. Thus, as highlighted above, the deduction applicable under the current retirement regime will apply under the two-pot retirement regime. Employer contributions made on behalf of employees will be treated as a taxable fringe benefit in the employee's hands.

4.2 Tax on withdrawals from the three components.

Under the two-pot retirement system, tax treatment will differ for each component in line with the withdrawal process permissible for that specific pot, as outlined above.

Tax treatment of the vested pot

As the retirement interest in the vested pot will still be accessible by pension members and provident finds upon ***resignation, retrenchment, or retirement,*** it will attract tax accordingly. Upon resignation, if a member decides to take their retirement savings as a cash lump-sum, it will be subjected to withdrawal lump-sum tax tables[9]. ***Based on the current withdrawal table, R27 500 is tax-free and beyond that, tax rates apply according to the table. There is no tax implication if the member decides to transfer their retirement interest to the retirement pot***. ***Notably, the tax-free amount applies only once, and any subsequent cash lump-sum withdrawals will be taxed in full.***

When members of pension and provident funds are retrenched and decide to take all or a portion of their funds in cash, this withdrawal is added to any severance payment received and taxed as per the retirement lump sum tax table[10]**.** ***In line with the current retirement lump-sum tax table, the first R550 000 is tax-free, considering any other pre-retirement withdrawals made by the member***. ***For amounts beyond the tax exemption of R550 000, tax rates will apply according to the member's retirement tax rates to the maximum of 36%.***

Notably, any withdrawal pre-retirement reduces the R550 000 tax-free amount at retirement. This is because the tax-free amounts apply to all withdrawal lump sums received over a member's lifetime, including divorce settlements or maintenance orders paid on your behalf after 1 March 2009.

At retirement, one-third (33%) taken as a cash lump sum will be subjected to the retirement lump sum tax table, as indicated above. ***The remaining two-thirds (67%) used to purchase income annuity will be taxed at the corresponding marginal tax rate when the member receives the pension from the annuity***. ***However, if the value of retirement benefits is below R247 500, the member can make a full withdrawal as a cash lump sum, subject to the lump-sum tax tables discussed above.***

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[9] Retirement fund lump sum withdrawal benefits consist of lump sums from a pension, pension preservation, provident, provident preservation or retirement annuity fund on withdrawal. Website link: https://www.sars.gov.za/tax-rates/income-tax/retirement-lump-sum-benefits/

[10] Retirement fund lump sum benefits consist of lump sums from a pension, pension preservation, provident, provident preservation or retirement annuity fund on death, retirement, or termination of employment due to attaining the age of 55 years, sickness, accident, injury, incapacity, redundancy or termination of the employer's trade.

Tax treatment on withdrawals from the savings pot

The withdrawal from the savings pot will be taxed at the member's marginal income tax rate[11] in the year of withdrawal. This implies that any withdrawal from the savings pot will not affect the lump sum benefits at retirement but will mainly affect the annual taxable income. ***The savings withdrawal benefit will be included in the taxpayer's gross income. Notably, the withdrawal amount could push members into a higher tax bracket.***

For example, if a member with a taxable income of R370 000 in the 2024/2025 tax year decides to withdraw R25 000 from the savings pot. During this assessment year, the member's taxable liability will be the sum of the taxable income and the savings withdrawal, R395 000. At the original taxable amount of R370 000, the tax liability would be R59 997 (R42 678 + 26% of the amount above R237 100 – primary rebate of R17 235). However, with the savings withdrawal at the taxable amount of R395 000, the member will be pushed to the next tax bracket and be liable for a tax of R67 722 (R77 362 + 31% of the amount above R370 500 - primary rebate of R17 235).

This tax treatment aims to discourage individuals from accessing a savings withdrawal benefit when they have other income sources and don't need to dip into their retirement fund savings. ***However, if a member becomes unemployed and has no income in the year of withdrawal, they could withdraw up to R95 750 from their savings pot tax-free, depending on the value of savings available.***

Members with retirement interest remaining in the savings pot until retirement will be allowed to withdraw full value as a cash lump sum, subject to retirement lump sum tax tables as discussed above.

Tax treatment on withdrawals from the retirement pot

As discussed on the vested pot, the annuitised retirement savings will be taxed at the corresponding marginal tax rate when the member receives the pension from the annuity. Retirement fund managers determine the taxation amount that annuitants are obligated to pay by considering their aggregate annual income from all their living annuities with that specific product provider. Annuitants are subject to taxation in accordance with their annual income. Those with an income below the tax threshold will not have to pay tax. The tax calculation is typically carried out at the onset of each tax year, commencing in the new tax year.

5. Conclusion

The article highlights how South African households often struggle financially when unexpected events occur due to insufficient savings or emergency funds. As a result, they are compelled to use debt to survive these trying times, while others prematurely resign to access their pension savings. Thus, the new pension system provides

[11] Marginal income tax rates are tax rates that apply to different categories of taxable income in the income tax brackets. Website link: https://www.sars.gov.za/tax-rates/income-tax/rates-of-tax-for-individuals/

members of retirement funds with a portion of their retirement savings as a financial safety net. By providing a safety net, the accessible savings pot reduces the perceived risk of locking away retirement funds.

The new pension system is projected to encourage the culture of savings by incentivising retirement savings. Individuals will want to preserve more towards their long-term retirement savings after witnessing the benefits of accessing a portion of their savings whenever they encounter financial hardships. Consequently, this could stimulate a higher participation rate in pension schemes and, thus, contribute to mitigating the retirement savings crisis. ***The new system can also provide pension fund members an alternative to using debt when dealing with unforeseen emergencies or financial shocks.***

The reform will also ensure that a substantial portion of retirement savings, ***two-thirds, is inaccessible until retirement.*** This provides a disciplined structure to ensure retirees have sufficient funds to maintain a standard of living beyond their working years. It is important to note that this reform is not a magic wand to be wielded indiscriminately in the short term through frequent savings withdrawals but rather a long-term mechanism to ensure a better standard of living at retirement. ***Frequent savings withdrawals are one of the downsides of the new reform, whereby the system is at risk of being exploited.***

While the savings withdrawal benefit will play a pivotal role in assisting members during times of financial distress, accessing funds from the savings pot will ultimately affect a member's retirement savings when they retire. Thus, recurring withdrawals from this pot could lead to a member ending up with far lesser retirement savings (cash-lump sum) than they would have had if they had not withdrawn money from this pot. As such, ***retirement members should be discouraged from frequently withdrawing from their savings pot unless they encounter unavoidable emergencies.*** This will help them maximise their retirement savings for when they retire.

Another downside of the new system is the tax implications for individuals withdrawing from the savings pot. Should a member withdraw from their savings pot, they will be taxed on the amount they intend to withdraw. ***Thus, when an individual withdraws funds during a specific tax year, they will pay additional tax during that tax year. Members should also be discouraged from making withdrawals without a substantial need for funds since savings withdrawals are allowed once every tax year.*** If a member withdraws from the pot early in the tax year, they can no longer access the savings pot later in the year if an emergency occurs.

Therefore, it is imperative for retirement funds to inform their respective members on how the new reform will impact them and educate members on financially savvy decision-making regarding managing their savings pot. This is particularly true regarding the new reform's implications for divorce settlements. Members should be educated on the changes to the sharing of pension interest to avoid circumstances involving uninformed members.