“Two Pots” retirement reforms – latest developments

June 2023

On 9 June 2023 National Treasury released an updated draft of the Revenue Laws Amendment Bill (RLAB - first issued in July 2022) as well as draft amendments to the Pension Funds Act, intended to harmonize the latter with the amended provisions of the Income Tax Act that the RLAB will introduce.

Comment on the two draft Bills is due by 15 July. WTW will send comments to Treasury, but even before we have fully considered the detail of the draft Bills we think it is important to give our retirement fund clients a sense of what is coming.

We highlight that the term “Two Pots” has been retained in this note, although it will become clear from the material below that there are “three pots” to consider.

Implementation of the “Two Pots” regime

The draft RLAB will come into effect on 1 March 2024 – this is now less than nine months away. Since COSATU has recently issued a statement highlighting 1 March 2024 as the implementation date of the pensions reforms,[1] it is sensible to assume that this date will not be put back. **It is therefore essential for Trustees to engage with their fund’s administrator, to assess (in detail) the administrator’s state of readiness as 1 March 2024 approaches.**

It will also be necessary for all funds that are receiving contributions to amend their rules in time for the implementation date, to carry out a communication programme for in-service members, and to consider the implications for their investment strategies.

Trustees should keep in mind that the Two Pots reforms are being enacted chiefly through changes to the Income Tax Act – specifically, to the definitions of “pension fund” and “provident fund” (among others). Funds will have no choice but to align themselves with these amended definitions, otherwise they will risk losing their tax-approval status.

“Two Pots” regime for Defined Contribution funds

The shape of the new regime for Defined Contribution funds is fairly clear:

- One-third of future retirement-funding contributions must be allocated to the “savings pot” (renamed the “savings component” in the draft Bills). The relevant fund return should be credited to this component. Members must be given a facility to make yearly withdrawals from the savings component if they so choose – limited to one withdrawal per tax year, with a minimum withdrawal amount of R 2 000.[2] Withdrawals will be taxed as income, at the member’s marginal tax rate – tax directives will be required in each case.

[1] “COSATU will continue to work with Treasury and Parliament to ensure these bills are passed by Parliament by December 2023. This is critical to ensure we meet the implementation date of 1 March 2024 when workers can access a portion of their pension funds.”

[2] The draft RLAB does not indicate whether it will be permissible to charge an administration fee for processing a savings withdrawal, either as a deduction from the net-of-tax withdrawal amount or as a debit against the balance in the member’s savings component. It is likely that some fund administrators will want to make a charge for this service.

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- The other two-thirds of future retirement-funding contributions must be allocated to the "retirement component" ("retirement pot"). Again, the relevant fund return should be credited to this component. This money is essentially locked away until the member retires, at which point she or he must use it to provide an annuity (subject to a *de minimis* provision, discussed below).
- It seems that the member can choose (at any time, up to and including retirement) to have the (full) savings component added to the retirement component, to be used in due course to provide an annuity. Alternatively, on retirement the member can choose to take the full remaining balance in the savings component as a cash lump sum, to be taxed on the current retirement basis.
- The requirement that the retirement component must be used to purchase an annuity does not apply on death of the member – so presumably the retirement component can be used to provide either annuities or lump sums for dependants (or a combination). The same seems to apply to the savings component, although the wording in the draft Bill implies that the full balance of the savings component must either be paid out as a cash amount, or used to provide annuities for the dependants (not a combination) – this is probably an oversight in the drafting.
- Special provisions will apply to the retirement component when a member emigrates. Treasury also intends that special provisions will apply to the retirement component on retrenchment, but these are not set out in the draft RLAB, and Treasury has indicated that this will be left for a further phase of these pensions reforms – this seems less than ideal.
- The above applies to future retirement savings, arising from contributions due after 1 March 2024. Existing retirement savings arising from contributions due before 1 March 2024 constitute the member's "vested component", and the current regime will continue to apply to this after 1 March 2024. (A "vested" balance must be struck on 1 March 2024, and this will grow with the relevant fund return thereafter.) This means that members will have the right to take the full vested component in cash (less tax, on the current withdrawal basis) when changing jobs, and pension fund members will have the right to take up to one-third in cash (less tax, on the current retirement basis) when retiring, while the balance must be used to provide an annuity.

  More complicated provisions apply to provident fund members on retirement, in line with the tax changes introduced in 2021.
- On resignation or dismissal (or retrenchment, as appears to be the case initially), a member will be able to take the full value of the vested component in cash (less tax on the current withdrawal basis). If the member has taken any cash out of the savings component since the start of the tax year, he or she may not make a further cash withdrawal from this component on resignation or dismissal, unless the remaining value is less than R 2 000. And the full balance in the retirement component, however small, must be preserved until retirement.[3] It will be a challenge to explain the various permutations (including the transfer options) to members!
- In cases where the insured arrangements for death and disability benefits incorporate an "offset" in respect of the member's fund credit (share of fund), Trustees will have to consider whether these arrangements need to be revised, to allow for the uncertain progress of members' savings components.
- If the combined value of the retirement component and two-thirds of the vested component is less than the *de minimis* amount (currently R 165 000), the member will be able to take the full amount in cash on retirement.
- There is a further "wrinkle" for persons who were members of a provident fund on 1 March 2021 and were then aged 55 or over, who continue to be contributory members of the same provident fund – they will be able to **choose** which regime should apply their post-1 March 2024 contributions. So, they can choose that their future contributions go to the "vested component", with the current regime applying, **or** that their future contributions are split between the savings component and the retirement component, with the new regime applying.
- The draft RLAB also deals with the issue of "seed capital", i.e. the initial funding of the savings component out of the member's pre-1 March 2024 retirement savings (the vested component). Treasury had initially proposed that **no** "seeding" of the savings component would be allowed – this has clearly been opposed by Labour and by others who gave feedback on the first draft of the Bill, and so Treasury is now proposing that "seed capital", limited to the **lower** of R 25 000 and 10% of the 1 March 2024 vested balance, must be allocated to the savings component.[4]

[3] Our interpretation is that a member who leaves service at the end of March 2024 will be entitled to take the full vested component and savings component in cash, but will be obliged to preserve the retirement component (by transferring it to another fund, or possibly by preserving it in-fund), which at that stage will amount to two-thirds of one month's retirement-funding contributions, i.e. typically a very small amount.

[4] We understand that Labour is lobbying to have this increased to the lower of R 50 000 and 30%.

- Members may choose to transfer amounts from the vested component or the savings component to the retirement component at any time (of course, once monies move to the retirement component they are subject to the applicable lock-ins until the member takes a retirement benefit). If benefits are transferred to another fund, all three of the vested, savings and retirement components must be transferred – they cannot be split among different funds. Tax directives will be required in all cases (including, apparently, for "intra-funds" transfers from a vested or savings component to a retirement component in the same fund) - but such transfers will of course be tax free.

"Two Pots" regime for Defined Benefit funds

The first draft RLAB was entirely silent on how the new regime should be applied by Defined Benefit funds (including, most obviously, the Government Employees Pension Fund). This shortcoming has been somewhat addressed in the new RLAB.

- Regarding the one-third of total retirement-funding contributions that must be allocated to the savings component, the draft Bill now says that *"in the case of funds with a defined benefit funding structure, the total value attributed to this component on or after 1 March 2024 is to be determined with reference to one-third of the member's 'pensionable service' as contemplated in the rules of that fund on or after 1 March 2024"*. No clear guidance is given as to how this "value attributed" should be calculated – our understanding is that Treasury does not want to be too prescriptive in this regard (so, some degree of discretion may be allowed to individual funds, possibly with some guidance from the FSCA which will have to approve the necessary rule amendments).
- What is clear however is that the member's years of pensionable service will have to be reduced (on some suitable basis) when the member withdraws cash from her or his savings component, and the Fund will also have to keep track of the amount of pensionable service remaining (not yet encashed) in respect of the savings component – common sense says that for every extra month of pensionable service accrued after 1 March 2024, the pensionable service allocated to the savings component will increase by one-third of a month (and the pensionable service allocated to the retirement component will increase by two-thirds of a month). Exactly how the fund's administrator will track and manage this will be somewhat challenging!

  It is clear that the Fund's valuator will need to be involved in determining the value attributed to any portion of the savings component that is withdrawn in a particular year.
- The "seed capital" provision will also apply to Defined Benefit funds – again, there is currently no clear indication as to how the "total value of the vested component as at 29 February 2024" should be calculated. (The seed capital would again be limited to the lower of R 25 000 and 10% of the member's vested component on that date.)
- No guidance is provided as to how "hybrid" funds (e.g. Defined Contribution funds with a Defined Benefit underpin) should implement the new regime – Trustees of such funds may need to take legal advice as to whether their fund qualifies as a "fund with a defined benefit funding structure", and what this means for the operation of the three components. Common sense says that funds which have both Defined Contribution members and Defined Benefit members (as separate in-service member categories) should apply the relevant principles to each category separately.

Amendments to the Pension Funds Act

The intention of this draft Bill is to harmonize the Pension Funds Act with the "two pots" provisions of the Income Tax Act. Some other tidying-up is included.

- Various definitions are added, "as defined in section 1(1) of the Pension Funds Act".
- Housing loans or guarantees will be limited to 65% of the member's available benefit (including all three "pots"), in line with the recent amendments to Regulation 28.
- Section 37D, dealing with permissible deductions from members' benefits, will be revised, although it is not clear yet how these deductions should be funded from the three "components" (presumably on a proportionate basis?). Deductions of amounts owed to the employer will now be permitted on the date on which employment is terminated (not the date on which Fund membership ceases) – employers will probably view this as positive. Valid court judgments against a member will include compensation orders under Section 300 of the Criminal Procedure Act of 1977. In the absence of a valid judgment, the fund may only withhold a benefit if there is a court order authorizing this.

- If there is a valid judgment that has not yet been enforced, or if the employer has granted a housing loan or provided a housing loan guarantee to a member, the fund may not allow a "savings withdrawal benefit" (an encashment from the savings component) if this would reduce the remaining benefit below the level needed to give effect to the judgment or to cover the loan or guarantee amount, unless the employer specifically agrees to this.
- A (long!) definition of "pension interest" is introduced, for divorce-splitting purposes – this largely replaces the current section 37D(6). For a contributory member of an occupational fund, the "pension interest" is essentially the resignation benefit on the date of the divorce order.
- There will be provisions restricting the payment of "savings withdrawal benefits" if this would deplete the member's total benefit to such an extent that other withdrawals under Section 37D would be impacted.[5] Importantly, the Act will in future provide that a divorce or maintenance order granted against a pension in payment must be funded from the monthly pension instalments, rather than from the capital value of the pension.

Conclusion

We emphasize that the above summary is based on our initial reading of the draft Bills and Explanatory Memoranda, and may not be accurate in all details. We (along with numerous others, no doubt) will be providing feedback to Treasury on these Bills, which should not be seen as final yet – although they do represent an advance on the draft legislation circulated last July.

As noted earlier in this note, Trustees do need to consider seriously the actions that will be needed to give effect to this legislation as from 1 March 2024, which now seems a very likely implementation date – this will require a lot of effort from the whole pensions industry, including the regulator.

[5] There will also be a ban on savings withdrawals, or housing loans or guarantees, if the fund is aware that a divorce order is pending (how would the fund be aware of this?) – unless the spouse consents.

The following table is intended to illustrate the overall "shape" of the Two Pots regime:

	Benefit available/accessible on leaving employment <u>(resignation / retrenchment)</u>	**Benefit available/accessible *<u>during</u>* employment**	**Benefit on <u>retirement</u>**
Pension Fund savings arising from contributions up to 1 March 2021	Up to 100% *can* be taken in cash Taxed on withdrawal tax table (Transfers and preservation are also options) This is the "vested component"	None, other than limited "seed capital" that will be moved to savings component[1]	Up to ⅓ *can* be taken in cash (rest used to buy a pension) ⅔ <u>must</u> be used to buy a pension[2]
Provident Fund savings arising from contributions up to 1 March 2021			Up to 100% *can* be taken in cash (rest used to buy a pension)
Savings arising from contributions (to either a pension or a provident fund) between 1 March 2021 and 1 March 2024			Up to ⅓ *can* be taken in cash (rest used to buy a pension) ⅔ <u>must</u> be used to buy a pension[2,3]
Savings arising from contributions (to either a pension or a provident fund) after 1 March 2024[4]	Up to ⅓ - *can* be taken in cash (while in employment, or on leaving employment including at retirement) – this is the "savings component" Cash taken before retirement taxed as personal income tax on normal tax scales.		⅔ <u>must</u> be used to buy a pension – this is the "retirement component"[2] If any cash is taken at retirement (from the "savings pot"), it will be subject to the retirement tax table.

Notes on table:

[1]. On or after 1 March 2024, a "seed" amount will be transferred from the vested component to the savings component – the amount will be the <u>lower</u> of 10% of the vested component value on 29 February, or R 25 000.

2 Subject to the "de minimis" provision – i.e. member may be able to take full benefit in cash, if the amount is below the applicable de minimis limit (currently R 165 000 in most cases). This limit applies to the value of the retirement component plus two-thirds of the value of the vested component.

3 This does not apply to provident fund members who were aged 55 or over on 1 March 2021, and who remain members of the same provident fund (of which they were members on 1 March 2021) up to their eventual retirement. These members have the right to take (up to) the full provident fund retirement benefit in cash – but see the next point.

[4]. Provident fund members who were over 55 on 1 March 2021 and remain members of the same fund will be able to choose whether to continue contributing to their vested component after 1 March 2024, or instead to contribute to savings and retirement components. The first option means they will be able to take the full benefit in cash (less tax) on retirement (but no cash withdrawals while still in service); the second option means they will have to use their post-1 March 2024 retirement component to buy an annuity when they retire, but they will be able to take cash withdrawals from the savings component while still in service.

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