"Two Pots" retirement reforms:– latest developments

February 2024

This note is an update on two important pieces of legislation that are currently before Parliament - when enacted and signed into law, these will give effect to the so-called "Two Pots" pensions reforms. At the time of writing this note, the likely implementation date for the Two Pots regime is **01 September 2024**, i.e. in a little more than six months' time.

We refer to "Two Pots" in this note, although, as highlighted in our previous client notes on this subject, there are in fact three "pots", or "components" as the draft legislation calls them, to consider. These are the retirement component, the savings component, and the vested component. (We will use the terms "pot" and "component" interchangeably.)

Please refer to the client notes that we issued in June and October 2023 for more details on the Two Pots proposals.

Legislative timetable

The Revenue Laws Amendment Bill ("RLAB"), which makes the key changes to the Income Tax Act that lay the foundation for the Two Pots regime, was introduced in Parliament by the Minister of Finance on 1 November 2023 and is progressing through the standard Parliamentary processes, including Committee hearings. At the time of writing, it seems that the Bill will be debated (and presumably voted on) by the National Assembly on 20 February. The Bill also has to be considered and approved by Parliament's other chamber (the National Council of Provinces) before it can go to the President to be signed into law. Depending on exactly when Parliament rises ahead of the upcoming national election, it should be possible to complete these processes during the current Parliamentary term.

The Pension Funds Amendment Bill, which (among other things) makes some consequential changes to the Pension Funds Act ("PFA"), was only introduced into Parliament at the end of January. National Treasury briefed the National Assembly's finance committee on this Bill on 6 February, but it appears that the further Parliamentary processes are only timed to begin in March. The Chairperson of the finance committee has already warned that there may not be enough time to finish processing this Bill before Parliament rises.

One issue raised by Treasury in the presentation to the finance committee is that it will be necessary to amend the Government Employees Pension Law, the legislation governing the Government Employees Pension Fund ("GEPF"), to give effect to the Two Pots regime for GEPF members, which has always been Government's intention. This may possibly be achieved by extending the scope of the Pension Funds Amendment Bill, but this would apparently require public hearings on the amended Bill, which will clearly delay the process.

Revenue Laws Amendment Bill

As noted above, the RLAB will amend the Income Tax Act and will provide the bedrock on which the Two Pots regime will rest. It does this chiefly by amending various definitions in Section 1 of the Income Tax Act – critically, the definitions of pension fund and provident fund (and pension preservation fund, provident preservation fund and retirement annuity fund) – and by introducing new definitions, including those of the various "pots" (retirement component, savings component, and vested component), which are referenced in the amended definitions of the various types of retirement fund.

Trustees must be clear about the impact of these amended definitions, once they come into effect. The significant tax privileges enjoyed by retirement funds depend on compliance with these definitions – in particular, with the specified requirements for fund rules. As from the commencement date of the Two Pots regime, fund rules **must** provide for the creation and operation of the retirement, savings, and vested components (among other things) – if the rules do not do so, the fund will lose its tax approval. (The Income Tax Act specifies that the SARS Commissioner may only "approve or recognise" a fund, in respect of a tax year, if its rules conform to the specified requirements).[1]

The current Bill replaced an earlier draft released in June 2023, and which we unpacked and commented on in our June 2023 client note. The overall shape of the proposed Two Pots regime is largely unchanged - so, rather than repeat a detailed explanation of how it will work, we comment here only on what is different. Some of these changes were covered in our October 2023 note, but have been confirmed by the publication of the updated Bill. (We append a summary of the overall provisions at the end of this note.)

- The effective date has of course changed to **1 September 2024** as seemingly agreed between the National Assembly's finance committee, National Treasury, and stakeholder groups including organised labour, SARS, and the FSCA. The draft Bill actually specifies the date as 1 March 2025, but we are confident this will be changed to 1 September 2024 by the time Parliament votes on the Bill.
- In our June 2023 note, we said that on the effective date "*a 'seed' amount will be transferred from the vested component to the savings component – the amount will be the lower of 10% of the vested component value immediately prior to the effective date, or R 25 000.*" This formula has changed to the lower of 10%, or **R 30 000**.
- The Bill clarifies that Section 37D deductions from a member's total benefit (e.g. to settle Fund-guaranteed home loans or divorce or maintenance orders) must be taken proportionately from the three "pots". (As noted below, Section 37D of the Pension Funds Act will be replaced in its entirety by the Pension Funds Amendment Bill.)
- Defined Benefit (and hybrid) funds that are unable to track the values of the retirement and savings components by adjusting pensionable service records may instead use a different method of allocation approved by the FSCA. However, as noted below, the wording of the Pension Funds Amendment Bill seems to require the use of pensionable service records for this purpose.
- Members who were aged 55 or over on 1 March 2021 and are members of a provident fund[2] will be "opted out" of the Two Pots regime unless they exercise a positive choice to "opt in". If these members are "opted out", their future retirement-funding contributions will go solely to the "vested component", with the current regime continuing to apply in full. Importantly, an "opted out" member will **not** be able to make "savings benefit withdrawals" while still in employment, because she/he will not have a "savings component". It is not clear whether this is a once-off choice when the legislation takes effect, or whether the member can decide to "opt in" at a later date. It is also still somewhat unclear whether "opting in" or "opting out" will be the default.
- For provident fund members who were below age 55 on 1 March 2021, "seed capital" transfers from the vested component to the savings component must be taken proportionately from the pre- March 2021 "protected rights" and post-1 March 2021 "non-protected rights" portions of their vested components (both rolled up to the Two Pots implementation date).[3]

[1] On 16 February the FSCA released Communication 3 of 2024, which sets out in rather broad terms the requirements for rule amendments submitted by retirement funds (including Defined Benefit funds, and by extension hybrid funds) to give effect to the Two Pots regime.

[2] The member concerned must be a member of the same provident fund as on 1 March 2021, to benefit from this option. (The 1 March 2021 date refers to the 2020 Taxation Laws Amendment Act, which placed limits on the amount that can be taken as a cash lump sum on retirement from provident funds with effect from that date.)

[3] "Protected rights" is our preferred term, although it is not used in the Income Tax Act – it refers to the portion of the total benefit, for such members, that may be taken 100% in cash on retirement, and is therefore not subject to the (minimum of two-thirds) annuitisation requirement. This does not apply to provident fund members who were aged 55 or over on 1 March 2021 because all of their benefits are "protected rights" (assuming they are still members of the same provident fund). Note that the Bill does not deal with the situation of people who have transferred their provident fund "protected rights" to a pension fund, in the period between 1 March 2021 and the Two Pots effective date, but common sense says that proportional splitting should apply to them too.

- The provision setting out what happens to a member's savings component on the member's retirement or death has been redrafted. On retirement, the member may "elect" that the savings component is paid to him as a cash lump sum (to be taxed on the retirement scale) – the Bill does not spell out what happens if the member does not so "elect", although the member can choose to transfer the (full?) savings component balance into her/his retirement component immediately before taking a retirement benefit. On the member's death, a nominee (but not a dependent who is not a nominee?), if allocated a benefit under Section 37C of the PFA, may similarly "elect" to receive the savings component as a cash lump sum, taxed on the retirement scale – again it is not clear what happens if the nominee does not so "elect".
- As we have noted previously, the "savings withdrawal benefit" is limited to one withdrawal in each tax year (i.e. 1 March to 28/29 February) and may not be less than R 2 000 before the deduction of any charges or tax. However, should a member exit their fund after previously taking a savings withdrawal from that fund during the current tax year, the member can then be allowed a second savings withdrawal if the remaining balance in the savings component is less than R 2 000.
- When a fund pays out a "savings withdrawal benefit", the fund must deduct tax at the "fixed tax rate that the Commissioner directs must be used" – this so-called withholding tax regime clarifies and simplifies the arrangements for taxing these benefits at the time of payment. (The benefits remain taxable as income in the hands of the member, in our understanding, but the fund is not required to do an accurate PAYE calculation or to obtain a full tax directive – presumably SARS will use some approximation in determining the tax percentage to be deducted.)
- However, there is a new provision requiring funds to obtain tax directives in respect of all transfers (from component to equivalent component) between funds, and also all transfers within the same fund (e.g. the transfers of "seed capital" from the vested component to the savings component). The latter seems pointless, because transfers inside the same fund will not be subject to tax – it appears that this is a drafting error, which (like several other apparent errors) will only be corrected by the publication of a further Revenue Laws Amendment Bill, later in the year.

Media coverage has highlighted that further legislation dealing with retrenchments will be part of a "second phase of pensions reform". The key issue is that members leaving employment before retirement age, including members who are retrenched, will not be able to access their retirement component (representing two-thirds of retirement-funding contributions made after 1 September 2024). In the short term, the amounts involved will be fairly small, but obviously the balance in the retirement component will accumulate over time, and there is bound to be unhappiness if retrenched workers are completely prevented from accessing this. Treasury recognises this issue and continues to suggest that access may be allowed "in tranches" or as an income stream, rather than as a single lump sum – the practical implications for funds would of course be significant. But at this stage there is no specific legislation on the table, in this regard.

Pension Funds Amendment Bill

The Bill as tabled replaces an earlier version, published in June 2023 – we commented on this in our June 2023 client note. Again we comment mainly on what has changed, compared to the earlier draft.

We note that this Bill is quite poorly drafted and contains a number of obvious errors.

- A new definition of "pension interest", in relation to divorce-splitting orders as defined, will be inserted in the PFA, being "the member's share of the value of the fund, determined in terms of the rules of the fund" – "pension interest" is then used in the new Section 37D, discussed below. This may require that funds insert a suitable definition in their Rules.
- Importantly, Section 14B of the PFA will be amended to provide that, in the case of a Defined Contribution fund, a savings withdrawal benefit is a permitted deduction from a "member's individual account", and in the case of a Defined Benefit (or hybrid) fund, the pensionable service used in calculating the member's minimum individual reserve ("MIR") must be reduced to take account of any savings withdrawal benefits paid (and these must also be deducted from the accumulated value of the member's contributions, which forms part of the MIR calculation). As noted earlier, this will at least make it more difficult for DB and hybrid funds to use alternative methods to keep track of members' savings and retirement components.

- Section 19, which deals with housing loans and guarantees, will be amended to restrict such loans or guarantees to a maximum of 65% of the member's value in the fund, in line with the amended Regulation 28.
- Section 37D, which deals with permissible deductions from members' benefits, will be entirely replaced. We discuss this, sub-section by sub-section, in an appendix to this note.

What actions should Trustees take now?

We suggest that Trustees consider the following steps, in the coming weeks and months (starting well before 1 September, needless to say):

- Set up a "Task Team" – likely to comprise selected Trustees plus the Principal Officer, supported by service providers who should be involved as and when needed. The benefit and investment consultants, actuary, communications consultant if any, legal advisor, and administrator will all need to be involved (although not all will be needed all the time).
- Approach a pensions lawyer with a view to beginning work on the rule amendments that will be needed. In principle at least, rule amendments must be made and registered by the FSCA before 1 September 2024, so that the Fund rules remain aligned with the definitions in the Income Tax Act and the Fund can retain its tax-approved status. The technical issues are quite challenging and, although WTW actuaries and consultants will naturally want to be involved e.g. in reviewing draft rules, we believe that the primary responsibility for drafting the rule amendments should be placed in the hands of legal professionals with suitable pensions knowledge.
- Engage with the Fund's administrator to assess their readiness for the significant changes due to take effect in September, and more specifically, to ask how they plan to process "savings benefit withdrawals" (e.g. how members will engage with the administrator to request such withdrawals, and what information will be needed), and how they plan to communicate the process to members. Our hope is that funds will be able to "piggyback" (at least to some extent) on member communication work being planned by the administrators – we certainly stress that member engagement and member education will be a huge challenge.
- In the case of defined benefit and hybrid funds, it is particularly important to liaise with the administrator, to ascertain how they would do the necessary record-keeping for "two pots", as this will very likely have to flow through into the rule amendments.
- Also liaise with the administrator about the possible charges that will be made for savings benefit withdrawals. It will be problematic to debit members' savings pots with large charges (or to deduct these from the benefit to be paid) if the withdrawal amount is small – members are unlikely to be happy with this.
- Consider the Fund's possible liquidity needs (to pay savings withdrawal benefits after 1 September), and ensure that there will be sufficient liquidity to meet these.
- Think about how to engage effectively with members, to communicate what will and will not be allowed, after September. Some examples of the critical messages which must reach members are:
  - *"Seed capital" is limited to the lower of R 30 000 and 10% of your value in the Fund, on 31 August 2024. If you only recently joined the Fund, so that your value in the Fund is less than R 300 000, you will not be able to take a savings withdrawal benefit of R 30 000 in September!*[4]
  - *An explanation of the exact processes members need to follow to take a savings withdrawal benefit – it seems likely that administrators will facilitate this via an online process, and members may be expected to register accordingly.*
  - *In any case, savings withdrawal benefits are subject to tax (and will be taxed as income) – few members, if any, will receive a full R 30 000. (There will very likely be administration fees for these withdrawals, which will also be deducted from the benefit amount.)*
  - *The timeframe for processing the "seed capital" credits to the savings component, and the first round of savings withdrawal benefits, is not yet certain. Even if the legislation comes into effect on 1 September as expected, it may not be possible to pay these benefits in the first few days of September. (The task team should get the administrator's view on the possible timetable for such payments – there may be delays in getting tax withholding rates from SARS as well as with the administrative processes.)*
  - *Savings withdrawal benefits are meant for financial emergencies! "Emptying out" your savings pot each year will mean your eventual retirement benefit is lower and may result in you not having enough money when you want to retire. The importance of preservation should be stressed!*

[4] Sampling a few of our clients suggests that in the typical Defined Contribution fund, a fair proportion of the members will have fund credits below R 300 000, and the number whose credits are less than half that figure will not be insignificant.

- *As from September, two-thirds of future contributions for retirement saving will be invested in your "retirement pot". You will NOT be able to access this money before retirement, i.e. if you resign from employment and take a withdrawal benefit from the Fund.[5] This money must be preserved – either in your current Fund, or in a new employer's fund, or in a preservation vehicle.*
- *(But conversely, "old rules" will apply to your value in the Fund prior to 1 September, minus the "seed capital", but increased with future investment returns – you WILL be able to take this portion, called your "vested pot", as a cash resignation benefit, minus tax of course, if you choose to do so.)*

The next few months will be testing for Trustees and their service providers. We believe funds should start planning for the coming changes, without delay.

[5] As an indication: if the member has a monthly pensionable salary of R 20 000, and the total retirement-funding contribution rate is 15%, then each month (2/3 x 15% x R 20 000) = R 2 000 will be invested in the member's "retirement pot". So if the member leaves service at the end of September 2024, there will be R 2 000 that he/she will NOT be able to access immediately, and if he/she leaves service in August 2025, the amount will be R 24 000 plus investment returns.

Appendix – the proposed new Section 37D

We set out here our understanding of these complex (proposed) changes to an already complex piece of legislation – Trustees are encouraged to consult with their administrators and/or legal advisors to ensure that we have this right!

- Sub-section 37D(1)(a) deals with the deduction of amounts required to settle housing loans made by, or (more commonly) housing loan guarantees given by the fund, in terms which are largely unchanged. Along with most of the other sub-sections considered below, sub-section (1)(a) will allow for "regulations" to be made in respect of such deductions. We assume that these will be regulations made by the Minister in terms of Section 36, rather than other regulatory instruments made by the FSCA itself.
- 37D(1)(b) deals with deductions (on termination of fund membership) in respect of amounts owed to the employer. This seems to be largely unchanged, despite some problematic drafting. (Court judgments against a member will in future include compensation orders under the Criminal Procedure Act of 1977.)
- A new 37D(1)(bA) will restrict a member's ability to take a savings withdrawal benefit, if this would leave insufficient funds to cover any unsettled amounts owing to the employer under 37D(1)(b). Similarly, a new 37D(1)(bB) will allow the fund to suspend a savings withdrawal benefit for a period of 12 months, pending a *possible* court judgment against the member. Note that these provisions will only apply to savings withdrawal benefits, not to resignation benefits.
- 37D(1)(c) essentially deals with permissible deductions from pensions, to fund medical aid contributions and insurance premiums. It appears that deductions to cover insurance premiums will in future be restricted to *life* insurance policies.
- 37D(1)(d) deals with divorce-splitting orders and maintenance orders. The new wording will refer to the new definition of "pension interest", discussed earlier. Funds will in future explicitly be bound by interim maintenance orders, made under court rules, as well as final orders.
- 37D(1)(e) deals with the deduction of tax from benefits and will specifically mention tax deductions from pensions in payment. (A new 37D(1A) will specify that 37D(1)(d) deductions must be made from the recurring pensions – it is not clear to us how this would work in the case of a divorce-splitting order.)
- A new 37D(1B) rather obviously states that a member's MIR or individual account value must be reduced to allow for Section 37D deductions, and that such reductions must be in accordance with "requirements prescribed by regulation", while new 37D(1C) usefully states that the effect of all the section 37D deductions may not be such as to leave the member with a negative value in the fund.
- 37D(2) seems unchanged – it provides that housing loan or guarantee amounts settled while the member remains in service (or on transfer to another fund) are classified as withdrawal benefits (not retirement benefits), which will affect their tax status.
- Significant additions (discussed below) will be made to 37D(3), which currently deals with the priority order in cases where there is more than one deduction. (3)(a) specifies that existing housing loan or guarantee amounts (even if not due to be settled yet) rank above divorce-splitting or maintenance orders. (3)(b) specifies that maintenance orders rank above divorce-splitting orders. The substance of these provisions does not appear to change.
- A new 37D(3)(aA) will state that no new loans or guarantees may be given, and no new savings withdrawal benefits paid, if the fund has been advised that divorce proceedings have been instituted or if an application for a divorce-splitting court order has been made (and, presumably, the fund is aware of this). This freeze will apply until the court order is made.
- New 37D(3)(aB) relates to payments under a maintenance order. Arrears amounts can be settled as a lump sum, but ongoing payments must be made monthly (or yearly in advance, if monthly payments are impractical).
- New 37D(3)(aC) specifies that a fund "may not allow" a savings withdrawal benefit where there is a maintenance order in place, unless the fund is satisfied that paying the benefit will not leave insufficient value remaining to cover the maintenance payments.
- New 37D(3)(aD) specifies that a fund may "suspend" a savings withdrawal benefit, if the fund "is aware that proceedings relating to a maintenance order" are pending and if paying the benefit would leave insufficient value remaining to cover the possible maintenance payments – but only if a court order authorises the suspension. (The conjunction of events that would give rise to such an outcome seems a bit far-fetched!)

- Section 37D(4) deals in detail with the divorce-splitting procedure but has been somewhat rewritten. The most significant change is a provision that will entitle the ex-spouse to fund return (on the amount specified in the court order) **from the date of the court order**, rather than the date on which the specified amount is deducted from the member's benefit following the ex-spouse's "election" as to how the amount should be dealt with (paid directly, or transferred to another fund). (There is also a cross-reference to the new provision in 37D(1A) noted above, that will require divorce and maintenance payments to be made by recurring deductions from pensions in payment, where the member spouse is a pensioner.)
- 37D(5) and (6), which provide some clarifications in relation to the Divorce Act of 1979, will be dropped.

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

<table>
<tr><th></th><th><u>Benefit available/accessible on leaving employment (resignation / retrenchment)</u></th><th>Benefit available/accessible <u>during</u> employment</th><th>Benefit on <u>retirement</u></th></tr>
<tr><td>Pension Fund savings arising from contributions up to 1 March 2021</td><td rowspan="3">Up to 100% can be taken in cash
Taxed on withdrawal tax table
(Transfers and preservation are also options)

This is the "vested component"</td><td rowspan="3">None, other than limited "seed capital" that will be moved to retirement component[1]</td><td>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]</td></tr>
<tr><td>Provident Fund savings arising from contributions up to 1 March 2021</td><td>Up to 100% can be taken in cash (rest used to buy a pension)</td></tr>
<tr><td>Savings arising from contributions (to either a pension or a provident fund) between 1 March 2021 and 1 September 2024</td><td>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]</td></tr>
<tr><td>Savings arising from contributions (to either a pension or a provident fund) after 1 September 2024[4]</td><td colspan="2">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.</td><td>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.</td></tr>
</table>

Notes on table:

1. On or after 1 September 2024, a "seed" amount will be transferred from the vested component to the savings component – the amount will be the lower of 10% of the vested component value on 31 August 2024, or R 30 000.

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 September 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 September 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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