

RMC Workshop 4.8.2014

Proposed fringe benefit tax on contributions to DB funds (17 July 2014 version)

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Note that the contents of this presentation are my (Arthur Els') own personal view of the proposals put forward by National Treasury on 17.7.2014.

Although they are based on previous proposals from the RMC, not all the following slides/comments have yet been vetted by the RMC.

Agenda

1. Proposals
2. Observations / comments
3. Contribution schedule
4. Questions

Proposals (17 July version)

Fund Member Category (“FMC”)

- Members are in same FMC if:
 - Same benefits apply; and
 - Same Ee and Er contrib rate
- Need to calculate deemed contrib rate (“factor”) for each FMC

Proposals (1)

Deemed value of Er contribution (for fringe benefit tax purposes) is:

$$X = (A * B) - C$$

where:

A = FMC factor

B = Retirement funding income

C = Member contributions

Let's take a closer look at factor A

Factor A

Factor A =

DB component factor

or

Underpin component factor

+

Risk component factor

+

DC component factor

DB component factor =

$$(A * B) + (C * D)$$

where:

A = annuity accrual rate (*average for FMC*)

B = prescribed factor

*(at age [65 + age where no reduction] / 2)
rounded up)*

C = Retirement lump sum accrual rate

D = 0.8

Prescribed factors

	Factor
Midpoint between 65 and earliest age of unreduced benefits	55 12.5
	56 11.9
	57 11.4
	58 10.8
	59 10.3
	60 9.7
	61 9.3
	62 9.0
	63 8.6
	64 8.2
	65 7.9

Example

DB component factor =

$$(A * B) + (C * D)$$

A = 1/50ths annuity

B = 8.6 (*at age 63 [65 + 60] / 2 rounded up*)

C = 6,7% lump sum

D = 0.8

Then DB component factor = 22,56%

Factor A (2)

Underpin component factor =

$$A + B * C$$

where:

A = Max {DC contribution rate; DB
component factor}

B = 0.10

C = Min { as for A }

Example

Underpin component factor =

$$A + B * C$$

DC con rate = 15%;

DB con rate (40ths) = 8.6/40 = 21,5%

$$A = \text{Max} \{15\%; 21,5\%\} = 21,5\%$$

$$B = 0.10$$

$$C = \text{Min} \{ 15\%; 21,5\%\} = 15\%$$

Then Underpin component factor = 23,0%

Factor A (3)

Risk benefit component factor =

$$A * B$$

where:

A = Average risk benefit on death in service,
expressed as multiple of salary

*(excludes DC benefits, disability benefits;
includes spouse and dependants benefits)*

$$B = 0.005$$

Example

Risk benefit component factor =

$$A * B$$

A = 5 times annual salary

B = 0.005

Then Risk benefit component factor = 2,5%

Example of FMC factor



Defined contribution component factor =

A

where:

A = Defined contribution component in a defined benefit fund

No example given in explanatory memo; not a common feature of DB funds

Example of FMC factor

Factor A =

DB component factor *(22,56%)*

or

Underpin component factor *(n/a)*

+

Risk component factor *(2,5%)*

+

DC component factor *(nil)*
25,06%

Example of deemed value

Deemed value of Er contribution is:

$$X = (A * B) - C$$

A = FMC factor 25,06%

B = Retirement funding income R 100 000

C = Member contributions (R 8 000)

Fringe benefit value R 17 060

Observations re Proposals

Observation 1:

Tax values are high

From explanatory memo:

“.. the intention of the factors is to approximately reflect some estimate of the long-run cost ..”

- Thus the tax value can be very different from actual value of the benefit*
- Generally too high, in my view.*

PMB's vs Tax value

Age	Fund 1 Pens + L sum	Fund 2 (Low Risk bens)	Fund 3 (high ave. age)
	PMB's per Pension Funds Act		
30	R 16 000	R 14 000	R 11 000
40	R 21 000	R 18 000	R 14 000
50	R 26 000	R 22 000	R 18 000
60	R 32 000	R 28 000	R 22 000
	Estimated Fringe Benefit Tax Value		
	R 30 500	R 22 000	R 21 000

Observation 2:

Insufficient transparency

From explanatory memo:

This table has been calculated taking the following factors into consideration:

- Average expected levels of post-retirement mortality
- Average expected salary-weighted levels of pre-retirement mortality
- Expected investment returns pre- and post-retirement on a portfolio of assets whose term, nature and security broadly matches the lump-sum and annuity liabilities promised by defined benefit pension funds
- The average level of spousal benefits provided by pension funds, and
- The prices of annuities available in the private market

- Underlying methodology used to calculate factors very vague – *does not allow for informed debate*
- Some prescribed values (e.g. 0.8 for lump sum benefits at all ages) appear to be arbitrarily chosen – *ditto*

Observation 3:

Assumptions questionable



- Based on GEPPF rather than typical closed, small DB funds in private sector
 - *Thus assumptions probably not valid for private sector e.g. future salary increases vs investment return*
 - *What is the allowance for future pension increases? Is equity risk premium taken into account?*

Observation 4:

Annuity cost inflated



- Based on annuity costs in insured market rather than within fund
 - *Insurers are subject to capital requirements (SAM), expense loading, profit loading, commission, conservative investment strategy etc*
 - *Hence insurer costs for annuities higher than if annuity paid from fund itself*
 - *Hence tax results inflated vs actual cost to fund to provide the annuity*

Observation 5:

Risk costs inflated?



- Risk benefit component based on full death benefit
 - *But actuarial reserve released at date of death, so that actual cost to fund is net amount*
 - *Has this been allowed for in the calculation of the tax factors? We can't tell from the available information*

Observation 6:

Small funds



- Most private sector DB funds are closed and many have small membership
 - *No allowance for size of fund. Even a one-person needs to have the actuary do the calculations*
 - *Proposals need to make allowance to avoid excessive costs in case of small funds*

Contribution Certificate (17 July version)

Contribution Certificate



1. To be provided by Board to Employer
2. Signed by valuator, two trustees, PO
3. Separate certificate for each FMC
4. Update certificate at each triennial valuation, or when benefits change

5. Fund to send certificate to employer at least one month before start of tax year
- *First certificate by 31 December 2014 (or 31 January 2015? – conflicting provisions)*

4. Contents of certificate

- a) Year of assessment that applies
- b) Fund details
- c) Employer details
- d) Benefits + rule numbers
- e) Breakdown of FMC into DB,
underpin, risk and DC components

5. SARS will do some form of auditing

Observations re Contribution Certificate

Observation 7:

Certificate needs adjustment for private sector funds



- Certificate to be revised at triennial valuation or when benefits change.
 - *But most private sector funds closed so that average benefit etc can change yearly*
 - *Thus need to be able to revise certificate more regularly if appropriate*

Observation 8:

Even more expenses!

- Contribution certificate has to be prepared by fund actuary and approved by trustees
 - *Given the sensitivity of tax matters, the actuary and Board need to do a comprehensive and in-depth exercise to determine the FMC factor*
 - *Will incur funds in further costs, which can be substantial – required by National Treasury*
 - *Yet the same National Treasury is on a drive to reduce fund expenses!*

Observation 9:

Personal view (Arthur Els)

- Tax is paid on contributions that exceed maxima. Affects relatively few members, small amounts
- But tax-free amount at retirement increased
- Thus much of a zero-sum game to SARS
 - *Q: Does this fringe benefit exercise add any value over longer term that offsets the extra costs to funds?*
 - *I very much doubt it!*
 - *Suggest that SARS abandon exercise at this stage*

Questions?

Thank you!

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