IRFA DISPATCH

Institute of Retirement Funds Africa

THE RETIREMENT INDUSTRY NEWSLETTER

29 NOVEMBER 2024

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Tribute to Enos Ngutshane: From student revolutionary to national leader

IN the annals of South Africa's liberation struggle, certain places become sacred ground, and certain moments become turning points. Naledi High School in Soweto stands as one such hallowed space, where in 1976, the seeds of revolution were planted in the fertile soil of youth resistance. It was here that Enos Ngutshane, a matriculant whose courage would shape history, penned the fateful letter to apartheid education minister, Minister M.C. Botha that became the first formal challenge to the oppressive language policy. But when the minister's silence spoke volumes about the regime's intransigence, it became clear that stronger action would be needed.

The tension reached its breaking point on June 8, 1976, when police arrived at Naledi High in their government-issue VW Beetle, seeking to arrest Tebello Motapanyane, the local leader of the South African Students' Movement (SASM). The response was electric – students, their patience exhausted, pelted the police with stones, forcing them to flee, and set their vehicle ablaze. It was a moment that transformed Naledi's schoolyard into the first battlefield of what would become a nationwide uprising. Ngutshane and Motapanyane, working in concert with other student leaders, knew they had to channel this spontaneous resistance into organized action. On June 13, they gathered with other leaders in a crucial meeting that would change the course of history. There, they crafted the plans for the June 16 protest – a date that would be forever etched in the nation's memory.

The '76 generation, of which Ngutshane was a leading light, redefined the parameters of the struggle. These young lions, with textbooks in their hands and freedom in their hearts, transformed their schoolyard into a command center for dignity and justice. When they rose against the imposition of Afrikaans, they were fighting not just against a language policy, but against the entire edifice of Bantu education – a system designed to confine Black minds within the prison walls of apartheid thinking. But Ngutshane's story didn't end with those tumultuous days of 1976. Like the true leader he was destined to become, he transformed the fire of youth resistance into the steady flame of professional excellence and national service. After his return from exile and studies at the University of Liverpool, he embarked on a remarkable journey of public service and corporate leadership that continues to this day.

As the former President of the Institute of Retirement Funds Africa (IRFA), where he continues to serve as a Board and Executive Committee member, Ngutshane has helped secure the financial future of countless South Africans. His intellectual prowess, demonstrated in his thought leadership on Corporate Governance, Local Government, Rail Engineering, Occupational Health and Safety, and Risk Management, shows how the revolutionary spirit of ’76 can be channelled into building and strengthening democratic institutions. His path has taken him from the lecture halls of Wits Faculty of Commerce and Law to the corridors of power as Deputy Director General for Housing and Local Government in Gauteng. As CEO of the South African Foundation for Public Management (SAFPUM), he helped shape the public service that would serve a free South Africa. His fifteen-year stewardship as Chairperson and Trustee of the Prasa Provident Fund demonstrated his commitment to workers’ security and dignity. As Chairperson of the CCMA Governing Body, Chairman of Utho Investment Management, and Board member of SASRIA, Ngutshane continues to build the South Africa he once dreamed of in those dangerous days at Naledi High. His current leadership at these crucial institutions shows how the courage to confront injustice can evolve into the wisdom to build justice.

From that brave young student who dared to challenge a minister, to the distinguished leader who helps guide national institutions, Enos Ngutshane embodies the transformation of South Africa itself. His journey reflects the country’s path from resistance to reconstruction, from protest to governance, from the fierce dreams of youth to the measured wisdom of leadership. The story of Enos Ngutshane reminds us that the spirit of ’76 wasn’t just about tearing down the old order – it was about nurturing the leaders who would build the new. In his continued service to South Africa, we see the fulfilment of the promises whispered in the classrooms of Naledi High School, where a generation dared to imagine freedom, and then stepped forward to create it.

The African Mirror | 25 November 2024

FSCA publishes list of employers in arrears for Retirement Fund contributions

The Financial Sector Conduct Authority (“FSCA”) has published FSCA Communication 41 of 2024 (RF) - Publication of names of pension funds and employers with arrear contributions. The communication provides the names of 2330 employers that have contravened section 13A of the Pension Funds Act, 1956 (“PFA”) which prescribes the manner in which the payment of contributions and other benefits should be made to a retirement fund. The FSCA received a total of 7770 employers that contravened section 13A of the PFA, as at 31 December 2023, from retirement funds supervised by the FSCA.

The FSCA has decided to publish the following names from the 7770 employers that were reported:

• 2003 employers who have outstanding contributions that are more than R50 000 and have been outstanding for a period of more than 5 months;

• 200 employers who have outstanding contributions that are more than R50 000 but the last contribution date has not been provided;

• 113 employer’s whose outstanding contributions are less than R50 000, but the outstanding LPI is more than R50 000 and has been outstanding for more than 5 months; and

• 20 employers that have not contributed since date of participation in the retirement fund.

The balance of the 5440 employers have not been included in the publication as they do not meet the thresholds set out above. The failure of employers to pay retirement fund contributions has severe consequences for members, affecting their withdrawal benefits, as we have seen with the introduction of the Two- Pot System, investment returns, and applicable risk benefits. Withholding these contributions despite deducting the contributions from employees' salaries, is a serious offense that could amount to theft and, in some cases, fraud. The FSCA oversees regulated entities, which include retirement funds and their boards. However, employers participating in retirement funds are not considered regulated entities under the PFA or the Financial Sector Regulation Act, 2017 ('FSR Act'), limiting the FSCA's ability to directly address non-compliant employers. This should be remedied by the introduction of the Conduct of Financial Institutions Bill (CoFI). Retirement fund boards have reported that the following actions, amongst others, have been taken in an effort to recover outstanding contributions:

• Legal action;
• Bargaining council enforcement process;
• Lodged complaints with the Office of the Pension Funds Adjudicator ("OPFA"); and
• Reported contraventions to the South African Police Service.

The FSCA will continue engaging with the National Prosecution Authority and the Directorate for Priority Crime Investigate to ensure that responsible parties are brought to book. The Authority also welcomes the arrests of the officials involved in the non-payment of contributions in the Kai! Garib, Renosterberg and Kamiesberg municipalities. Members affected by employer non-compliance should engage with their employers and retirement funds directly. If these efforts are unsuccessful, members may lodge a complaint with the Office of the Pension Funds Adjudicator.

FA News | 25 November 2024

FSCA wants reasons for high two-pot withdrawal fees

While it is no price regulator, it may insist on transparency, disclosure, and fairness of fees.

The Financial Sector Conduct Authority (FSCA) says it is identifying fund administrators that charge high transaction fees for members who withdraw funds under the two-pot retirement system, and they will be asked for the reasons thereof. The watchdog hosted a media roundtable discussion on Friday where trends and challenges under the two-pot system came under the spotlight. It also gave an update on the issue of employers who are in arrears in paying over their workers' retirement contributions to pension funds. The FSCA's Corlia Buitendag, departmental head of retirement funds conduct supervision, shared some of the key challenges that have emerged since the two-pot system came into effect on 1 September 2024. They include system-related issues due to the volumes of withdrawal requests, account verification and payment delays, and slow turnaround times.

Consumer complaints specifically include poor communication from fund administrators, website downtime, delays in receiving payouts, and high transaction fees. Buitendag says the regulator has since established that the average transaction fee charged for the maximum savings pot withdrawal of R30 000 is R357. The FSCA emphasises that it is not a price regulator, but as part of its supervisory role, it may insist on transparency, disclosure and fairness of fees charged by funds and administrators. In a questionnaire circulated to pension funds and their administrators, they were asked about the costs of implementing new systems required under the new regime – both once-off and ongoing – as well as the amounts they charge per withdrawal transaction.

Transparency

Astrid Ludin, deputy commissioner at the FSCA, says different funds adopted different models whereby fees are charged. This depends on the volume of the work required, whether there are existing systems, and whether they needed to outsource any work. "We are working through the responses and where we find outliers we'll engage with them to understand it better. It's important that there is transparency and comparable information available to funds – and to members to hold funds accountable." Ludin points out that ultimately the pension funds are responsible for negotiating the level of charges with administrators. "But smaller funds have less bargaining power, and in this instance, we would like to play a supervisory to help balance the costs."

Withdrawal trends

In the presentation, the FSCA shared some of the latest trends in withdrawals from savings pots.
The portion of withdrawals per annual pensionable salary category are as follows:

- Less than R59 988 – 4.63%
- R60 000 to R119 988 – 25.05%
- R120 000 to R179 988 – 15.67%
- R180 000 to R239 988 – 25.82%
- R240 000 to R359 988 – 13.83%
- R360 000 to R599 988 – 12.4%
- R600 000 to R959 988 – 1.77%
- R960 000 and above– 0.83%

The highest percentage of withdrawals were therefore from members earning between R15 000 and R20 000 per month, and the second highest from those with a monthly salary of between R5 000 and R10 000. Considering withdrawals per age category, the highest percentage of withdrawals (41.85%) were by members in the age group 31 to 41, followed by those between the ages of 41 to 51 (34.86%). Only 0.66% of fund members above 60 years withdrew funds from their savings pots. The second lowest percentage of withdrawals (9.47%) were from members aged 21 to 31.

Employers in arrears

The FSCA has published the names of 7 770 employers who are in arrears with their workers' pension fund contributions on its website. The arrears amount to an estimated R5.2 billion, affecting 310 000 members. The biggest culprit as far as arrear contributions are concerned is the private security sector with 36.2% of outstanding contributions, followed by hairdressing, beauty and skincare at 12.37%. The FSCA notes most of these employers are small enterprises with variable incomes and contract employees.

Municipalities also culprits

However, municipalities are also an employment sector whose contributions are regularly in arrears. Recently, a top official in the Kamiesberg Municipality was arrested after more than R2 million in employee pension contributions had been allegedly unpaid for nearly five years. According to the FSCA's statistics, 149 municipalities out of the total 257 – representing 58% – were reported to be in arrears with their employees' contributions. The Free State is the province with the biggest portion of arrears (68%), at a total of R1.4 billion.

The names that feature on the FSCA's website include:

- 2 003 employers that have outstanding contributions of more than R50 000 that have been outstanding for a period of more than five months;
- 200 employers who have outstanding contributions of more than R50 000, but the last contribution date has not been provided;
- 113 employers whose outstanding contributions are less than R50 000, but the outstanding late payment interest is more than R50 000 and has been outstanding for more than five months; and
- 20 employers that have not contributed since the date of participation in the retirement fund.

The names of another 5 440 employers have not been included as they do not meet the thresholds.

Moneyweb | 25 November 2024

‘I don’t believe in retirement annuities’, say investors

Here’s why some say it, and here’s why they’re wrong.

10X investment consultant Michael Rossouw has spoken to thousands of investors over the past decade and all too often he hears the words: “I don’t believe in retirement annuities.” Which is strange, as Rossouw and others in the industry will tell you an RA is one of the best long-term investment options. So why the dissonance? Why is it that investors feel this way about retirement annuities?

Rossouw’s take is that it boils down to four key issues.

Poor investment management

Unfortunately, the management of retirement annuity investments has traditionally left investors prone to looking elsewhere, with many funds underperforming against market returns. According to SPIVA (S&P Indices versus active management), as of 30 June 2024, 67% of funds have underperformed the S&P South Africa DSW Capped Index over the past decade. That’s more than two thirds of all the funds available to investors. At 10X, we help investors compare their returns to the market to see if they are having investment management problems and to discuss whether 10X can improve their situation. We’re not here to tell you what to do; we’re here to give you the facts so that you can be confident in making the right decision yourself.

Incorrect asset allocation

If you are investing in a retirement annuity, you most likely have a long-term investment horizon. Many investors tend to invest too conservatively into shorter-term defensive assets such as cash and bonds. While that typically allows for less risk and volatility than equities, for example, the potential returns are generally lower, too. If you misallocate, you could receive lower returns. If you correctly match your asset allocation with your investment horizon you are more likely to receive the highest potential return over that period. Have a look at the different funds available through 10X to see how we think about asset allocation.

High fees

There are many companies that charge more than 3% per annum for a retirement annuity. While 3% doesn’t sound like a lot, the negative compounding effect is much larger than one might think and can reduce the money available to you in retirement by up to 30% over 20 years. The worst part is that there are many investors who don’t even know that they are paying 3% or higher. You can easily find out what your total fee is by asking your investment provider for your EAC (effective annual cost). If you are paying 3% and looking at minimising your fees as one of the ways to maximise your returns, there are investment companies that charge less than 1% per annum. You can try our EAC calculator to easily see if you can make any savings on fees.

Not understanding total return

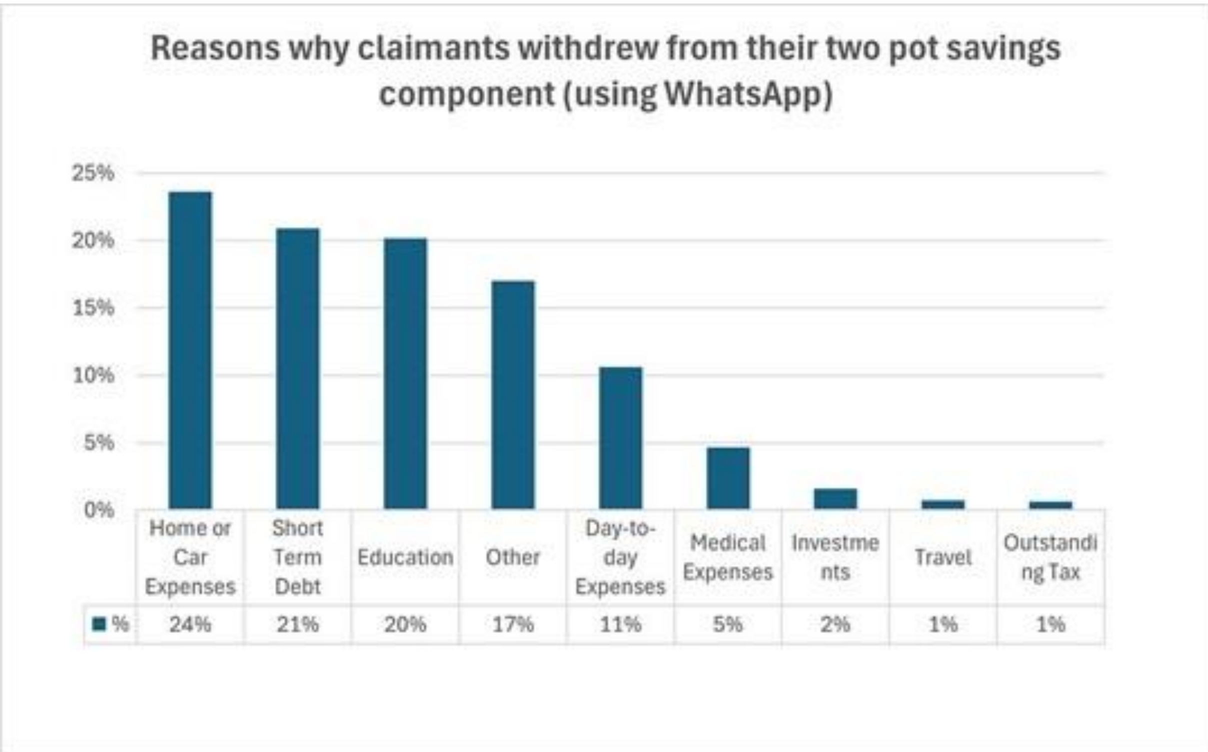
The mistake investors tend to make is only looking at investment returns and *forgetting to add the guaranteed tax return* you get when contributing towards a retirement annuity. For example, if your investment return for a retirement annuity is a measly 1% because of the three reasons above, you may think the RA is not worth your while. Yet, if you earn R1 million and contribute R100 000 towards a retirement annuity, you will receive R41 000 (41%) tax return. This results in a total return of 42%, of which 41% was guaranteed by the South African Revenue Service (Sars) irrespective of how the investment performed. Imagine what your total return could be if you improved the way it is managed, invested with the correct asset allocation, and reduced your fees. If you want to know more, you are more than welcome to chat to 10X. We are here to help.

Moneyweb | 26 November 2024

Two pots on the JSE just got bigger

The billions in two-pot withdrawals will be going somewhere …

The last official number I am aware of regarding the two-pot retirement system is that around R21 billion has been withdrawn by local savers – but, anecdotally, the figure now sounds closer to between R35 billion and R40 billion. After taxes, some of this should flow into our economy. Let's assume that the net flow is now R21 billion after taxes. Below is an exit poll by Discovery as to the reasons consumers are accessing their two-pot savings. It is notable that two thirds say they have made withdrawals for home/car expenses, short-term debt and education.



Source: Discovery Corporate and Employee Benefits (16 to 27 September 2024)

‘Home/car expenses’ should flow through retailers on the local bourse, but given that, for example, Shoprite Holdings (SHP) has an annual turnover of around R240 billion, this really is only a small, marginal boost to them. Relatively speaking, who are the potential winners here? That would be ‘Debt’ and ‘Education’. The two-pot capital that repays debt should benefit local banks (via lower bad debts), but these banks are large. Relatively speaking, how big could the impact be? In my opinion, the real winners here are the debt collectors – and one of these is listed on the JSE! Transaction Capital (TCP) has cleaned up its balance sheet and, after all the current transactions happen, appears like it will have net cash of around R1 billion. Taking this out of its market cap and assuming a profit after tax run-rate for Nutun of around R300, the group is trading on a price-earnings (PE) multiple of around three to four times – against its global peers, which trade at PEs of more than 16 times.

(Let’s assume that SA Taxi is worth zero for this discussion, but a clever deal here may see it salvage some value …) Nutun, using the *same* debt collection infrastructure, holds around R7.9 billion of acquired debt on its balance sheet (which it literally bought from other businesses for cents in the rand) and acts as a principal collector for lots of major corporates in South Africa. In both instances, Nutun gets paid when it collects the debt. Thus, it is very likely that two-pot capital that goes towards repaying debt should find its way into Nutun’s turnover (perhaps not at once, but certainly over time). How much? I have no idea but we can do some maths … 21% of the R21 billion implies added collections of around R4.4 billion. If 4.5% of *this* amount flows through Nutun’s miniscule revenue of around R1.4 billion to R1.5 billion (with little additional costs, might I add, as call centres are fixed-cost operations), then I estimate that the group’s headline earnings per share (Heps) could rise by as much as 50%. All hypothetical, but Nutun certainly stands to benefit more than the traditional lenders from the two-pot system.

Education

Next, let’s assume that the two-pot capital flowing into education goes to the private education sector (which I think is likely). Assume (based on my workings) that AdvTech (ADH), Stadio (SDO) and Curro (COH) collectively are around 10% of this private education sector *and* that no one wins or loses any market share. Finally, let’s assume that some of this capital is used to pay educational debt (all three groups have struggled with bad debts in the past couple of years) and some is used for new fees – both after-tax payments ultimately arrive at these education stocks’ bottom lines. Do the maths (R21 billion x 20% x 10% and proportioned across these three stocks according to their respective level of market share), and the uplift to their last 12-month trailing profit after tax is:

- Stadio: 12.9%
- AdvTech: 16.3%
- Curro: 192%

Curro stands out as its R4.9 billion 12-month trailing turnover only generated R55 million in profits. Bad debts were a particular problem for it. Adding a possible R144 million two-pot benefit to the group has a massive leverage effect on the bottom line here, thus the huge kicker to its profits from the maths. In short, the two-pot money is flowing, and consumers appear to be prioritising two thirds of it for living costs, education, and debt repayment. While our local retailers are so large that their allocation is unlikely to be very noticeable, Nutun (in Transaction Capital) and the three local education stocks stand to disproportionately gain here and should be looked at more closely. This is particularly true given some of the relatively modest valuations of these smaller stocks.

Moneyweb | 26 November 2024

Retirement annuities 101: A comprehensive guide

Many aspects of these funds are not immediately apparent. Understanding these details can enhance your investment strategy and optimise your retirement savings.

With only three months remaining in the 2024/2025 tax year, now is a good time to explore the workings of this highly tax-efficient retirement funding vehicle. The long-term benefits of investing in a retirement annuity are considerable; however, many aspects of this funding structure may not be immediately apparent. Understanding these details can significantly enhance your investment strategy and optimise your retirement savings.

Here's what you need to know about maximising the advantages of retirement annuities:

What is a retirement annuity?

Governed by the Pension Funds Act, a retirement annuity (RA) serves as an individual retirement fund designed for anyone seeking to save for retirement in a tax-efficient manner. Unlike pension and provident funds, which are employer-linked, an RA operates independently of one's employment status or employer group. This independence allows employees contributing to company provident or pension funds to utilise an RA to enhance their retirement savings. Additionally, those without access to group retirement benefits can rely on an RA as their primary funding vehicle.

What about tax?

As an RA investor, you can contribute up to 27.5% of your taxable income on a tax-deductible basis, with an annual maximum of R350 000. This means that at the end of the tax year, you can reclaim taxes paid on your contributions to the RA. When calculating your taxable income, it is essential to consider various income sources, including rental income, dividends from real estate investment trusts, and investment income. Furthermore, retirement annuities enable investments with tax-free money, and they enjoy exemptions from tax on dividends and interest, with no capital gains tax applied to investment growth.

How do I set one up?

Establishing an RA is relatively straightforward, with minimal barriers to entry. The minimum monthly premium for a unit trust-based RA typically ranges from R500 to R1 000. Modern RAs are hosted on a LISP platform, offering investors a diverse selection of unit trusts. However, it is crucial to remember that investment risk within an RA structure is regulated by Regulation 28 of the Pension Funds Act. This legislation aims to protect retirement investors from poorly diversified portfolios by imposing limits on offshore and equity exposure within retirement funds. While Regulation 28 may appear to hinder investment growth, the long-term tax benefits of an RA significantly outweigh these restrictions, providing substantial advantages for retirement planning.

Are they customisable?

RA investors have the flexibility to design a portfolio that aligns with their specific objectives, investment horizons, risk tolerances, and required returns. This customisation allows them to select underlying funds and asset allocations tailored to their individual needs. Additionally, if using a unit trust-based RA, investors can fully customise their contribution methods, which is particularly advantageous for commission earners, self-employed individuals, or those with irregular incomes. Contributions can be structured on a monthly, quarterly, bi-annual, or annual basis, and investors can start or stop premiums at their discretion, without incurring penalties or administrative charges.

When can I retire from RAs?

The minimum retirement age is set at 55, meaning investors generally cannot access their retirement funds prematurely, except in cases of ill health or emigration, which will be discussed further below. Importantly, there is no age limit for retiring from an RA. Therefore, an RA should be integrated into a well-structured retirement plan that considers the tax implications of withdrawals, future cash flow requirements, and any existing retirement funding vehicles.

Can I transfer my company funds to an RA?

If you leave formal employment, one option is to transfer your pension or provident fund benefits into an RA, which is a tax-neutral transfer. Alternatively, you may choose to move your funds into a preservation fund, which has the unique advantage of allowing one full or partial withdrawal before age 55. However, a significant drawback of a preservation fund is that you cannot make any additional contributions going forward. If you decide to transfer your pension or provident fund benefits to an RA, while you are unable to make withdrawals before reaching age 55, you do have the flexibility to make additional contributions to your investment. Consequently, the decision to house your retirement benefits in either a preservation fund or a retirement annuity should be a carefully considered process, taking into account your specific circumstances and retirement goals.

What role can they play in estate planning?

RAs play a significant role in estate planning, but it is essential to recognise the limitations regarding beneficiary nominations. These government-incentivised funding structures are designed to encourage individuals to save for retirement and, consequently, reduce the state's burden. As a result, RA benefits must be allocated among your financial dependants upon your death. The distribution of these benefits is strictly governed by Section 37C of the Pension Funds Act, which ensures that anyone who is wholly or partially dependent on you at the time of your death is adequately provided for. Importantly, since these benefits are distributed directly to your financial dependants, the funds in your RA do not form part of your deceased estate and are not subject to estate duty, provided that the contributions were tax-deductible. While the funds in your RA are safeguarded from creditors, this protection does not extend to taxes owed to Sars or maintenance claims.

Are RAs included in divorce settlements?

The funds within your RA may be included in your divorce settlement, but this is largely contingent on your marital regime. If you are married out of community of property without the accrual system established after 1984, your non-member spouse will not have a claim to your retirement funds, as your estates are entirely separate. Conversely, if you are married with the accrual system, the value of your retirement annuity will be considered in the calculation of the accrual. In a marriage in community of property, your RA benefits are part of the joint estate, entitling each spouse to a 50% share of the pension interest at the time of divorce. To determine the pension interest of an RA for a divorce settlement, the total contributions made to the fund up to the date of divorce will be calculated, along with simple interest at the prescribed rate. Understanding these nuances is crucial during divorce proceedings.

Can I transfer my RA to another investment platform?

If you are invested in a unit trust-based RA, you have the flexibility to transfer your investment to another investment house or platform without incurring any costs or penalties. Such transfers are governed by Section 14 of the Pension Funds Act and typically take a few months to finalise. Remember, the 27.5% of taxable income you can invest on a tax-deductible basis is calculated collectively across all your RAs. Therefore, managing multiple RAs requires careful tracking of your investment premiums to ensure your contributions remain within the tax-efficient limits. Unlike the old, insurance-based RAs, new-generation RAs are flexible, transparent, highly customisable, and cost-effective, and remain one of the most attractive options for long-term retirement investing.

Moneyweb | 26 November 2024

UK pension megafunds: the tax perspective

As the Government embarks on ambitious reforms to the UK pension fund investment sector, with major implications for the private capital industry, the tax treatment of pension fund returns may not be uppermost on the agenda but should not be neglected by policymakers. Fund sponsors across asset classes in the UK and abroad will also be taking note as the world's third-largest stock of pension assets is dramatically reshaped.

Megafunds: The Policy

In her first Mansion House speech to the UK business and finance community on 14 November 2024, the UK Chancellor Rachel Reeves announced "plans to create Canadian- and Australian-style "megafunds" to power growth in our economy" in line with recommendations set out in the Pensions Investment Review Interim Report (the Interim Report), the first fruits of an initial period of consultation under the new Government. The Interim Report recommends broad consolidation measures for both the UK's £392 billion Local Government Pension Schemes (LGPS), currently administered across 92 local authorities, and its similarly-fragmented £600 billion workplace defined contribution (DC) schemes. From the Chancellor's speech and the accompanying further consultation documents, the creation of the megafunds is currently expected to involve:

- Supercharging (through increased size, enhanced delegation, and reformed governance and investment mandates) the existing eight LGPS asset pools which were first created in 2015 and which current hold only about half of LGPS investable assets and
- Imposing minimum size and maximum number requirements on DC scheme default funds.

Legislation is expected to follow in 2025 in the form of the previously-announced Pension Schemes Bill, with the LGPS reforms potentially in place by early 2026 and the DC scheme reforms taking full effect by 2030. The Government's forecasts suggest AUM in LGPS and DC schemes may hit a total of £1.3 trillion by 2030 – "mega" numbers indeed. The Interim Report is clear on the dual intended benefits of consolidation – increasing saver returns and UK domestic investment. As the Chancellor's speech puts it: "*Through consolidation of the DC market and Local Government Pension Schemes into megafunds … previous domestic and international experience suggests … that we could unlock around £80 billion for investment in private equity, including exciting growth businesses … and in vital infrastructure projects including transport, energy and housing projects here in the UK.*" The extent to which the twin aims of improving returns and domestic investment work in harmony remains to be seen and it is notable that the Government is currently looking to *laissez-faire* economics rather than strict mandation to ensure that the investment flows to UK businesses. This aspect of the reforms may yet develop further as the second phase of consultation progresses. Current UK Government policy – the "vision" set out in the Interim Report – is therefore to actively promote pension fund investment in private capital funds and projects in order "to achieve better outcomes for members and maximise investment opportunities", with the chosen mechanism being comprehensive regime redesign via primary legislation rather than piecemeal reforms over time. Thus far, however, with the exception of some speculation as to potential tax incentivisation (possibly including National Insurance Contributions savings) of contributions into prioritised sectors, tax has been conspicuously absent from the consultation and policy-making process. This may be as expected for a generally UK tax-exempt sector of the economy, but there is nonetheless a clear opportunity for the industry to identify opportunities and make the case for improvement to its interface with the tax system.

Megafunds and other pension funds: Tax considerations

Registered pension schemes qualify for exemption from UK taxation on income and gains on investments held for the purposes of the scheme, but are taxable on other categories of income and gains. The key tax consideration for UK pension funds when deploying assets on behalf of members is therefore to ensure that, to the maximum extent possible, the return to the fund represents an investment for UK tax purposes and not (for example) profit from a trade or other source. In practice reaching this determination may be riddled with complexities and there are frequently grey areas over which pension funds and their advisers spend considerable time agonising. The distinction between investment and trading returns also causes considerable head-scratching among non-UK fund sponsors facing requests from UK pension fund investors for contractual (e.g., side letter) and structural measures to mitigate the risk of returns in a form that is unexpectedly taxable. Comparisons with non-UK concepts such as US "effectively connected income" are unfortunately of limited degrees of usefulness here.

HMRC guidance helpfully clarifies some points of uncertainty, including the conditions under which stock lending fee income, returns from certain derivative contracts and underwriting commissions may qualify as investment returns, but there are a host of common private capital investment scenarios where the lack of a clear answer has the potential to skew decision-making and delay deal timetables. It is common, for example, for private equity funds to rebate certain fees to investors and equally common for UK pension funds (which may not otherwise have filing obligation) to disclaim that fee income due to its potential taxability and the attendant administrative requirements. Or alternatively pension funds investing into tax-transparent structures (operated through UK or non-UK partnership-type vehicles) may conservatively set up and bear the ongoing costs of running blocker entities in order to avoid the risk of realising trading income, even where the underlying return is generally expected to be of an investment nature. These are surely not desirable aspects of the current regime or consequences that are calculated "to achieve better outcomes for members".

Potential improvements: Guidance, rulings, treaty reliefs

Given the entrenchment of the investment/trading divide within the UK tax system and its centrality to the pensions tax regime in place since 2004, it does not seem likely that the megafund reforms will see any major rethinking of this approach – welcome though that might be for the industry – but there is certainly scope for changes that could benefit funds and their members. The guidance provided by HMRC on its interpretation and application of the law in this area is useful but could be expanded and made more specific. Pension funds considering anchor investments, perhaps particularly in the credit fund space but also in many common co-investment scenarios, would certainly welcome any expansion of the scope to seek specific clearances or rulings from HMRC on the basis of the fund's investment parameters. Change in this area would be in line with the Government's recent commitment, in the Corporation Tax Roadmap published at the Autumn Budget, to "develop a new process for increasing the tax certainty available in advance for major investments" into infrastructure and renewables projects. Any enhanced ruling procedure might also extend to certainty as to the tax transparency or opacity of overseas entities for UK purposes, an area in which pension fund investors similarly depend on valuable but incomplete HMRC guidance. Although facilitating non-UK investments by the new megafunds does not serve the policy aim of promoting domestic investment, it will be essential to the other aim of improving returns so opportunities in this area should also be considered.

Accordingly, and in particular, ongoing UK tax treaty renegotiation efforts should seek to achieve relief, where available, from source state withholding taxes and other investee jurisdiction taxes applicable to non-residents. Change in this area is notoriously slow, but the advent of the megafunds may mean negotiation teams find fairer hearings especially as various treaty partners already actively incentivise the investment of superannuation funds. There are a host of other areas where the Government could consider investment-friendly tax changes for the pensions industry, including the residential property sector and infrastructure-adjacent investments in plant and machinery. The opportunity to input into the Government's two ongoing consultations (LGPS: Fit for the future and Unlocking the UK pensions market for growth) as part of a root and branch rethinking of a major area of the UK asset management industry is unlikely to recur soon. In a business world where size undeniably matters, the new megafunds may yet focus thinking – at home and abroad – on ways in which tax could better serve the UK pension fund investment sector.

Ropes & Gray | 25 November 2024

Retirement: Crunch time

Some things you need to know before going into a discussion with your advisor about ‘transforming’ your investment from growth to income-producing.

In my last blog, I discussed pre-retirement and how to use those crucial accumulation years to fatten the pot and give you the retirement you expect. Once you have reached that ‘event’ and that pot of money has to be converted from accumulating for retirement to producing an income, you have reached a crossroads – and if you and your advisor haven’t long since made a plan for this day, then please proceed with caution. Decisions made with your retirement funds often cannot be reversed. If you don’t have an embedded retirement plan, you’ll probably hear things you don’t like from your planner. They may say that your income from your funds is way below your expectations, let alone the replacement income you’re used to. You may be tempted to ignore their advice and shop around until you find someone who meets your expectations. I have discussed this before in other posts, but it bears repeating: If you want your income at retirement to be certain, increase contributions by inflation annually. And if you want it to last all of your life, a PRUDENT drawdown on that capital will be needed, above which those basic income needs go out the window.

Here are some things that you need to know before going into any discussion with an advisor who will help you ‘transform’ your investment from growth to income-producing:

1. Expenses

The first thing you need to do is get a very good handle on your expenses and, if necessary, start cutting out the things that are no longer necessary. What medical aid are you on – and can you afford it going forward? It really shouldn’t be more than 10% of your monthly expenses. What aspects of your life cover do you still ‘need’? (What you want is an entirely different conversation with your advisor and will depend on how much fat there is left in your pension after all the necessities). Disability cover falls away at age 65, but do you need life cover? Perhaps – if you still have liabilities or your dependants cannot live on your ‘pension’. Dread disease cover is expensive, and if you have medical aid and gap cover, then it is another ‘nice to have’. How you decide to spend your pension is completely personal, and everyone’s priorities are different – just keep the spending within your ‘pension’. One of the most problematic areas is car replacement in retirement—that is probably going to have to be a lump sum amount. One popular solution is to have a ‘newish’ (new-second-hand is the more cost-effective choice) car that will last at least 10 years. Thereafter, Uber is probably a way better solution.

2. Lump sum withdrawal

If you have a formal retirement fund – pension, retirement annuity, provident fund, etc., you can take one-third as a lump sum, the first R550 000 of which is tax-free – a lifetime amount; the rest is taxed progressively from 18% to 36%. You do not HAVE to take this lump sum; in fact, it might be prudent just to take the first R550 000 if it's still tax-free and convert the rest to a compulsory annuity. That R550 000 can be used to pay off any remaining debt or be a slush fund for unforeseen expenses that your income can't accommodate. If you have bits and bobs of investments in pension funds that you've accumulated over the years, it might be prudent to consolidate them first (this often creates a 'critical mass' that is cheaper to invest and opens more investment opportunities).

3. Annuitisation

The other two-thirds have to be taken as a compulsory annuity. There are three types of compulsory annuities – a living annuity (that survives after your death, leaving your beneficiaries with the investment), a life annuity (in its various forms, including a joint annuity with your spouse, increasing at inflation, etc.) where you lose the capital remaining on your death (or your spouse perhaps) and then a hybrid of the two (which is quite complicated, and if recommended to you, make sure you fully understand before signing onto).

4. Living annuity

In a living annuity (my preference unless you haven't guessed), the annual drawdown (i.e., income) you can get is between 2.5% and 17.5% per annum. Warning: The devil is in the details, and a broker can fool you into thinking they are getting you a "better deal." This annuity will have to put food on your table and a roof over your head for decades into the future, and I cannot emphasise enough how important it is to choose a 'prudent' and sustainable annual income drawdown percentage. **Ask your advisor this simple question: Will this income be constant (not fluctuating at any time, for example), grow with at least inflation every year, and never run out, no matter how long I live?**

To achieve that, the 'income drawdown' in a living annuity should not exceed 4.5% to 5% of the capital per annum (in today's interest rate and inflation environment – if this changes substantially, then those assumptions will have to change too – but in a living annuity you can at least do that). Anything over this, and you risk the capital being depleted and eventually running out. The problem I have with 'life annuities' is that the amount you are paid is pegged on the day you get it, and no matter what happens to interest rates thereafter, you're stuck. In life annuities, as soon as you start factoring in inflation increases, the percentage you're paid drops so much you might as well have a living annuity – and have some wriggle room for when things change. (And it is WHEN, not IF – markets and economies change all the time, sometimes drastically – if you give away your flexibility for the illusion of 'certainty' you may severely impact your future financial security – at a time that you can't do anything about it – you can't exactly go out and get a job).

5. Tax

Your income from any of the above annuities is taxed as income in your tax return. Even if you've been comfortable with auto-assessment from Sars up to now – do yourself a favour – find a tax practitioner; there are significant changes as you go over 65 years, and there are more claims you can make, especially regarding medical expenses. If you still have other taxable income, your annuity income will be taxed at the 'marginal' rate. I will discuss this in more detail in my next post. (I have a free newsletter that will give you a heads-up on the economy and new posts and podcasts. Contact me if you'd like to subscribe.) Your retirement fund should include a tax scenario (for both you and your spouse, if you have one) and include recommendations on how to optimise that tax (especially if you are married and perhaps have different marginal tax rates – (Section 56(1)) of the Income Tax Act). One of my future posts will go into this in much more detail.

6. Check previous withdrawals

If you have ever been retrenched, 'retired from', or cashed in a formal retirement fund, you may not have the full R550 000 tax-free amount you expect. Get your advisor to check with Sars.

7. Get a comprehensive financial plan

Please insist on a full financial, retirement and estate plan that you and your advisor can use as a benchmark going forward.

8. Estate planning

If you haven't done it yet, now is the time to make sure your financial affairs are organised and easily accessible to your family or whoever is going to be tasked with helping you, should you become incapacitated or (as is inevitable, unfortunately) – die. A digital filing system, while useful to you, is useless to anyone else. I have an old-school physical filing system I give to all my clients (free to anyone on request): the RedFile. This system stores all the important information that someone might need to file claims, wind up an estate, find the will and living will, and a lot more. This should also have copies of your financial plan so that if you wake up in the middle of the night or over a weekend, you can check on the plan and not have to blow up your poor advisor's phone for reassurance.

Moneyweb | 26 November 2024

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