# RETRENCHMENT AND TAX

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THINK WORLD CLASS

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by Sanlam

# WHAT RETRENCHMENT MEANS

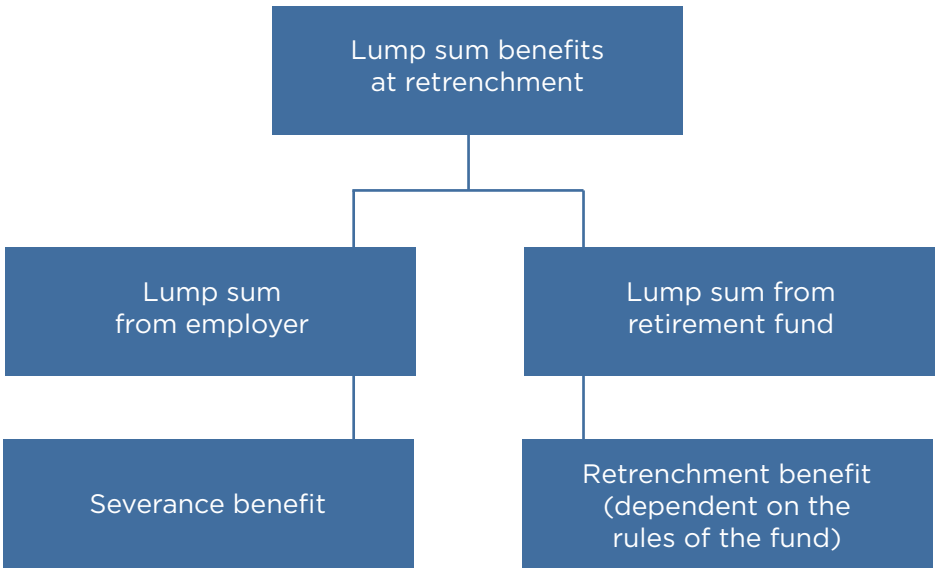
Retrenchment is defined in the Pension Funds Act as dismissal from employment based on the operational requirements of the fund member's employer.

These operational requirements are provided for in section 213 of the Labour Relations Act to include the economic, technological, structural or similar needs of an employer.

Employees that are retrenched expect retrenchment packages, severance pay and so forth.

**What exactly does that mean and how is it taxed?**

## Your possible benefits at retrenchment



## 1.1. Severance benefit

If you are retrenched, a severance package is something that your employer will offer you. It is important to remember that the Labour Relations Act demands a consultation process that includes consensus on the value of the severance package[1]. It is during this consultation process that it is important that the mention of voluntary retrenchment does not lead to you resigning instead of being retrenched, as this has detrimental tax results for you. See below for more detail on this.

There are different sums of money that you could receive at retrenchment such as severance pay[2], notice pay and a gratuity amount.

TAXED LIKE NORMAL REMUNERATION

| | |
|---|---|
| **severance pay** | • one week's remuneration per completed year of service<br>• legislated in the Basic Conditions of Employment Act<br>• where the employee unreasonably refuses an alternative offer of employment, the obligation for severance pay expires |
| **notice pay** | • value of salary if employee works notice period<br>• if notice period is not worked, notice pay is payable dependant on terms in employment contract<br>• depending on employment contract notice pay could form part of the severance package if payable for notice period |
| **accrued leave pay** | • last payslip and part of remuneration |
| **other contractually agreed amounts** | • pro rata bonus for example<br>• dependant on terms in employment contract |
| **lump sum gratuity** | • negotiable<br>• outside of employment contract |

**Figure 2**

The sums of money that you would have received in terms of an employment contract, irrespective of retrenchment, remains accrued income for service and is therefore taxed like normal remuneration.

A "severance benefit"[3] refers to an amount received or accrued from your employer (or associated institution) in respect of the termination or variation of office or employment if you:

- are at least **55 years old**; or
- are terminated due to **permanent incapacity** (permanently incapable due to sickness, accident, injury or incapacity of mind or body); or
- are terminated as a result of **retrenchment** (your employer ceases to carry on trade or your role is redundant as a result of a reduction in personnel), except where you at any time held more than 5% of the shares or members' interests of the employer.

In *figure 2* above, the severance pay and the gratuity lump sum, will form part of the severance benefit paid by your employer. The notice pay and accrued leave pay will form part of remuneration and will be taxed at marginal tax rates.

## 1.2 Severance benefit and tax

In the past, the severance benefit lump sum received from an employer was exempted from income tax in terms of section 10(1)(x) of the Income Tax Act, however, this section was removed and now the lump sum is taxed according to the retirement tax tables (first R550 000 taxed at 0%) and the aggregation principle applies. [4]

| Taxable income | Rate of tax |
|---|---|
| R0 – R550 000 | 0% |
| R550 001 – R770 000 | 18% of the amount over R550 000 |
| R770 001 – R1 155 000 | R39 600 + 27% of the amount over R770 000 |
| R1 155 001 + | R143 550 + 36% of the amount over R1 155 000 |

Therefore, a severance benefit is taxed in the same manner and using the same tax table as the retrenchment benefit received from the retirement fund. Refer to 2.2 below.

NOTE: A severance benefit cannot be transferred to a preservation fund or any other approved fund, as it does not originate from a retirement fund.

## 2.1 Retirement fund membership

Remember that membership of a pension and provident fund is dependent on the employer/employee relationship and therefore when you leave your employer, you can no longer be a member of your employer's pension/provident fund.

The fund rules will allow for your retirement benefits to be provided to you upon termination of your fund membership due to retrenchment.

This benefit is called the **retirement fund retrenchment benefit.**

You will generally have the following options regarding your retrenchment benefit:

- Take the benefit as a cash lump sum
- Transfer the benefit to another approved fund[5]
- A combination of the above

## 2.2 Retrenchment benefit and tax

Paragraph (e) of the definition of **gross income** in section 1 of the Income Tax Act specifically includes a retirement fund lump sum benefit or retirement fund lump sum withdrawal benefit into the gross income of a taxpayer.

The calculation of the tax payable on a lump sum received from a retirement fund, however, occurs separately to the calculation of the tax payable on taxable income at marginal tax rates. The lump sum mentioned earlier is taxed on either the retirement or withdrawal table depending on the event that triggers taxation. Any previous events such as withdrawals, retirements or retrenchments (including the receipt of severance benefits) could also influence the tax payable at a given time.

Therefore, all lump sums received from retirement funds, i.e. withdrawal and retrenchment benefits (including severance benefits), before retirement, could influence the tax payable on the lump sum taken at retirement. The same principle applies when a taxpayer retires from different funds on different dates. The income tax will be calculated on the aggregate of all retirement fund lump sum benefits received previously within specific time windows.

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### 3. Voluntary or involuntary?

Retrenchment is not a voluntary process. Where you choose to resign ahead of retrenchment, this is commonly referred to as **voluntary retrenchment**. It would typically be when employees are offered additional benefits to ease the retrenchment process by resigning instead. Resignation affects the employees benefits and their consequent taxation.

SARS no longer differentiates administratively between voluntary and involuntary retrenchment. They view both as retrenchment, if so, indicated on the applicable forms.

Where you are party to such a process, it would be advisable not to resign. Insist on being part of the formal retrenchment process in order for any possible severance benefits that you may receive, to qualify for a better tax rate.

Also remember, the moment that you are older than 55 years (irrespective of the above) any benefit received from the employer due to the termination of your employment, qualifies as a severance benefit.

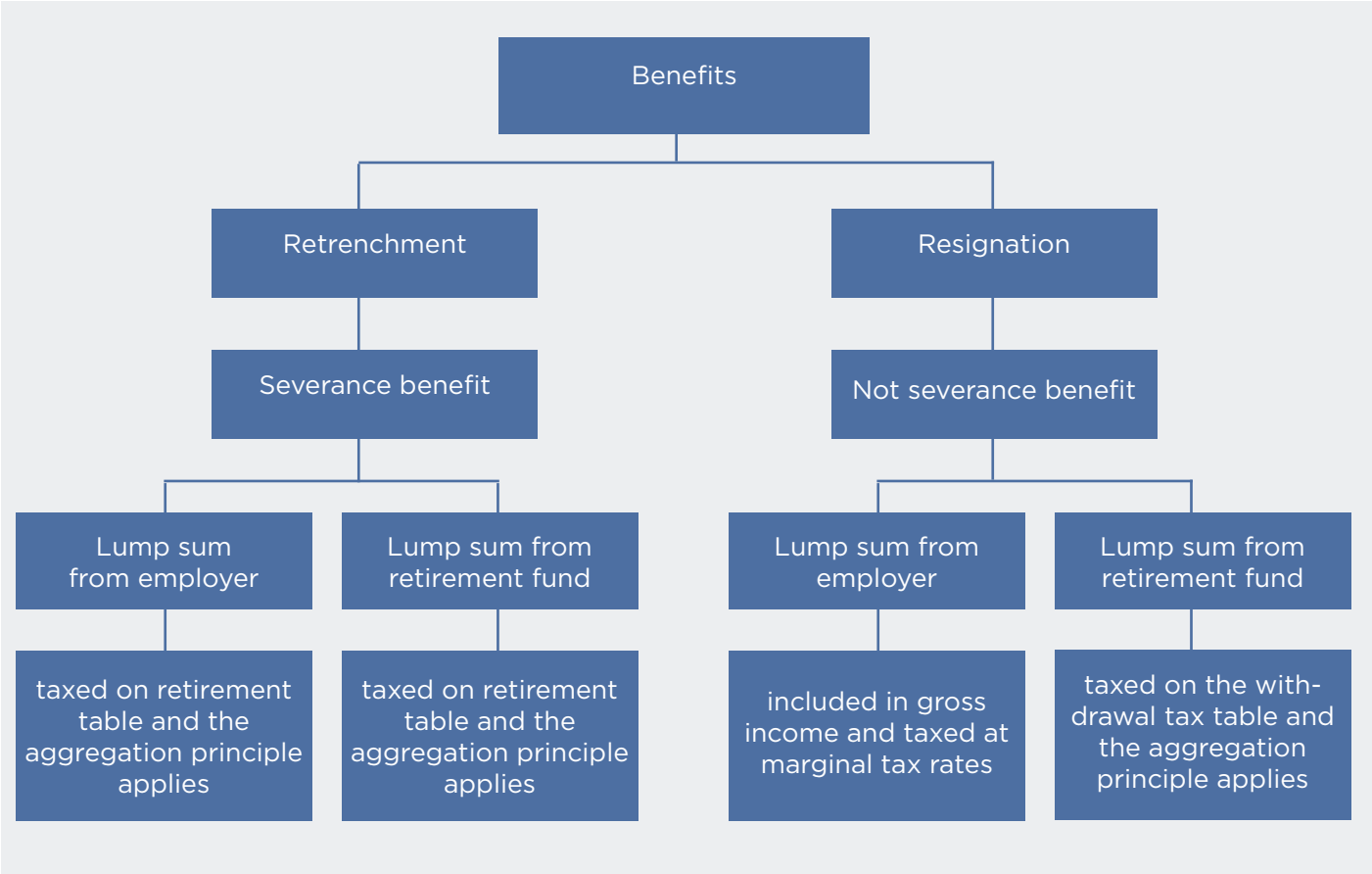


**Figure 3**

## 4. Conclusion

Whilst the benefits all accrue as gross income to you, the former employee, the lump sums are not all taxed in the same manner or on the same tax table.

- Retrenchment packages = retirement fund to employee = retirement table
- Severance packages = employer to employee = retirement table

  **Retirement fund resignation** lump sum = retirement fund to employee = withdrawal tax table

  Voluntary packages upon resignation (if you are younger than 55 and definitely not a severance) = employer to employee = marginal tax rate of employee

**Notes:**

[1] Section 189 of the Labour Relations Act, 66 of 1995

[2] Section 41 of the Basic Conditions of Employment Act, 75 of 1997

[3] Defined in section 1 of the Income Tax Act 58 of 1962

[4] The rules of the Personal Portfolios Preservation Provident Fund and the Personal Portfolios Preservation Pension Fund do not allow a severance benefit to be transferred to the preservation fund as contributions can only be received from another fund and not from an employer.

[5] A transfer to the Personal Portfolios Preservation Provident Fund, Personal Portfolios Preservation Pension Fund or Personal Portfolios Retirement Annuity Fund will be tax neutral.

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