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Deferred compensation revisited

Are threatened developments fair or wise?

by Tony Davey

Lobbyists for the Long-Term Insurance industry should be cognizant of the Budget Review published this month by the National Treasury. This states that salary-structuring arrangements, including what is known in insurance jargon as 'deferred compensation', will be reviewed from the perspectives of both employers and employees.

In essence, a deferred-compensation plan is a contractual arrangement, funded by an insurance policy, between an employer and employee to grant the employee a gratuity at retirement or, upon earlier death, the employee's heirs.

Employee tax proposal

Under s 10(1)(*x*) of the Income Tax Act a R30 000 tax exemption is allowed on a lump-sum award granted by an employer to an employee who has attained the age of 55, upon retirement or other termination-of-service event.

Such an award (which may include pay in lieu of leave) by an employer, of which the first R30 000 is tax free, is currently distinct from any benefit payable by a retirement fund upon retirement, where a lump-sum benefit qualifies for a R300 000 exemption. In other words, a combined tax-free total of R330 000 is currently on offer.

It is now proposed that the deferred-compensation award be merged with the retirement fund tax dispensation, on an inclusive, aggregated basis, with the effect that a deferred-compensation award will reduce the balance of a retirement fund tax-free benefit.

Prima facie, it could be argued that employees of smaller sized firms who are not members of an employer-sponsored retirement fund registered under the Pension Funds Act will benefit from a deferred-compensation plan of R300 000 instead of R30 000 if such a proposal becomes law. On the other hand, tax relief might be limited to the employer.

Employer tax proposal

It seems that the Treasury is either:

- Reviewing s 11(*w*). This permits an employer to deduct premiums paid under an insurance policy funding a deferred-compensation arrangement. This is perhaps seen as a tax-deferral arrangement, since the *fiscus* recoups tax only many years later when the employee receives the award of the insurance policy proceeds.
- Seeking to subject the employee to tax on each premium.

In my view, the fairness of this rationale is questionable, in that the same could be said of an employer's deductions of contributions to a pension or provident fund.

Conclusion

It is conceded that retirement funds are formally registered with the Registrar of Pension Funds and subject to legal and governance requirements under the auspices of the Financial Services Board. Yet the reality faced by smaller firms providing much-needed employment is that they cannot afford to fund the legal, compliance and administrative costs of retirement funds for employees. If anything, less formal arrangements such as deferred compensation, albeit adhering to certain prescribed criteria, should be encouraged.