Non-retirement savings: Tax free savings accounts

14 March 2014

National Treasury

Contents

Contents 2
1. Introduction 3
2. Executive summary 4
3. Savings in South Africa 5
4. Determinants of saving 5
5. Responses to previous discussion document 6
6. Design of the tax free savings account 7
- The annual contribution limit 7
- Treatment of withdrawals 8
- Types of accounts 9
- The lifetime limit 9

7. Provision and products 10
- Eligible service providers 10
- Criteria for savings and investment products to be included 10
- Transfer of funds 14

8. Administrative details 14
- Dividends tax 14
- Reporting requirements 15
- Contributions that are over the limit 15

9. Other reforms to encourage savings 17
- Additional products and costs 17
- Reckless lending practices 18

10. Conclusion 18
11. Comments 19

1. Introduction

"*Tax-preferred savings accounts, first mooted in the 2012 Budget Review as a measure to encourage household savings, will proceed. As previously announced, these accounts will have an initial annual contribution limit of R30 000, to be increased regularly in line with inflation, and a lifetime contribution limit of R500 000.*

Tax free savings accounts will proceed

The account will allow investments in bank deposits, collective investment schemes, exchange-traded funds and retail savings bonds. Eligible service providers will include banks, asset managers, life insurers and brokerages." **2014 Budget Review**

"*Legislation to allow for tax-exempt savings accounts will proceed this year, to encourage household savings*". **2014 Budget Speech**

This paper provides more details on the non-retirement savings reform announcements made by the Minister of Finance in his 2014 Budget Speech and responds to the comments received from the discussion document *Incentivising non-retirement savings* that was published in October 2012. It also provides a revised proposal to promote non-retirement savings, which will lay the basis for the legislation that is required to introduce the accounts. A complimentary paper provides more details on the retirement reform announcements in the Budget.

Incentivising non-retirement savings illustrated savings trends in South Africa, which highlight the inadequacy of current savings patterns, the determinants behind household savings and efforts to improve household savings. The paper concludes with the proposal of a new tax-incentivised product to replace the existing interest exemption.

This paper comprises: a brief overview of the key points raised in the previous discussion paper regarding savings levels in South Africa and the determinants of savings; a short summary of the responses received from the previous discussion paper; a description of the updated policy proposal after consideration of comments, including design and scope; and an outline of the expected administrative requirements for service providers, the South African Revenue Service, and individuals for operating the new accounts.

2. Executive summary

Following comments received on the discussion document *Incentivising non-retirement savings* published in October 2012, government intends to proceed with the implementation of the tax free saving accounts. This document incorporates revisions to the original proposal based on comments received and further consultations. It also provides an outline of the administrative requirements and procedures for these accounts.

Most comments supported the establishment of a tax free savings proposal. Many comments were received on the proposal to abolish the interest income exemption. The revised proposal now retains the current interest income exemptions, but it is not intended that the exemptions increase with inflation, hence the real value of these interest tax exemptions will reduce over time. These transitional arrangements should allow sufficient time for individuals to restructure their financial affairs.

Individuals will be allowed to open one or two accounts per year, where they may invest in either interest bearing or equity instruments or both types of investments in each account, but total contributions for the tax year may not exceed the annual limit of R30 000. Unnecessary withdrawals will be discouraged by not permitting replacement of withdrawn amounts.

Institutions that have a banking or collective investment scheme licence, as well as government, will automatically be eligible to offer products through tax free savings accounts. Stockbrokers that are registered with the Financial Services Board (FSB) and the Johannesburg Stock Exchange (JSE) will also be eligible to provide investment products through a tax free savings account, provided that products offered comply with the stated principles and characteristics.

Not all market savings or investment products may be appropriate for inclusion in these tax free savings accounts. Most collective investment schemes are the typical type of investment to be included in the tax free savings accounts, along with bank savings accounts, fixed deposits, retail savings bonds, REITs and insurance investment products that meet the stated principles.

This document seeks to outline a set of principles and characteristics that products to be included should abide by. These include simplicity, transparency and suitability. Direct share purchases will not be allowed although most exchange traded funds (ETFs) will qualify.

Products with contractual periodic contribution obligations (such as insurance contracts) or *excessively* high early termination charges will not be considered appropriate. National Treasury will engage with the FSB and industry in determining a reasonable early termination charge.

Taxpayers will be responsible for managing their overall yearly contributions to remain within the prevailing limit. Two options to ensure adherence to the annual contribution limits are explored.

3. Savings in South Africa

The National Development Plan recognises that the current level of savings is too low, stating that 'sustainable growth and development will require higher savings, investment and export growth'. Net household savings as a percentage of disposable income have gradually declined over time and have on average been negative since the turn of the century[1]. Not only is the aggregate level of saving across the economy low, but surveys suggest that the number of adults who do any saving at all is around 42%, with only half of those saving through formal channels[2].

'Sustainable growth and development will require higher savings, investment and export growth'.

There are numerous reasons why South Africans do not save sufficiently, such as low levels of employment and household income (and a low labour participation rate), the increased availability of credit, and the bias towards instant gratification. Households that have not saved enough are vulnerable to shocks and can easily fall into a cycle of impoverishment where they become reliant on debt to finance consumption.

Low savings have wider implications for the overall economy as it increases dependence on foreign capital flows to finance investment, may lead to lower levels of overall domestic investment and hampers future growth prospects. Increasing household savings should help push total gross savings above the current level of around 15% of GDP to levels that are more in line with other growing emerging markets[3].

The key objectives of the savings proposals (for both retirement and non-retirement) are to promote an increase in household savings to reduce the vulnerability of households. Though not the objective, an increase in household savings will also have broader macroeconomic benefits, as it can increase fixed investment and reduce reliance on foreign capital and excessive debt.

Key objective is to decrease household vulnerability

4. Determinants of saving

To create an effective proposal it is important to understand the factors behind why households do not generate enough savings. Households save in an attempt to smooth the amount that they can consume over time, say through saving for retirement when there will be no other regular income, or in order to provide a buffer for unforeseen payments or for large once-off purchases. Traditionally the most important factor in thinking about what motivates household savings is the expected rate of return. To encourage

[1] South African Reserve Bank, Quarterly Bulletin December 2013

[2] FinScope Survey 2013

[3] China, 51%; India, 34%, Russia, 30% - World Bank

Households may not act in their own best interest when it comes to savings decisions

households to save more governments could decrease the taxation of savings and increase the after tax returns to savings, making saving more attractive. More recent research has shown that there could be other more important considerations that are not related to the impact of tax on savings[4].

The behavioural economics literature has illustrated how households may not always act in their own best interest, especially when it comes to financial planning. Households appear to make a number of common errors. A few key findings[5] are that individuals often:

- Procrastinate, especially when it comes to saving
- Lack self-control, which leads to impulse spending
- Are intimidated by complexity and have limited financial knowledge
- Are influenced by cues, signalling or framing
- Are more likely to follow default options

Policy design beyond the rate of return is important to encourage savings

The design of policy interventions to promote saving should ideally take these considerations into account as they may be as important, if not more, than any increase in the rate of return due to a decrease in the tax on savings.

5. Responses to previous discussion document

The current mechanism to incentivise non-retirement household savings is the annual interest tax exemption, which is R23 800 for individuals below 65 and R34 500 for individuals above 65. This incentive is not highly visible and only provides a decrease in the tax paid on earnings that come in the form of interest.

The paper *Incentivising non-retirement savings* proposed the introduction of tax free savings accounts that would have a R30 000 annual contribution limit and a R500 000 lifetime contribution limit. It was proposed that there would be two accounts, one which would include equity products and one for interest bearing products. Withdrawals from the accounts could only be replaced up to the value of the annual limit and the interest exemption was to be discontinued.

Comments generally supported the idea of a tax free savings account

Over forty written comments were received from interested parties, including industry bodies, businesses and individuals, in response to the discussion paper. In general the comments welcomed the initiative to increase non-retirement household savings, however, there were some criticisms in relation to the design of the policy.

---

[4] For example: Madrian, Brigitte C., and Dennis F. Shea. "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior." *The Quarterly Journal of Economics* 116 No. 4 (November, 2001):1149–87.

[5] Leicester, A, Levell, P and Rasul, I. "Tax and benefit policy: Insights from behavioural economics" Institute for Fiscal Studies

The design option that received the most comments was the proposal to abolish the interest exemption. Those responding felt that this part of the policy would force individuals to sell existing interest earning assets in order to move them into the new accounts, which may result in capital gains tax charges, penalties and other administrative hassles. Other individuals may have fixed term deposits and would either not be able to transfer these amounts within a reasonable timeframe or pay heavy fees for the transfer, putting these individuals in a worse position.

The main criticism was on abolishing the interest exemption

The commentators also felt that the annual and lifetime limits were too low and that it was unfair not to allow the replacement of withdrawn capital. If individuals were required to use these funds for an emergency or if individuals had a variable income they would be at a disadvantage by not being able to replenish withdrawals in addition to the annual contribution limit.

Other comments argue that there is no need for two separate accounts; one for interest and one for equity. One account that could include both types of investments would be simpler. It was also felt that a tax incentive would be of little value in promoting savings amongst those with low incomes since they do not pay income tax.

Further comments suggested that all investment products should be included, that these products needed to be actively sold to low and middle income households, that individuals should not be subject to unreasonable termination costs if they wished to transfer products or change service providers and that compliance and monitoring costs should be minimised to avoid discouraging the participation of intermediaries.

6. Design of the tax free savings account

Taking into account the comments received, the design of the tax free savings accounts has been modified to retain the interest exemption so that individuals will not be required to transfer assets to access the proposed saving incentive. The current interest tax exemptions will not increase in value with inflation, hence the real value of these interest tax exemptions will erode over time. These transitional arrangements should allow a sufficient time for individuals to restructure their financial affairs.

Interest exemption will now be retained, but will not increase with inflation

The annual contribution limit

The annual limit is a central feature of the structure of the tax incentive. The idea of contribution limits is a common characteristic of tax incentivised savings accounts in other countries such as Canada, Ireland and the United Kingdom[6].

[6] OECD (2007), "*Encouraging Savings through Tax-Preferred Accounts*", OECD Tax Policy Studies, No.15

The annual contribution limit will put a deadline on saving, to avoid procrastination

The annual limit is a specific design feature that is meant to address the problem of procrastination by putting an annual deadline on the saving decision. If an individual misses that deadline then they lose out on tax free returns on that amount for as long as that amount would have been in the account. The annual limit plays the part of encouraging saving in the short term, for future benefit.

If individuals were allowed to roll over any unused amount there would no longer be a specific end point where they would be required to save and the individual would most likely put off actually saving the money 'until later'. The annual limit is thus intended to encourage individuals to save 'today'. Including a roll over for, say, two years to cater for individuals with variable incomes would weaken this design element considerably, to the benefit of a small minority who have variable incomes.

It is intended that the annual limits are increased on a regular basis to take into account the impact of inflation.

Treatment of withdrawals

The rationale for the treatment of withdrawals is again closely linked to findings from the behavioural economics literature. The relevant research conclusion here is that individuals often struggle with self-control, which may result in impulse purchases at the expense of saving.

Withdrawals cannot be replaced, acting as a disincentive to impulse spending

The withdrawals of accumulated savings cannot be replaced and any contributions (even if they originate from the previously withdrawn amounts) will be subject to the annual and lifetime limits. This design feature attempts to discourage the use of short to medium term savings (which are likely to be in liquid assets) for impulse purchases. At the least it would encourage individuals to 'think twice' before withdrawing their savings from the accounts, creating a check to help prevent any rash decisions but still allowing access to the assets when they are needed.

There may be circumstances when a taxpayer is required to withdraw these amounts for an emergency, if they have no other available assets, and they can reinvest the amount withdrawn a short while later. Amending the treatment of withdrawals to cater for this particular circumstance would diminish the policy intent to address problems of self-control. Providing any explicit special dispensation for this occurrence would be excessively complex and will be difficult to accommodate.

Types of accounts

The United Kingdom Individual Savings Account (ISA) model distinguished asset classes into separate account types due to the legacy of the previous tax exempt special savings accounts (TESSA) and personal equity plan (PEP) accounts, which housed investments in interest income and equity products respectively. Though such a legacy does not exist in South Africa, it was important to discuss the potential administrative impacts of having one or two types of accounts with different service providers.

Consultations with industry indicated that the majority of potential service providers preferred having one account where an individual could hold both interest and equity products. In order not to disadvantage any service providers who may only offer one type of product it is proposed that each individual will be allowed to open two accounts within a year. Each account may have interest or equity products or both interest and equity products within the same account and the total annual contributions to both accounts may not exceed the annual limit of R30 000. For example, investors have the choice of opening an interest only account with one service provider and an equity account with another if they wish, or they may open one account with only interest bearing investments and another with both interest and equity products. Providers who offer both products should not be at an unfair advantage.

There may be one type of account that can house interest and equity product

Investors may open up to two accounts per year, but contributions to both may not exceed R30 000

The lifetime limit

The lifetime contribution limit of R500 000 is well above the current annual limit and will not be reached for a number of years (about 16 years, if the annual limit remains at R30 000). It is not intended that the lifetime limit be increased by inflation in the short term[7]. The inclusion of the lifetime limit acts a measure to scale back the extent of the incentive if the revenue foregone is likely to become excessive in future years. Hence, the lifetime limit could in future be adjusted upwards, depending on affordability conditions.

The lifetime limit of R500 000 will remain in place but will not have an effect in the short term

It should be noted that this is a lifetime *contribution* limit. The accumulated savings (contributions plus earnings) could (and over time should) be in excess of R500 000.

[7] If the lifetime limit were to be increased by inflation in the same way that the annual limit is increased then the annual limit would never 'catch up' and there would be no reason for having the lifetime limit in any case.

7. Provision and products

Eligible service providers

National Treasury recognises the importance of service providers in contributing to the success of this initiative. Research findings indicate that most individuals are not pro-active when it comes to saving. This lends weight to the importance of distribution and the need to actively sell some savings and investment products, skills that are firmly located in the financial services industry. National Treasury will endeavour to develop a framework, based on acceptable and sound principles, that makes it attractive for firms to participate in this initiative, whilst at the same time ensuring value to savers and investors (consumers). Institutions that have a banking or collective investment scheme licence, as well as government, will automatically be eligible to offer products through tax free savings accounts.

Banks, asset managers and brokers will all be allowed to offer the product

Stockbrokers that are registered with the FSB and the JSE will also be eligible to provide investment products through a tax free savings account.

Criteria for savings and investment products to be included

A large number of the existing investment products available would be suitable for inclusion in the account

The introduction of the tax free savings accounts is not intended to lead to a vast assortment of new investment products that specifically cater for these accounts. Instead, the accounts will allow a large number of the current available savings / investment products to be included. This should immediately provide consumers with a wide range of potential savings / investments products to choose from and decrease the administrative hassle that firms would face in creating tailor made savings / investment products.

The type of products to be used within the tax free account play an important part in keeping the entire proposal simple, attracting a greater number of individuals to save. Simplification of choices is an important element in creating an environment where it is appealing for individuals to save, particularly for those who struggle with financial literacy. Investing in a simple product where the returns can be easily calculated may help to improve financial literacy and increase public engagement with investment products.

Defaults can help address the daunting task of choosing a savings vehicle by indicating public endorsement. Government can provide a useful service to consumers by implicitly signalling the broad types of products that would be suitable savings vehicles. Allowing certain types of saving / investment products to be included in the tax free savings accounts acts as both a recommendation or cue and a guide towards a potential list of defaults.

Instead of explicitly stating which exact products should be included and excluded, the current policy proposal seeks to outline a set of principles and characteristics that products should meet, designed to protect the consumer. These principles are simplicity, transparency and suitability.

A principles based approach will be used to determine which products are eligible

Simplicity

Saving / investment products should be simple to understand in terms of identifying the underlying assets and how to determine the returns to the product.

The principles are simplicity, transparency and suitability

The majority of savers would have little need for a niche product with a complicated conditional return structure. These products are by their nature not vanilla investment products and it may be difficult for ordinary investors to determine how returns are generated. This will create uncertainty in the mind of the investor which could lead to the individual disengaging from the savings process. Products that include derivatives, which are not directly used as a hedge within a pooled investment, would not be appropriate.

Transparency

There should be clear disclosures on the costs involved from the inception of the product, including any intermediary fees, and these should be disclosed to the client with each statement on a regular basis. The cost breakdown should include fees that are incurred at each level of service, once off and recurring fees and a common measure of the impact of fees on the level of returns.

Providers will be obliged to disclose standardised costs and other information for products to be eligible

The potential saver should be provided with a clear and understandable language description of the underlying assets that drive returns and an indicator to inform them of the potential risk involved by investing in the product. A grading of potential risky investments from high to low, with an explanation behind the reasons for the risk differentials, would assist in both managing expectations and improving financial education.

The requirements on cost disclosure and product information are intended to be in line with the Key Information Documents that are being developed by the FSB and the National Treasury under the Treating Customers Fairly framework.

Suitability

Each investor should ideally have a customised individual financial plan where the suitability of each investment is based on their current circumstances. In this context suitability refers to the impact of an individual investment product on the “average” person’s portfolio. The products should therefore not be of a speculative nature (by taking on a disproportionate amount of risk) or geared towards unique payoff strategies.

Although more structured products may be suitable for those persons with a higher net worth and specific objectives, it is unlikely that they will be appropriate for the majority of individuals. Simpler

investment products with some diversification are less intimidating to potential savers and are still a useful component of even the largest of portfolios.

Products that have obligatory monthly deposits will be excluded

The eligible products should make it as easy for individuals to save and should not unduly penalise savers depending on the occurrence or non-occurrence of a future event, such as death, disability or non-payment of premiums. Penalties or loss of benefits due to the inability to pay a monthly premium, which may arise just as the individual experiences a cash flow problem (from the loss of employment perhaps), are characteristics of a product that do not assist the saver at the moment when the need for precautionary savings is the greatest. Investors will, however, be able to authorise a product provider to regularly debit an amount into an investment product, but this should not be a requirement that is met with penalties if these regular contributions are not met.

Early termination charges that decrease the pay-out of the investment below the market value of the underlying assets at the time of withdrawal have a similarly adverse impact on the consumer. Investments with excessive early termination charges will not be allowed within these accounts. National Treasury will engage with the FSB and industry in determining a reasonable early termination charge.

Eligible products

Interest bearing accounts and collective investment schemes

Collective investment schemes, fixed deposits, REITs and retail savings bonds are eligible products

Most collective investment schemes are the typical type of investment to be included in the tax free savings accounts, along with bank savings accounts, fixed deposits, retail savings bonds, REITs and insurance investment products that meet the stated principles.

Exchange traded funds

Exchange traded funds (ETFs) that are registered as collective investment schemes (CIS) will be allowed in the accounts[8], providing exposure to a diversified pool of securities at a relatively low cost. Exchange traded notes and ETFs that are not registered as CISs have lower regulatory requirements and some of these non-CIS products, such as the Gold ETFs, are not sufficiently diversified. Although products such as the Gold ETFs may act as a good hedge when used as part of a broader portfolio, they may be inappropriate as a single investment. ETF's and exchange traded notes that are not registered as CISs are not recommended for inclusion.

Direct share purchases

Stockbrokers are included as eligible service providers, however the trading of individual securities within the tax free account would not be permitted. The objective of the policy is to encourage short to medium term savings and investments and not speculation. If direct share purchases were allowed taxpayers may be tempted to follow a

[8] If the disclosure requirements in relation to charges are met

strategy of purchasing highly volatile penny stocks through the tax free account in order to create large short term gains which can then generate tax free income from regular investments in future periods. However, investing in ETF's or similar pooled investments through a stockbroker will be permitted in the tax free savings accounts. The inability of the individual to trade specific securities will not mean that asset managers cannot trade in the underlying pooled investment on behalf of the investor (for example by reweighting the portfolio of assets in a CIS).

Insurance products

Products must permit flexible contributions and may not bind individuals into any future contribution schedules. Many insurance investment policies would currently not match these criteria. Government is not open to providing a tax incentive for products that have high charges and may have an adverse impact on household welfare at the point at which the household is increasingly vulnerable. In this regard some savings products, for example endowment policies and any similar investments that include *excessively* high penalties in the case of early termination of the policy, pose a policy challenge from a market conduct perspective and will not be allowed in these accounts. As discussed, National Treasury will engage with the FSB and industry in determining a reasonable approach to charges and early termination.

Linked and non-linked insurance policies that meet the above principles would be suitable for these accounts. These products may have a guarantee, but they would not be eligible if they require contractual monthly payments, they charged an excessive penalty on early termination or if their benefit structure was overly complex. Eligible insurance investment products would have a similar structure to a fixed deposit with a maturity of five years or greater.

Linked and non-linked insurance investment policies that meet the stated principles are also eligible

Insurance policies that insure death, disability, etc. may also have a vastly different benefit pay-out in comparison to the value of the premiums (savings) that were contributed up to that point. These policies already have a specific tax treatment[9] where contributions are not deductible but the benefits are tax free. It is proposed that insurance products that include death, disability and other risk benefits be excluded from the tax free savings accounts.

In summary

The general theme is that in order to provide a credible signal to potential savers, government needs to initially be careful regarding the range of products that persons may invest in to access the incentive.

A further consideration is how these proposals will align with the Retail Distribution Review (RDR) that is being conducted by the FSB. This policy proposal is not meant to precede or anticipate the final conclusions from the RDR but should instead align with those conclusions. Although the principles should be clear there are likely

[9] Income protection policies will follow the same tax treatment from 1 March 2015.

to be some products (and reporting standards) whose inclusion could be a matter of interpretation. To create more certainty the resulting product parameters and characteristics and the exact requirements for disclosure will be set out in draft regulations to be published by July 2014.

The FSB will monitor service providers to ensure the product parameters are adhered to

The FSB will be responsible for monitoring managers and product providers to ensure adherence to the principles and requirements set out in the draft regulations. This will form part of the Treating Customers Fairly framework and the future role of the FSB as a dedicated market conduct regulator under the Twin Peaks regime.

In extreme cases of market misconduct, the eligibility of the account may be cancelled altogether. Service providers can approach the FSB where there is uncertainty.

Transfer of funds

Funds may be transferred between tax free savings accounts at different providers

To promote competition amongst service providers it is proposed that the full amounts within the tax free savings accounts may be transferred to another service provider upon request, with no impact on the annual or lifetime limits.

In the case of CIS's products must pay, at all times upon the request of the owner, the fair market value of the underlying assets. In the case of fixed deposits and linked and non-linked insurance policies, products must pay the market value of the claim, subject to a reasonable exit penalty.

8. Administrative details

Dividends tax

No dividends tax will be payable on dividends in the account

All earnings within the account are free from tax, including dividends. The income tax on interest and capital gains is paid by the individuals on assessment, however, the 15% tax that is paid on dividends is withheld by the withholding agent[10].

Service providers would be required to indicate to the company or withholding agent that the shares in respect of which the dividend accrues are linked to a tax free savings account, which is exempt from tax, so that the company or withholding agent does not withhold dividends tax.

[10] The withholding agent may be the company that has issued the dividend or a regulated intermediary

Reporting requirements

Both service providers and taxpayers who make use of the tax free accounts will be required to provide information to SARS in the prescribed returns. Individuals who file returns will be required to provide information in their annual ITR12 return forms (which can be done through e-filing), while managers will have to make use of the IT3 forms. Individuals will need to include the income earned in the tax free account as non-taxable income under a separate source code (for interest, other income, capital gains and dividends) as well as the total amount of contributions made into tax free accounts in that tax year.

Individuals will be required to provide information on the ITR12 return forms

Service providers will be required to provide additional information to the current IT3 form, namely the amount of contributions for the tax year, the amount of returns on the investment and the market value of assets in the account. The current structure of the IT3 does not accommodate the information referred to above. The Business Requirement Specification will have to be expanded to accommodate all of the fields required.

Service providers will need to provide additional information through the IT3 process

To accurately record the transfer of funds within a tax free savings account from one product provider to another it is proposed that there is an additional information requirement that states how much was transferred and to which institution. The receiving institution will provide similar information as a cross reference.

SARS will act as a central repository to collect the reported information which will allow them to monitor whether individuals have abided by the account limits and to be informed of transfers between tax free savings accounts. Anonymised information on the usage of the account will be passed on to National Treasury in order to monitor and evaluate the progress of the incentive against the stated objectives.

SARS will consolidate all the annual information to check the annual limits are not exceeded

Draft legislation of amendments to the Income Tax Act to allow the introduction of the tax free savings accounts will be published as part of the 2014 annual Taxation Laws Amendment Bill process.

Contributions that are over the limit

The annual limit will apply to overall contributions per tax year. Taxpayers will be responsible for managing their overall yearly contributions to remain within the prevailing limit. Notwithstanding this, each service provider will need to ensure that taxpayers adhere to the prevailing limit in the accounts they manage.

There are two options on how to administratively deal with individuals who have exceeded the annual limits in a tax year. Even if all service providers were well disciplined and did not allow a single customer to contribute more than the R30 000 limit, one person may still go to a competing service provider and make additional contributions into a separate account. In the absence of a real-time system the possibility of this situation cannot be excluded. The same possibility could also arise even if there was only one

Two options are presented on how to manage accounts that have over contributed

account that was allowed to be opened. A first step to try and stop this type of behaviour is to highlight to the individual that there is an annual limit. This could be done by ensuring that the individual signs a disclaimer on the opening of the account that they will not contribute over the limit and this is not the third (or more) account that they have opened.

The growth and earnings from the over contributions should not be eligible for a tax incentive since they would be in breach of the allowable limits. However, practical constraints would require an alternative method of discouraging over contributions.

Option 1: Reversals of over contributions and earnings

Option 1 is a complete reversal, where the over contributions are withdrawn and tax to be paid is corrected

The theoretically purest option in dealing with contributions in excess of the annual limit is to reverse the process completely by withdrawing both the excess contributions and the growth on those contributions from the time they were deposited into the account with a rectification of tax payments if there was an underpayment of tax[11]. This is likely to be administratively onerous for the service provider as they must carry out the reversal, and for SARS as they may be required to manually contact the service provider and audit the procedures used in the reversal. Any calculation of tax that is underpaid would also be dependent on the taxable income of the individual for that year, information that is not readily available to the service provider.

There is no built-in form of penalty or other disincentive in this approach. Individuals could simply over contribute without risk, in the knowledge that the problem will simply be reversed. Since there is no real incentive for taxpayers to over contribute, this type of behaviour may not make sense. However, where over contribution does take place for whatever reason (perhaps simply out of error), SARS and possibly other parties must make changes and such changes take time and effort.

The alternative to a reversal is to levy a "penalty" that is sufficiently severe to discourage any over contributions in the first place.

Option 2: Applying general tax rules

Option 2 is to apply general tax rules which would minimise the administrative burden

A simpler option to a system of reversing investments and return on investments is to use the general tax rules to deal with over contributions. Under this option, no withdrawals would take place. Instead, general tax rules will apply during the year of assessment if the overall contributions exceed the annual cap. A proportion of interest, dividends, other receipts and accruals, and unrealised capital gains in the account for that year will be taxed at the marginal rates of tax for that individual, without applying the tax exemptions. The proportion could be based on the extent of the over contributions to the account. The general tax rule would result in a tax charge that is higher than if the returns on the over contributions were generated

[11] HM Revenue and Customs in the United Kingdom follow this method. Although the administrative hassle is apparently minimal since there are only a few of these cases each year.

outside the account. This approach would be simpler for SARS and service providers to administer as there would be no manual intervention or reversals and the return on the investment for the year is taxed on assessment of the individual.

The general tax rule would apply until the cumulative value of the contributions is below or at par with the cumulative value of the annual limit. This would be a simpler mechanism, although it may seem overly harsh for taxpayers who contributed an amount over the annual limits in error and for a short space of time. Since the reporting requirements are on an annual basis it would only be possible to identify the extent of time that the over contribution was in the account by asking for considerably more information from service providers. This would add to the administrative requirements of offering the accounts and increase compliance costs. Contributions over the limit should only occur on rare occasions and the mechanisms with which to deal with such situations should thus be relatively simple.

Comments on the preference between these two methods would be appreciated

Comments on the preference between the methods to deal with contributions over the annual limits would be appreciated.

9. Other reforms to encourage savings

Additional products and costs

The proposal for a tax free savings account is the first in a series of proposals to reform non-retirement retail savings. The RSA retail savings bond is another such measure. Due to public demand, a top up retail bond has been developed to cater for smaller investors investing more frequently, as well as informal groups, such as stokvels. The minimum initial capital amount that may be invested is R500, with a maximum of R5 million. The minimum amount may be topped up from as little as R100 at any time during the duration of the term. Only one term of three years is available. Investors will have access to their investments after one year. A small penalty is, however, payable on the amount drawn. Interest will be accumulated every quarter, at a floating interest rate and payable with the amount invested on the maturity date. This product will also be structured to fit the proposed tax free savings account. Government will also explore the introduction of a sukuk (Islamic) retail bond to expand the product offering.

National Treasury and the FSB will over the next two years explore further issues that affect non-retirement savings, such as charges in unit trusts and other related industries. Details on tackling these issues will be provided when the technical work necessary to develop firmer proposals is completed.

Reckless lending practices

Government also announced in December 2013, the need to deal with reckless lending and the provision of inappropriate credit and poor market conduct practices around credit, which lead to increased over-indebtedness. Increased levels of inappropriate debt make it more difficult for households to save and improve their financial security. In December 2013, Cabinet noted that the level of household indebtedness has risen to 76 per cent of disposable income, which adversely affects the ability of households to afford their current expenditure needs and save for the future.

Exploitative practices in retail lending, including reckless lending and the abuses in payday loans, have aggravated the problem of over-indebted households, driving many households into debt spirals. Cabinet has requested that the Ministers of Trade and Industry, Justice and Finance act jointly to develop a coherent programme to deal comprehensively with this problem, and take preventative steps to protect future borrowers.

10. Conclusion

The proposal for a tax free savings account aims to increase household saving to reduce the vulnerabilities that some households face from unexpected expenses which lead to increases in debt. Improvements in household savings can also contribute to increasing the overall level of savings in the economy to finance higher levels of fixed investments and promote growth prospects.

Recent insights from behavioural economics into the behaviour of households, and how they save, show that the appropriate design of a tax incentive is crucially important for an intervention to be successful in promoting savings. The tax free savings account will be exempt from any tax on earnings and has an annual limit to encourage households to save in the current period. Unnecessary withdrawals will be discouraged by not permitting arrear contributions for by-gone years. Individuals will be allowed to open one or two accounts per year, where they may invest in either interest bearing or equity instruments or both types of investments in each account, but total contributions for the tax year may not exceed the annual limit of R30 000.

The investment products available in the account include collective investment schemes, unit trusts, exchange traded funds, fixed deposits, retail savings bonds, REITs, and insurance investment products that meet the stated principles of simplicity, transparency and suitability.

This document provides greater detail on the policy design and administrative requirements to generate feedback that will inform the legislative and regulatory requirements that are required to introduce the tax free savings accounts in 2015.

11. Comments

The public is invited to comment on the principles, allowable savings and investment products, and the two options to deal with non-compliance to the annual contribution limit contained in this response document by no later than **30 April 2014**. Comments may be submitted to:

Attention: Mr Chris Axelson, Director: Personal Income Taxes and Savings, Economic Tax Analysis, Private Bag X115, Pretoria, 0001. Or by fax to 012 315 5516. Or by email to:

savings.incentive@treasury.gov.za

These comments will help inform draft legislation and regulations that will be published for public comment by July 2014.