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# Retrenchment 101

Due to the economic impact of the COVID-19 pandemic, many South Africans are facing retrenchment and must make some difficult decisions. With that in mind, we have compiled this guide to assist in explaining the different options available in respect of severance benefits and retirement fund benefits on retrenchment, as well as their tax implications.



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## What is retrenchment?

Retrenchment is a form of dismissal due to no fault of the employee, based on the employer's operational requirements. During this period, the employer must follow a fair procedure as set out in the Labour Relations Act, 66 of 1995, as failure to do so may result in the retrenchment being considered unfair. Operational requirements refer to the economic, technological or structural needs of the employer.

## Are voluntary and involuntary retrenchments subject to different benefits and tax treatments?

Voluntary retrenchment typically refers to the initial period of the employer's retrenchment process where an employee can elect to take up an offer of a severance package, which is sometimes more favourable than an involuntary retrenchment. Taking up such an offer does not change the nature of the employee's termination of employment to a resignation, as it is the employer that initiates the process due to its business requirements. This contrasts with involuntary retrenchment where the employer decides which employees are to be retrenched. From a tax perspective, however, it is irrelevant whether a retrenchment is voluntary or involuntary, and any severance benefit or retirement fund lump sum received as a result of a retrenchment will be treated the same.

Note that the South African Revenue Service's (SARS') Completion Guide for IRP3(a) and IRP3(s) Forms, and the actual IRP3(a) forms still differentiate between voluntary and involuntary retrenchment. However, SARS has confirmed that severance benefits due to voluntary and involuntary retrenchment should be treated the same from a tax perspective.

## What types of benefits may the retrenched employee receive?

An employee is legally entitled to the amounts set out in the Basic Conditions of Employment Act, 75 of 1997, their employment contract (for example, a pro rata bonus) and applicable company policies. In terms of this Act, the following benefits must be paid to an employee who is retrenched:

### Accrued leave

### Notice pay

if the employee is not required to work the notice period; and

### A severance benefit

the minimum amount prescribed is one week's salary for every completed year of continuous employment.

Furthermore, the employee may also elect to take their retirement fund benefit as a lump sum (subject to tax in terms of the retirement tax table), or transfer the benefit to an approved retirement fund on a tax-neutral basis.

## Severance benefits

A "severance benefit", as defined in the Income Tax Act, 58 of 1962, is taxed in accordance with the retirement tax table, which currently allows up to R500 000 to be received tax free (if no previous applicable lump sums were received). Before 1 March 2011, section 10(1)(x) of the Income Tax Act provided that only the first R30 000 of a severance benefit was tax free.

A severance benefit is defined as an amount received by or accrued to a person as a lump sum, in respect of the relinquishment, termination, loss, repudiation, cancellation or variation of the person's employment if:

- such person has attained the age of 55 years; or
- such relinquishment, termination, loss, repudiation, cancellation or variation is due to the person becoming permanently incapable of holding the person's office or employment due to sickness, accident, injury or incapacity through infirmity of mind or body; or
- such termination or loss is due to
  - the person's employer having ceased to carry on or intending to cease carrying on the trade in respect of which the person was employed or appointed; or
  - the person having become redundant in consequence of a general reduction in personnel or a reduction in personnel of a particular class by the person's employer,

unless, where the person's employer is a company, the person at any time held more than five per cent of the issued shares or members' interest in the company.

Leave pay and bonus pay are considered as payments for services rendered and are therefore not defined as severance benefits. Similarly, notice pay flows from the employee's contract of employment and therefore also does not fall within the definition of severance benefits. These payments are taxed in accordance with the PAYE table, i.e. at the employee's marginal rate.

Although a severance benefit is taxed in the same way as a retirement fund lump sum, it is not a retirement fund benefit. Therefore, the employee does not have the option of transferring the benefit to a retirement annuity or preservation fund on a tax-neutral basis. Such benefit can only be paid out in cash to the individual (although the after-tax funds can be invested in a retirement annuity in order to obtain further tax benefits).

## Retirement fund benefits

In addition to receiving a severance benefit, the retrenched employee may also decide to take a lump sum benefit from their retirement fund. This lump sum will also be taxed in accordance with the retirement tax table, where the first R500,000 is tax free, provided that the tax-free portion has not already been utilised with the severance benefit (or any other retirement fund benefits previously received).

Alternatively, the retirement fund benefit can be transferred to an approved fund on a tax-neutral basis. However, should the retrenched employee transfer their retirement fund benefit to a preservation fund and opt to take a once-off withdrawal at a later stage, the benefit will then be taxed in accordance with the withdrawal tax table (taking into account any severance benefit received, as well as previous retirement fund benefits). The once-off withdrawal from the preservation fund will not be regarded as a retrenchment benefit.

The table overleaf compares the taxes payable when a retrenched employee decides to take a retirement fund lump sum on retrenchment (Scenario 1), versus the taxes payable if the individual opts to preserve their benefit in a preservation fund and subsequently does a once-off withdrawal (Scenario 2). For the purposes of these examples, we have assumed that the employee has taken no previous withdrawals from retirement funds or retirement lump sums.

The once-off withdrawal from the preservation fund will not be regarded as a retrenchment benefit.

## Comparison of taxes payable

	Scenario 1	Scenario 2
	The employee receives a severance benefit of R300 000 and takes a lump sum of R1 200 000 from their retirement fund.	The employee receives a severance benefit and transfers their retirement fund benefit to a preservation fund. The individual subsequently takes a once-off withdrawal from the preservation fund.
<b>Severance benefit</b>	R300 000	R300 000
Tax on severance benefit*	0% of R300 000 = R0	0% of R300 000 = R0
After-tax severance benefit	R300 000	R300 000
<b>Retirement fund benefit</b>	There is a lump sum of R1 200 000 at the time of retrenchment.	The employee transfers their benefit of R1 200 000 to a preservation fund and thereafter takes the full benefit as once-off withdrawal.
	Tax on retirement fund lump sum*	Tax on retirement fund benefit**
	<b>Step 1:</b> R130 500 + 36% of ((R1 200 000 + R300 000) – R1 050 000) = R292 500  <b>Step 2:</b> 0% of R300 000 = R0  <b>Step 3:</b> R292 500 – R0 = R292 500	<b>Step 1:</b> R203 400 + 36% of ((R1 200 000 + R300 000) – R990 000) = 387 000  <b>Step 2:</b> 18% of (R300 000 – R25 000) = R49 500  <b>Step 3:</b> R 387 000 – R49 500 = R337 500
After-tax retirement fund lump sum	R907 500	R862 500
Total tax payable for severance benefit and retirement fund lump sum	R292 500	R337 500

\*Using retirement tax table.

\*\*Using withdrawal tax table.

Please refer to Annexure A, for the applicable retirement/retrenchment tax tables, the withdrawal tax tables, and a summary of the steps to follow to calculate taxes payable in respect of a specific benefit.

## Other considerations when facing retrenchment

Employees may also have to consider other benefits previously provided by the employer that may be lost as a result of retrenchment. In addition to their salary and future retirement fund contributions, retrenched employees also stand to lose the following benefits:

- Risk protection benefits (life insurance, trauma/dread disease cover as well as income protection); and
- Medical aid.

Most employee benefit providers offer employees the option to transfer their risk benefits and their medical aid to a private policy when their employment is terminated. Advisors should pay careful attention and obtain a full list of all the benefits the employee received while employed.

## Conclusion

Advising an employee facing retrenchment can be complicated. It requires careful analysis of all the options available in respect of benefits payable, the tax implications of such options as well as consideration of the other benefits the employee may stand to lose.

## Annexure A: Taxation of retirement fund lump sums

### Retirement fund withdrawal benefit

Taxable income (R)	Tax
0 – 25 000	0% of taxable income
25 001 – 660 000	18% of taxable income above R25 000
660 001 – 990 000	R114 300 + 27% of taxable income above R660 000
990 001+	R203 400 + 36% of taxable income above R990 000

To calculate the tax in respect of a withdrawal lump sum:

- Step 1** Add current lump sum to all previous lump sums\* and apply current withdrawal tax tables.
- Step 2** Add all previous lump sums\* and apply current withdrawal tax tables.
- Step 3** Answer in step 1 minus answer in step 2 = tax payable on current withdrawal lump sum.

\*Only retirement lump sums received or accrued on or after 1 October 2007, withdrawals received or accrued on or after 1 March 2009 and severance benefits received or accrued on or after 1 March 2011 must be taken into account.

### Retirement lump sum or severance benefit

Taxable income (R)	Tax
0 – 500 000	0% of taxable income
500 001 – 700 000	18% of taxable income above R500 000
700 001 – 1 050 000	R36 000 + 27% of taxable income above R700 000
1 050 001+	R130 500 + 36% of taxable income above R1 050 000

To calculate the tax in respect of a retirement lump sum:

- Step 1** Add current lump sum to all previous lump sums\* and apply current retirement tax tables.
- Step 2** Add all previous lump sums\* and apply current retirement tax tables.
- Step 3** Answer in step 1 minus answer in step 2 = tax payable on current retirement lump sum.

\*Only retirement lump sums received or accrued on or after 1 October 2007, withdrawals received or accrued on or after 1 March 2009 and severance benefits received or accrued on or after 1 March 2011 must be taken into account.

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