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**SOUTH AFRICAN REVENUE SERVICE**

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**GUIDE  
ON  
THE TAXATION  
OF  
LUMP SUM BENEFITS**

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Another helpful guide brought to you by the  
South African Revenue Service



# GUIDE ON THE TAXATION OF LUMP SUM BENEFITS

## Foreword

This guide provides general guidelines regarding the taxation of lump sum benefits from retirement funds in South Africa. This guide does not attempt to reflect on every scenario that could possibly exist but does attempt to provide clarity on the majority of issues that are likely to arise in practice. Where this guide does not address a specific issue, it must be taken up with the local SARS branch office.

This guide is not meant to deal with the precise technical and legal detail that is often associated with taxation and should, therefore, not be used as a legal reference. It is not a binding general ruling in terms of Part IA of Chapter III of the Income Tax Act, No. 58 of 1962 (the Act).

Should an advance tax ruling be required, visit the SARS website at Advance Tax Ruling (ATR) System.

This guide is based on legislation as at 1 October 2007.

Should you require additional information, you may –

- contact your local South African Revenue Service (SARS) branch;
- visit SARS website at [www.sars.gov.za](http://www.sars.gov.za);
- contact your own tax advisors;
- if calling locally, contact the SARS National Call Centre on 0860 12 12 18; or
- if calling from abroad, contact the SARS National Call Centre on +27 11 602 2093.

Comments and/or suggestions regarding this guide may be sent to the following e-mail address: [policycomments@sars.gov.za](mailto:policycomments@sars.gov.za).

Prepared by

**Legal and Policy Division**  
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## **1. BACKGROUND**

The way in which lump sum payments (benefits) from pension, provident and retirement annuity funds (retirement funds) are taxed changed recently. This guide discusses some of the more important legislative aspects relating to these types of benefits and does not currently deal with associated operational or administrative aspects.

Unless otherwise indicated, references in this guide to sections, subsections, paragraphs and schedules are to sections, subsections, paragraphs and Schedules to the Act.

The taxation of lump sum benefits from retirement funds, together with other aspects relating to retirement funds, are currently subject to a policy and regulatory review process. The outcome of this process may affect the way in which these benefits are taxed.

## **2. LUMP SUM BENEFITS PAYABLE ON RETIREMENT OR DEATH**

### **2.1 Pension funds, provident funds and retirement annuity funds**

#### **2.1.1 Typical lump sum benefits on retirement**

##### **a) Pension funds and retirement annuity funds**

On retirement, a member of an approved pension fund or retirement annuity fund may commute up to one-third of the total value of his or her interest in the fund for a single payment (that is, a lump sum). There is one exception to this rule: where the value of the remaining two-thirds does not exceed a pre-determined amount, the total value of the interest in the fund may be commuted for a lump sum. The latter is more fully explained in paragraph 4 below.

The remaining two-thirds, if not commuted on the basis explained in paragraph 4 below, must be utilised to provide a compulsory, non-commutable life-annuity that may either be paid by the fund itself or be purchased by the fund from a registered South African long-term insurer.

##### **b) Provident funds**

A member who retires from a provident fund is entitled to receive the full value of his or her interest in the fund by way of a lump sum.

##### **More information**

More information on the nature of lump sum benefits and the circumstances in which these benefits typically become payable is contained in the SARS issued General Notes and Retirement Fund Practice Notes, and can be accessed on the SARS website at:

[www.sars.gov.za/it/Retirement%20Fund%20main.htm](http://www.sars.gov.za/it/Retirement%20Fund%20main.htm)

#### **2.1.2 Typical lump sums paid on death**

Retirement funds often provide group life cover, paying a lump sum benefit in consequence of a member's death. A lump sum benefit paid upon the death of a member is deemed, for income tax purposes, to have accrued to the deceased member on the day prior to the member's death.

#### **2.1.3 Taxation of lump sum benefits on retirement or death: Before 1 October 2007**

Prior to 1 October 2007 the tax-free portion of a lump sum benefit was determined in terms of "formula A", with regard to pension funds and provident funds, and capped in terms of

“formula B” as defined in the Second Schedule. In terms of these formulae, the tax-free portion of a lump sum was determined by, amongst others, the number of years of membership of the member in the fund and (with regard to pension funds and provident funds) his or her average salary over a pre-determined period, and limited to a maximum of the greater of R120 000 or R4 500 multiplied by the number of completed years of membership to the fund. The tax on the taxable portion of the lump sum was then determined in accordance with section 5(10) at the so-called “average rate of tax”.

#### 2.1.4 Taxation of lump sum benefits on retirement or death: On or after 1 October 2007

With effect from 1 October 2007 and in terms of the Taxation Laws Amendment Act, No. 8 of 2007 –

- i) “formula A” was repealed; and
- ii) “formula B” has been simplified.

The tax-free portion of a retirement fund lump sum benefit paid by a pension fund, provident fund or retirement annuity fund is now determined by reference to “formula B” only.

<b>Z = C + E - D</b> (this is formula B)	
Where:	
<b>Z</b> =	the tax-free amount to be determined
<b>C</b> =	R300 000
<b>E</b> =	own contributions that were not permitted as a deduction, <u>plus</u> (if any) a tax-free public sector portion previously transferred to the fund by the public sector fund
<b>D</b> =	tax-free portions in previous years of assessment

The taxable portion of all retirement fund lump sum benefits received by or accrued to a member during a year of assessment is determined as follows:

Total of all lump sum benefits received or accrued during the year of assessment	R xx
Less: “formula B”	<u>(Ryy)</u>
Included in taxable income	<u>Rzz</u>

The taxable portion (that is, after applying “formula B”) of all retirement fund lump sum benefits is included in the taxpayer’s gross income in terms of paragraph (e) of the definition of “gross income” in section 1.

No deductions, losses or other exemptions apply in relation to the taxable portion included in “gross income”, effectively making it part of the taxpayer’s “taxable income” for that year of assessment.

The normal tax payable on the taxable portion of the total of these retirement fund lump sum benefits is determined by reference to a separate scale of rates, without taking any rebates into account. Refer to paragraph 7 of this guide.

#### 2.1.5 The term “retirement fund lump sum benefit”

The term “retirement fund lump sum benefit” was inserted in section 1 of the Act to apply with effect from 1 October 2007 to differentiate between retirement and death benefits on the one hand and other lump sum benefits. This differentiation was necessary to enable the simplified

tax dispensation that applies to “retirement fund lump sum benefits” with effect from 1 October 2007.

Section 1 defines the term “retirement fund lump sum benefit” as the amount determined in terms of paragraph 2(a) of the Second Schedule to the Act in respect of a year of assessment, after taking into account the provisions of paragraphs 2A, 2B and 2C of that Schedule. Effectively, therefore, “retirement fund lump sum benefits” are lump sum benefits that are derived in consequence of or following upon retirement or death.

### **3. LUMP SUM BENEFITS ON WITHDRAWAL, RESIGNATION OR WINDING-UP**

#### **3.1 Determining the taxable portion: Before 1 October 2007**

The deduction against a lump sum benefit paid on withdrawal or resignation that was available prior to 1 October 2007 remains the same.

#### **3.2 Determining the taxable portion: On or after 1 October 2007**

Subsequent to 1 October 2007, but with effect from 1 March 2006, any tax-free public sector portion that was previously transferred to the fund must also be taken into account (for more information see paragraph 6 of this guide).

#### **3.3 Determining the rate of tax**

The taxable portion of withdrawal and resignation benefits paid on or after 1 October 2007 continue to be subject to tax at the so-called “average rate of tax”, determinable in terms of section 5(10)..

### **4. COMMUTATION OF SMALL TOTAL VALUE ANNUITIES**

#### **4.1 Benefits**

As discussed in paragraph 2 of this guide, a member of a pension or a retirement annuity fund may ordinarily commute up to a maximum of one-third of his/her retirement benefit (interest in the relevant fund) for a lump sum. There is one exception to this rule: where the value of the remaining two-thirds does not exceed a pre-determined amount, the total value of the interest in the fund may be commuted for a lump sum. The value of the pre-determined amount is determined with reference to the date of the accrual of the lump sum, as explained in the following two paragraphs.

#### **4.2 Taxation of lump sum benefits: Before 1 October 2007**

Prior to 1 October 2007, a member was entitled to commute, in full, an annuity for a lump sum where the total annual amount did not exceed R1 800. The underlying capital that was required to fund such an annuity was determined by SARS to be R25 200. In practice it was accepted by SARS that an annuity may be commuted if the underlying capital was less than this amount.

#### **4.3 Taxation of lump sum benefits: On or after 1 October 2007**

With effect from 1 October 2007, a member may commute the remaining two-thirds of the underlying capital (that is, the portion that would ordinarily be utilised to provide a pension) provided that the capital amount does not exceed R50 000. Effectively, this means that a member whose total underlying capital (that is, the full three-thirds) in the fund is R75 000 or less may commute the total capital for a lump sum benefit.

#### **4.4 Commutation is determined per fund**

The total underlying capital in a fund in respect of a particular member, whether in one account or in multiple accounts or policies, must be taken into account for purposes of determining whether that member may commute the capital in full.

#### **4.5 Annuities in existence on 1 October 2007**

Where the trustees of a retirement fund are satisfied that a member or former member did not commute any portion of the total value of the annuity or annuities to which he or she became entitled prior to 1 October 2007, the rules of the fund may permit the member to commute the total value of the annuity for a lump sum on condition that the total value on the date of commutation does not exceed R75 000. Where the trustees cannot satisfy themselves that a member or former member has not commuted before, the rules of the fund may permit the commutation of the remaining total value of the annuity for a lump sum on condition that the total value on the date of commutation does not exceed R50 000.

### **5. EXTRAORDINARY LUMP SUMS**

#### **5.1 Distribution of surplus apportionment**

##### **5.1.1 Surplus apportionments**

The provisions of section 15B of the Pension Funds Act, No. 24 of 1956 regulate the distribution of a surplus apportionment to pensioners, former members and current members of retirement funds under a scheme approved by the Financial Services Board. In terms of this, active members receive their apportionment in the form of a credit to their member accounts, while former members as well as pensioners receive the apportionment in the form of a lump sum cash distribution.

##### **5.1.2 Tax status of surplus apportionments to active members**

A surplus distribution to the account of a member is not taxable in the hands of the member at the date of distribution, but any subsequent benefit or increase in a benefit is taxable under the normal tax rules associated with retirement fund benefits.

##### **5.1.3 Tax status of surplus lump sum cash distributions**

With effect from 1 October 2007, any surplus lump sum cash distribution subsequent to a person's retirement or death or withdrawal or resignation from the distributing fund, which is approved on or after 1 January 2006 by the distributing fund, is excluded from taxable income in terms of paragraph 2C of the Second Schedule.

#### **5.2 "Statement of Intent" benefits**

##### **5.2.1 Benefits**

Certain pre-defined payments to certain members and former members of retirement annuity funds have since become payable following an agreement dated 12 December 2005 between the Minister of Finance and the long-term insurance industry. In terms of this agreement, minimum values are payable to retirement annuity fund members or former members who, for some reason, discontinued their contributions prematurely. Regulation 5.3 (1)(b) of the Regulations under the Long-Term Insurance Act, No. 52 of 1998 gives effect to this arrangement.

##### **5.2.2 Taxation of benefits**

Provided the payment is made in terms of the provisions of Regulation 5.3 (1)(b) referred to in 5.2.1 above and provided further that the payment is made subsequent to the person's

retirement or death or withdrawal or resignation from the distributing fund and paid on or after 1 January 2006, the payment is excluded from taxable income in terms of paragraph 2C of the Second Schedule.

### **5.3 Benefits in terms of paragraph (b)(x)(cc) of the definition of “Retirement Annuity Fund”**

#### **5.3.1 Benefits**

Paragraph (b)(x)(cc) of the definition of “retirement annuity fund” in section 1 of the Act allows for a lump sum benefit from a paid-up retirement annuity in circumstances where the value of such benefit is less than an amount determined by the Minister of Finance from time to time, which amount is currently R7 000.

#### **5.3.2 Taxation of benefits**

This benefit comprises a taxable withdrawal from a (paid-up) retirement annuity fund, and is therefore not excluded from the provisions of gross income.

### **5.4 Divorce orders, maintenance orders and housing loan defaults**

#### **5.4.1 Benefits**

Section 37D of the Pension Funds Act, No. 24 of 1956 makes provision for the deduction of a divorce order, a maintenance order and a housing loan repayment from a member’s benefit or minimum individual reserve.

#### **5.4.2 Taxation of benefits**

A deduction from a member’s benefit does not affect the taxable portion of the benefit. In other words, the taxable portion of the member’s benefit is not reduced by the deduction.

Similarly, a deduction from a member’s minimum individual reserve is deemed to be a taxable lump sum benefit for purposes of the Second Schedule.

## **6. PRE-1 MARCH 1998 TAX-FREE LUMP SUMS BY PUBLIC SECTOR FUNDS**

With effect from 1 March 2006, the amount that was excluded from the provisions of the Second Schedule, through the operation of “formula C” as defined in the Second Schedule, upon transfer to an approved or recognised retirement fund, is added to the deduction that is available against a lump sum benefit payable on death or retirement from the transferee fund or, in the case of withdrawal or resignation benefits, creates a minimum deduction.

This deduction is only available from the retirement fund to which the public sector fund initially transferred the benefit on or after 1 March 2006. Any subsequent transfer will result in the pre-1 March 1998 vested rights losing their tax-free status.

## **7. TAX RATES APPLICABLE TO LUMP SUM BENEFITS (2008 rates)**

### **7.1 “Retirement fund lump sum benefit”**

<b>Taxable Amount</b>	<b>Rate of Tax</b>
Not exceeding R300 000	18% of the taxable income
Exceeding R300 000 but not exceeding R600 000	R54 000 plus 27% of the taxable income

	exceeding R300 000
Exceeding R600 000	R135 000 plus 36% of the taxable income exceeding R600 000

## 7.2 Other lump sum benefits

The normal tax on lump sum benefits other than “retirement fund lump sum benefits” remains determinable in terms of section 5(10).

## 8. CONCLUSION

This guide (first issue) contains the basic framework of the current legislative dispensation. The contents will be expanded over time to cover more related issues. It will also be updated in the future to ensure that it continues to reflect the ongoing reforms in the retirement savings arena.

It is hoped that this guide will contribute to greater clarity regarding the application and interpretation of the provisions of the Act pertaining to the taxation of lump sum benefits. Further information concerning taxation ~~is~~ available on the SARS website [www.sars.gov.za](http://www.sars.gov.za) or can be obtained from SARS branches.

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## ANNEXURE A: EXAMPLES

### Example 1

#### Retirement from a pension, provident fund or retirement annuity fund

The taxable portion of the lump sum will be determined in the same way, regardless of whether a member retires from a pension fund, provident fund or retirement annuity fund.

T retires from Big (Pty) Ltd on 1 December 2007 and was a member of the company's pension fund and provident fund for 30 years. He was also a member of a retirement annuity fund, from which he retired on the same date. He will be receiving a lump sum of R900 000 from the pension fund, a lump sum of R400 000 from the provident fund and a lump sum of R150 000 from the retirement annuity fund. During his membership of the funds, all his contributions were allowed as deductions in terms of either section 11(k) or 11(n) of the Act and he had not previously received any lump sum as a result of retirement.

Because this is a retirement, the tax-free portion in relation to the total of the lump sum benefits received by him during the year of assessment will be computed in terms of "formula B".

**"formula B":  $Z = C + E - D$**

in which formula –

- **Z** represents the tax-free portion of the lump sum
- **C** represents an amount of R300 000
- **D** represents previous deductions allowed as a result of retirement
- **E** represents own contributions that were not permitted as a deduction plus the value of pre-1 March 1998 rights in a public sector fund (if any)

The tax-free portion of the lump sum will therefore be determined as follows:

- $Z = R300\ 000 + 0 - 0$
- $Z = R300\ 000$

The taxable portion of the total lump sum benefits is therefore determined as follows:

Total lump sum benefits received during the current year of assessment	R1 450 000
Less: "formula B" deduction	<u>(R300 000)</u>
Taxable portion	<u>R1 150 000</u>

R1 150 000 will, therefore, be included in his gross income in terms of paragraph (e) of the definition of "gross income" in section 1.

The taxable portion will then be included directly in taxable income by ring fencing it against other deductions, exemptions and losses.

The tax payable on the lump sum will be determined by reference to the scale of rates listed in paragraph 7.1 above.

## Example 2

### Retirement from a fund in current and previous years of assessment

T retires from Big (Pty) Ltd on 1 December 2007 and was a member of the company's pension fund. He was also a member of a retirement annuity fund, from which he retired in the previous year of assessment on 1 September 2006. He will be receiving a lump sum of R900 000 from the pension fund, and received a lump sum of R200 000 from the retirement annuity fund the previous year of assessment, of which R120 000 was tax-free. During his membership of the funds all his contributions were allowed as deductions in terms of either section 11(k) or 11(n).

Because this is a retirement, the tax-free portion in relation to the total of the lump sum benefits received by him during the year of assessment will be computed in terms of "formula B".

**"formula B":  $Z = C + E - D$**

in which formula –

- **Z** represents the tax-free portion of the lump sum
- **C** represents an amount of R300 000
- **D** represents previous deductions allowed as a result of retirement
- **E** represents own contributions that were not permitted as a deduction plus the value of pre-1 March 1998 rights in a public sector fund (if any)

The tax-free portion of the lump sum will therefore be determined as follows:

- $Z = R300\ 000 + 0 - R120\ 000$
- $Z = R180\ 000$

The taxable portion of the total lump sum benefits is therefore determined as follows:

Total lump sum benefits received	
during the current year of assessment	R900 000
Less: "formula B" deduction	<u>(R180 000)</u>
Taxable portion	<u>R720 000</u>

R720 000 will, therefore, be included in gross income in terms of paragraph (e) of the definition of "gross income" in section 1.

The taxable portion will then be included directly in taxable income by ring fencing it against other deductions, exemptions and losses.

The tax payable on the lump sum will be determined by reference to the scale of rates listed in paragraph 7.1 above.

### **Example 3**

#### **Retirement from a private sector fund after vested rights benefits were initially transferred from a public sector fund**

Mulalo has been a member of a public sector pension fund ever since she was appointed on 1 March 1978. She resigned with effect from 1 March 2006 from the public sector and her benefits of R500 000 were transferred to an approved private sector pension fund following her appointment in the private sector. Mulalo retired on 29 February 2008 after 30 years of employment and received a lump sum of R960 000 from the private sector pension fund.

Because this is a retirement, the tax-free portion will be computed in terms of "formula B".

**"formula B":  $Z = C + E - D$**

in which formula –

- **Z** represents the amount to be determined
- **C** represents an amount R300 000
- **D** represents previous deductions allowed as a result of retirement
- **E** represents own contributions that were not permitted as a deduction plus the tax-free value of pre-1 March 1998 rights in a public sector fund

The tax-free portion of the pre-1 March 1998 vested rights in the public sector fund is determined by reference to "formula C" which is defined in the Second Schedule as follows:

$$A = \frac{B}{C} \times D$$

in which formula –

- **A** represents the taxable amount
- **B** represents years of membership from 1 March 1998 until date of exit from the public sector fund
- **C** represents the total number of completed years of membership of the public sector fund until date of exit from the public sector fund
- **D** represents the lump sum payable upon exit from the public sector fund

The tax-free value that must be included in symbol **E** of "formula B" must, therefore, be calculated as follows:

Symbol <b>D</b> of "formula C"	Rxx
Less: Symbol <b>A</b> of "formula C"	<u>(Ryy)</u>
Tax-free portion of pre-1 March 1998 rights	<u>Rzz</u>

The tax-free portion of Mulalo's pre-1 March 1998 rights will, therefore, be determined as follows:

Symbol <b>D</b> of "formula C"	R500 000
Less: Symbol <b>A</b> of "formula C"	<u>(R142 857)</u> , that is, $\frac{8}{28} \times 500\,000$
Tax-free portion of pre-1 March 1998 rights	<u>R357 143</u>

The tax-free portion of the lump sum will be determined as follows:

- $Z = R300\,000 + R357\,143 - 0$

Z = R657 143

Taxable portion: R302 857 (R960 000 – R657 143)



## **ANNEXURE B: FREQUENTLY ASKED QUESTIONS**

- (1) What is the impact of the 1 October 2007 legislative amendments on lump sums that are paid under deferred compensation arrangements and retrenchment / severance packages?**

The current legislative amendments refer to benefits paid by retirement funds, the taxable portion of which is included in “gross income” in terms of paragraph (e) of the definition of “gross income” in section 1 of the Act. On the other hand, the benefits referred to in the question above are paid by an employer and are included in “gross income” in terms of paragraph (d) of the definition of “gross income” in section 1. The legislative changes, therefore, only apply in respect of benefits paid by a retirement fund.

- (2) Are the legislative amendments applicable to benefits on withdrawal from a retirement fund?**

The changes are applicable mainly to “retirement fund lump sum benefits” as defined in section 1 of the Act, which definition only refers to retirement or death benefits.

- (3) Is the “R50 000 two-thirds” rule applicable in the case of death of a member?**

Yes.

- (4) Will a member who transferred a pre-1 March 1998 vested benefit to a private sector fund and subsequently to a further private sector fund, still be entitled to receive the benefit tax-free on exit from the last fund?**

No. The pre-1 March 1998 vested benefit retains its identity only in the first transferee fund.

- (5) What is the difference between a pension fund and a provident fund?**

**(i)** Contributions by members to a pension fund are tax deductible up to certain allowable limits, whereas contributions to a provident fund are not initially allowed as a tax deduction.

**(ii)** A lump sum commutation paid by a pension fund is limited to a maximum of one-third of the underlying retirement capital and the remaining two-thirds must be utilised to purchase an annuity. A retirement benefit from a provident fund is commonly paid by way of a lump sum.

- (6) What is the difference between a defined benefit and a defined contribution fund?**

The benefit in a defined benefit arrangement is calculated on the basis of a formula which, amongst others, requires reference to the member's period of service / membership to the fund. The benefit in a defined contribution arrangement is the sum of the member's contributions, the employer's contributions, and the fund growth.