momentum

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# LEGAL UPDATE FAW 4/2009: CONTRIBUTIONS TO PENSION AND PROVIDENT FUNDS

## Normal contributions

Member contributions to a pension fund are tax deductible, to a maximum of 7,5% of the member's remuneration. Member contributions to a provident fund are not permitted as a tax deduction, which means that an employee's salary is first taxed before contributions to a provident fund are deducted.

Employer contributions to a pension fund, provident fund or benefit fund are tax deductible in terms of section 11(l) of the Income Tax Act, to a maximum of 10% of an employee's approved remuneration or such higher amount as the Commissioner for the South African Revenue Services (SARS) may regard as reasonable and allow. Current departmental practice by SARS is to allow a deduction of up to 20% of remuneration. This 20% includes contributions to a benefit fund, which is defined to include *any medical scheme registered under the provisions of the Medical Schemes Act, 1998*. Put differently, the employer's total contribution towards a pension fund, provident fund and medical scheme is limited to 20% of the employee's approved remuneration.

## Additional voluntary contributions

Additional voluntary contributions (AVCs) are contributions made by either a member or their employer, over and above the normal contributions, in order to secure additional benefits for the member. This may only be done if the rules of the fund allow it.

Where a member's normal contributions and AVCs to a pension fund are less than the allowable 7,5%, both his normal contributions and AVCs can be claimed as a tax deduction. Any contributions in excess of the 7,5% may only qualify as a tax deduction upon the member's withdrawal or retirement from the fund.

Section 11(k)(ii) of the income Tax Act provides for the following deduction: "*any sum contributed during the year of assessment to any pension fund by any person who as a member of such fund, has in terms of the rules governing such fund undertaken to pay such sum in respect of any past period which is to be reckoned as pensionable service of that member: Provided that - (aa) the deduction to be allowed in respect of sums so paid shall not in the year of assessment exceed the sum of R1 800*."

This is often understood to mean that a member in a defined contribution pension fund will be entitled to deduct R1 800 per annum in respect of additional voluntary contributions to that fund. SARS has however confirmed that 'the R1 800 per annum tax deduction for arrear contributions to a pension fund is available *only* to the extent that the member is so contributing pursuant to the purchase of past service in terms of the rules of the fund concerned'. Accordingly this R1 800 can only be used if it relates to the buy back of past service.

In a provident fund, the same principle as that applying to normal contributions apply in respect of AVCs made by a member – AVCs are not tax deductible in the year of assessment in which the contributions are made; these contributions are also made from a member's after tax salary.

As stated above, employer contributions up to 20% of the employee's remuneration is tax deductible. In so far as the employer's normal contributions and his AVCs to a pension fund, provident fund and medical scheme in respect of a member is less than the prescribed maximum of 20% of the employee's approved remuneration, both the normal contributions and AVCs will qualify as a tax deduction. Contributions in excess of the 20% will not be tax deductible.

**Taxation of lump sum withdrawal benefits**

Before 1 March 2009, when a member withdrew from a pension fund or provident fund, the member's tax free portion would be the greater of:

- R1 800 plus any amounts transferred to approved funds; OR
- the member's contributions (including AVCs) that did not previously qualify as a tax deduction and tax free transfers from public sector funds.

From 1 March 2009, lump sum withdrawal benefits are taxed according to a table similar to that used for lump sum retirement benefits. Although this table has not been published yet, it is generally accepted that it will be as follows:

| Lump sum benefit | Tax rate |
|---|---|
| First R22 500 | 0% (Tax free) |
| Difference between R22 501 and R600 000 | 18% |
| Difference between R600 001 and R900 000 | 27% |
| Amount over R900 000 | 36% |

The tax free amount of R22 500 applies cumulatively over the member's lifetime, which means that subsequent lump sum benefits that accrue will be added and taxed at higher marginal rates. This will apply in respect of both the member's withdrawal and retirement. The existing tax concessions continue to apply, which means that members will still be able to claim a deduction in respect of their contributions that did not previously qualify for a tax deduction, which will include AVCs.

**Salary sacrifice schemes**

Many employers have established salary sacrifice arrangements in terms of which the employee's salary is reduced by the amount of the provident fund contribution and in return, the employer assumes the total contribution payment to the provident fund. The employee's remuneration and his conditions of employment are then amended to reflect a lower basic salary payable to the employee and an increased employer contribution to the provident fund. By structuring the contributions in this way, it ensures that the employee avoids the potential negative tax consequences attached to provident fund membership and in most instances, the employee's take home pay will not be reduced. The rules of the fund would therefore reflect a nil member contribution and x% employer contribution and upon withdrawal from the fund, the member will not be able to claim a deduction in respect of these contributions. The entire contribution will be deductible in the hands of the employer.

The following factors need to be considered regarding operating a salary sacrifice scheme and making additional voluntary member contributions to a provident fund:

(i) A member must understand that participating in a salary sacrifice scheme means that normal contributions to the fund are always reflected as employer contributions. Since there are no member contributions, on withdrawal from the fund, no tax deduction may be claimed on member contributions.

(ii) Additional voluntary member contributions to a provident fund, like normal member contributions, will not be permitted as a tax deduction in the year of assessment in which the contributions are made.

(iii) Where the member makes an AVC to the fund, the tax benefit will only be enjoyed when the member actually withdraws from the fund or retires, as a deduction on member contributions can only be claimed at that stage.

The member therefore needs to decide whether they would prefer to not make any contributions to the provident fund and enjoy the tax benefit upfront by (more take home pay in terms of a salary sacrifice scheme) or make contributions to the fund and enjoy a tax deduction at withdrawal stage in respect of their normal and additional voluntary member contributions.

Alternatively, the employer could establish a hybrid scheme consisting of two separate funds, one being a pension fund, to which the members contribute, and the other a provident fund, to which the employer contributes. This then ensures that members will receive up to 7.5% of their contributions as a tax deduction to the pension fund, resulting in their pension fund contributions first being deducted from their salaries before their salaries are taxed. This ensures a greater take home pay, but their total benefit from the pension fund will be taxed at withdrawal. Before an employer decides on a hybrid scheme they have to consider that fees are normally payable on both funds.

Another option could be that members channel their additional contributions to a retirement annuity fund. In this case, members would enjoy a yearly tax deduction in terms of Section 11(n)(aa) of the Income Tax Act.

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