

Legal update

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Retirement fund contributions

Summary

The Taxation Laws Amendment Act No. 31 of 2013 that was published in Government Gazette No. 37158 on 12 December 2013 changes the tax treatment of contributions and aligns the annuitisation requirements between pension, provident and retirement annuity funds. This Legal Update addresses the taxation of retirement fund contributions. Legal Update 4 of 2014 sets out the post-retirement alignment between retirement funds.

From 1 March 2015, employer contributions will be taxed in the hands of the member and the member will get a tax deduction on the total contribution towards retirement funds, subject to an annual percentage and monetary limits.

Current position for retirement fund contributions

There are three types of retirement funds with recurring contributions: pension and provident funds, which are employment-based, and retirement annuity funds, which are retirement funding vehicles for individuals. There are different tax deductions that apply for the contributions to these funds.

	Pension fund	Provident fund	Retirement annuity fund
<i>Deduction on member contribution</i>	Up to 7.5% of **“retirement-funding employment”.	None	Up to 15% of non-**“retirement-funding employment”.
<i>Deduction on employer contribution</i>	Up to 10% of ***“approved remuneration”. In practice SARS allows up to 20%.	Up to 10% of ***“approved remuneration”. In practice SARS allows up to 20%.	N/A

* “Retirement-funding employment” is defined as income consisting of “remuneration” as defined; it is the income taken into account in determining the contributions made by the employee or employer for the benefit of the employee to a pension fund or provident fund.

**Approved remuneration” is defined as follows in section 11(l)(iii) of the Income Tax Act: *so much of the total remuneration accrued to such employee during such year of assessment in respect of his employment by the employer concerned as the Commissioner considers to be fair and reasonable in relation to the value of*

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the services rendered by such employee during such year of assessment to the employer and having regard to other benefits, if any, derived by him from his employment by the employer.

Position from 1 March 2015 for retirement fund contributions

	All retirement funds (pension, provident, retirement annuity)
Deduction on member contribution	Up to 27.5% of the greater of ***remuneration or taxable income, subject to an annual monetary limit of R350 000.
Deduction on employer contribution	Unlimited deduction. Employer contributions taxed as a fringe benefit in employee's hands and deemed to be employee contributions.

***Remuneration refers to the payment made to an employee (their salary) and for the purposes of this calculation will exclude any retirement fund lump sum, lump sum withdrawal benefit or severance benefit. Taxable income is a person's total income, from all sources, less the allowable deductions and exemptions. An employee, who receives a salary from their employer but also has other sources of income, can potentially have a taxable income that is higher than their remuneration. In that case, the maximum deduction will be based on their taxable income instead of just their remuneration.

Employee contributions

From 1 March 2015, the contributions paid by an employer for the benefit of their employee to a retirement fund will be deemed to be an employee contribution and will be taxed in the employee's hands. These contributions however, together with the member's other retirement fund contributions, will qualify for a deduction of up to 27.5% of their remuneration or taxable income, whichever is the higher, subject to an annual maximum of R350 000. By implication, the maximum amount that can be taken into account for calculating the maximum retirement fund contributions in a specific year is R1 272 727. Any contribution over that amount will not qualify as a deduction in that year of assessment, but will be carried forward to future years of assessment, once again subject to the annual limits. Whatever the member is not able to claim as a deduction before leaving the fund, can be claimed as a deduction in terms of the Second Schedule to the Income Tax Act when they leave the fund or alternatively, as a reduction in taxable annuity income. This can be illustrated by way of the following example.

Mark earns a salary of R1 500 000 per annum. He also lets out his property and receives rental of R120 000. His deductible expenses in relation to the property are R150 000. His taxable income of R1 470 000 (R1 500 000 + R120 000 – R150 000) is less than his remuneration of R1 500 000. For purposes of calculating the maximum tax deduction for his retirement fund contributions, he will use his remuneration of R1 500 000.

Mark's defined contribution pension fund's rules provides for an employer contribution of 15% and an employee contribution of 7.5% of his salary. Mark also contributes 5% of his salary towards a retirement annuity fund.

Mark will pay tax on 27.5% (15% employer pension fund contribution + 7.5% employee pension fund contribution + 5% retirement annuity fund contribution). He will pay tax on R412 500 (27.5% of his salary of R1 500 000). He can deduct a maximum of R412 500 or R350 000, whichever is the lowest. He will accordingly only be able to deduct R350 000 in the year of assessment, with the balance of R62 500 rolling over until the next year of assessment. If Mark's taxable income remains the same and the monetary cap does not increase, it will mean that the amount to be rolled over each year will increase by the excess of the specific year of assessment. The total amount rolled over by the time the member leaves the fund, can be deducted from his lump sum before the tax paid on the lump sum is calculated. If the total amount rolled over exceeds the lump sum, the deduction can be made against the member's pension.

While the deduction of employer contributions in a defined contribution fund is fairly straight-forward (being equal to the value of the amount contributed by the employer for the benefit of the employee – the employer contribution), that is not the case in a defined benefit fund. In the latter, the cash equivalent of the amount that the employee can deduct is the total of the value of the employer contribution to the defined contribution component of the fund and the employer contribution to the defined benefit component of the fund in accordance with the formula $X = Y ((A \times AF) + (L \times LF)) - V$ as set out in the newly introduced paragraph 12D of the Seventh Schedule to the Income Tax Act.

Employer contributions

The deduction of the employer contribution is still allowed. In fact, the employer's position as far as the deductibility of contributions towards a retirement fund will be even better from 1 March 2015. The 10% limitation in section 11(l) of the Income Tax Act has been removed. This means that the employer has an unlimited retirement fund contributions deduction; they can deduct whatever they contribute for the benefit of their employees to a pension, provident or retirement annuity fund.

In the example above, Mark's employer will be able to deduct the employer contribution of 15%.

Impact on FundsAtWork

The impact on the average member should not be different from the current position. The combined contribution rate on the FundsAtWork schemes is in the region of 12% and most members' remuneration fall below R1 272 727. Although all members will have to pay tax on their employer contributions from 1 March 2015, and given that these contributions are below the deduction threshold as outlined above, they are expected to qualify for a full tax deduction for those contributions. Their tax position is therefore expected to be tax neutral. Instead of taking out a separate retirement annuity to boost their retirement savings, members may even decide to make additional voluntary contributions to their FundsAtWork Umbrella Pension or Provident Fund and make optimal use of the maximum tax deduction on their retirement fund contributions. Members may even find that making an additional voluntary contribution of 5% does not necessarily mean that their take-home pay will decrease by 5%. Take the following as an example. A member with an annual salary of R240 000 with a marginal tax rate of 25% contributes 10% (R24 000) towards his pension fund. He does not have any other taxable deductions. His taxable income after the deduction of R24 000 is R216 000. The tax payable on that is R54 000, which leaves him with a net salary of R162 000. If that member decides to increase his contribution to 15% (R36 000), his taxable income is R204 000. The tax on that is R51 000, which leaves him with a net salary of R153 000. Although his contribution went up by R12 000 (from R24 000 to R36 000), his take-home pay only dropped by R9 000 (from R162 000 to R153 000), resulting in a tax benefit of R3 000. Members are encouraged to take full advantage of the maximum tax deductions for contributions.

In light of the increased tax deduction on contributions, employers might choose to increase contributions or even to restructure the scheme to only have employer contributions. This will lead to an increase in the number of Special Rules that require amendment. The suggestion is that if employers want to increase their contributions or restructure the contribution rates, they don't wait until 2015 to do so, but rather request the amendments sooner (perhaps towards the last quarter of 2014).

The contribution deductions apply to all contributions made to a fund. They therefore include the administration costs and the costs of the insurance benefits provided by the fund. Where members need a higher percentage of their salary to be allocated towards retirement savings and also need the maximum deduction to apply to their retirement savings, rather than fund-provided insurance benefits the employer might decide to rather choose insurance benefits outside of the fund.

Where an employer does provide separate insurance benefits to their employees, and the premiums for those benefits are included in the employer contribution to a pension or provident fund (otherwise referred to as an inclusive scheme), the employer must make sure that the insurance premium portion of the contribution is taxed correctly. In these cases, the employer cannot allow the employee to claim the total



employer contribution to the fund as a deduction under section 11(k) of the Income Tax Act; the portion of the employer contribution that relates to the employer-provided insurance benefit must be taxed as a fringe benefit in the hands of the employee in terms of paragraph 12C of the Seventh Schedule, with no corresponding deduction. Refer to Legal update 2/2014 for more information on the taxation of employer-provided (group) insurance premiums and benefits.

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