momentum

Legal update

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Retirement fund contributions

This Legal Update must be read together with Legal Update 3 of 2014, issued on 17 January 2014, with the substitution of the date 1 March 2015 with 1 March 2016. It must also be read together with Legal Update 4 of 2016, which looks at the impact of the post-retirement alignment between retirement funds on members and employers.

A. The Amendment Act

The Taxation Laws Amendment Act No. 25 of 2015 that was published in Government Gazette No. 39588 on 8 January 2016 confirms the changes to the tax treatment of contributions and the alignment of the annuitisation requirements between retirement funds from 1 March 2016. This Legal Update looks at the impact of the changes to retirement fund contributions on members and employers.

B. Summary

	Tax effect on member	Tax effect on employer
Employer contribution	Taxed as fringe benefit in member's hands	Gets deduction
Deductions allowed	Member and employer contribution, including approved insurance benefit premiums and administration costs. Administration costs include commission & investment advice fees	Employer contribution
Deduction limit	27,5% of the higher of the member's remuneration and taxable income, subject to a maximum of R350 000 per year	Unlimited
Unapproved insurance benefit premiums	Deduction not allowed. Member pays fringe benefit tax on these premiums	Deduction still allowed

C. Impact on the member

1. All members

- Employer contributions will be taxed as fringe benefits in the hands of the member.
- A member can deduct up to 27,5% of the higher of their remuneration and taxable income, subject to a maximum of R350 000 per year, for both member and employer contributions. These deductions must be taken into account by the employer in each month during which the fringe benefits tax is levied.

2. Pension fund member

No impact on take-home pay if the member's total contributions are below the tax thresholds referred to under paragraph 1.

Currently members get a deduction of up to 7,5% of their retirement funding employment (generally their pensionable salary) on their own contributions, and no deduction on their employer contribution. From 1 March 2016, they will pay fringe benefit tax on the employer contribution, but at the same time get a deduction on both their own and their employer's contributions, subject to the limits referred to in the previous paragraph. This will leave them in the same position as before 1 March 2016, provided the contributions are below the tax thresholds referred to under paragraph 1. This can be illustrated with the following example:

<u>Example 1</u>

Susan's pensionable salary is R100 000 per annum.

Her pension fund contribution is 5% (R5 000 per annum), and her employer's contribution is 10% (R10 000 per annum). There are no other deductible benefits.

Tax position before 1 March 2016: R5 000 was deducted from her R100 000, so she only paid tax on R95 000.

Tax position after 1 March 2016: She pays fringe benefit tax on the employer contribution of R10 000. We add that R10 000 to her pensionable salary of R100 000, to get to a taxable salary of R110 000. At the same time, she gets a tax deduction for both her R5 000 contribution and the employer's R10 000 contribution.

R110 000 – R15 000 = R95 000.

Her position after 1 March 2016 and before 1 March 2016 is the same.

3. Provident fund member

Positive impact on take-home pay.

Currently members do not get an immediate deduction on their own contributions, and also no deduction on their employer contribution. From 1 March 2016, they will pay fringe benefit tax on the employer contribution, but at the same time get a deduction on both their own and their employer's contributions, subject to the limits referred to in the previous paragraph. This will leave them in a better position than before 1 March 2016. This can be illustrated with the following example:

<u>Example 2</u>

Susan's pensionable salary is R100 000 per annum.

Her provident fund contribution is 5% (R5 000 per annum), and her employer's contribution is 10% (R10 000 per annum). There are no other deductible benefits.
Her total cost to company is R110 000 (pensionable salary of R100 000 + employer contribution of R10 000).

Tax position before 1 March 2016: The member contribution was not deducted from Susan's pensionable salary when calculating the member's tax[1], so she paid tax on the full R100 000.

Tax position after 1 March 2016: She pays fringe benefit tax at her marginal tax rate on the employer contribution of R10 000. We add that R10 000 to her pensionable salary of R100 000, to get to a taxable salary of R110 000. At the same time, she gets a tax deduction for both her R5 000 contribution and the employer's R10 000 contribution. Her taxable pensionable salary is as follows:

R110 000 – R15 000 = R95 000.

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[1] A member's own provident fund contributions did not rank for deduction during the years in which the contributions were made

The position after 1 March 2016 is better than the one before 1 March 2016 as far as her take-home pay is concerned; it increases by R900, which is the tax payable on R5 000, calculated at a marginal rate of 18%.

4. Maximum deductions

- If the higher of a member's remuneration or taxable income is R1 272 727 and the contributions for this member are at the maximum of 27,5%, he will reach the maximum allowable deduction of R350 000. 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 under the Second Schedule to the Income Tax Act when they leave the fund or alternatively, as a reduction in taxable annuity income.
- If the contributions for this member are at a rate lower than the maximum allowable contribution rate of 27,5%, he can have a higher pensionable salary before reaching the maximum allowable deduction of R350 000.

5. Boosting retirement savings

Instead of taking out a separate retirement annuity to boost their retirement savings, a member may decide to make an additional voluntary contribution (AVC) to their FundsAtWork Umbrella Pension or Provident Fund and make optimal use of the maximum tax deduction on their retirement fund contributions. A member may find that an AVC 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 pensionable salary of R240 000 contributes 10% (R24 000 per annum) 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 following applies under the tax table for the 2016 tax year (1 March 2015 to 29 February 2016):

Taxable income (R)	Rates of tax (R)
181 901 - 284 100	32 742 + 26% of the amount above 181 900

The tax payable would then be R28 351, calculated as follows:

Basic tax under the current tax table	R32 742
plus	
26% on R34 099 (R216 000 – R181 901)	R 8 866
Total	R41 608
minus	
Primary rebate	R13 257
Total	R28 351

This leaves the member with a net salary of R187 649.

If that member decides to increase his contribution to 15% (R36 000), his taxable income is R204 000. Using the same basis for the calculation as the one above, the tax on that is R25 230, which leaves him with a net salary of R178 770. Although his contribution went up by R12 000 (from R24 000 to R36 000), his take-home pay only dropped by R8 880 (from R187 650 to R178 770), resulting in a tax benefit of R3 000. (For convenience, amounts have been rounded. The amounts in this and the previous example will be different if the tax tables for the 2017 tax year differ from the current tax tables).

Members should consider taking full advantage of the maximum tax deductions for contributions, in consultation with their financial adviser.

D. Impact on the employer

1. Payroll

- The employer must align its payroll system to tax the employer contributions as a fringe benefit in the hands of the members.
- The employer must make sure that their payroll service provider changes the following on the members' tax certificates (IRP 5 & IT3(a)):

Old	New
Deduction limits linked to "retirement funding income" or "non-retirement funding income"	Deduction limits linked to "remuneration" and "taxable income"
Employer contributions to pension or provident funds not reflected	Reflect all employer contributions as a fringe benefit
Only reflected member contributions as a deduction for pension fund members	Reflect deductions on both member and employer contributions, for pension and provident funds

- Be on the lookout for the new Business Requirement Specification (BRS) with the new codes and validations to be released by the South African Revenue Service (SARS). This will assist employers in issuing the relevant IRP5 and IT3(a) certificates.

2. Pension and provident funds: deductions

- The employer must allow the employer's and employee's pension or provident fund contribution as a deduction from the member's remuneration every month in terms of paragraph 2(4)(*a*) of the Fourth Schedule to the Income Tax Act. This paragraph reads as follows:

  (4) The amount required to be deducted or withheld from any remuneration under this Schedule by way of employees' tax must be calculated on the balance of the remuneration remaining after deducting therefrom-

  (a) any contribution by the employee concerned to any pension fund or provident fund which the employer is entitled or required to deduct from that remuneration, but limited to the deduction to which the employee is entitled under section 11(k) having regard to the remuneration and the period in respect of which it is payable;

- The employer still gets a deduction on its contributions to a pension and provident fund. In fact, the employer's position as far as the deductibility of contributions towards a retirement fund will be even better from 1 March 2016. The 10% limitation in the Income Tax Act has been removed. This means that technically the employer has an unlimited deduction on retirement fund contributions; they can deduct whatever they contribute for the benefit of their employees to a pension, provident or retirement annuity fund, as long as the South African Revenue Service does not regard the contribution to be excessive in relation to the duties performed by the employee.

3. Pension and provident funds: scheme structure

There is no reason for the employer to change the contribution structure on a pension or provident fund to, for instance, only allow for member contributions. If the employer does that, both the member's and the employer's position will be the same.

If in example 2 above, the scheme structure is changed to also categorise the employer contribution as a member contribution, the tax position will be as follows:

The employer's contribution of R10 000 is added to Susan's pensionable salary of R100 000. Her pensionable salary is now R110 000.

Susan gets a tax deduction for her R15 000 contribution.

R110 000 – R15 000 = R95 000.

Her net position remains the same.

The employer's net position is also the same. Since there is no employer contribution, there is also no deduction for the employer. But, if the employer is not contributing to the member's pension or provident fund, it begs the question why the employer should involve itself in the member's retirement provision at all. If the answer to the employer's question of "what's in it for me?" is "nothing", then the employer might not even want to provide this benefit to their employees.

4. Pension and provident funds: insurance benefits

- The contribution deductions apply to all contributions made to a retirement fund. The deductions include the administration costs (which includes commission and the investment advice fee) and the costs of the insurance benefits provided by the fund (approved insurance benefits). Before 1 March 2016, employer contributions to medical aid schemes were also claimed as a deduction under section 11(l), but from 1 March 2016 they will be deductible in terms of the general deduction section. 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, the employer might decide to rather choose insurance benefits outside of the fund (unapproved insurance benefits). This decision might also be influenced by the taxation of the unapproved insurance benefits; if the employer paid premiums on behalf of its employees, these premiums will be subject to fringe benefits tax in the hands of the employees, and the benefits will be tax free. Also, unapproved insurance death benefits are not subject to Section 37C of the Pension Funds Act and can potentially be paid out quicker. Section 37C sets out how the trustees have to pay out a benefit to the beneficiaries of a member that has passed away.
- Where an employer provides separate insurance benefits to their employees through employer-owned group policies, the members have to pay tax on the premiums. From 1 March 2015, no tax deductions were allowed for any of these premiums.

  If the premiums for these insurance benefits are included in the employer contribution to a pension or provident fund (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 can't 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 under paragraph 12C of the Seventh Schedule, with no corresponding deduction. The following example illustrates this:

	Taxable in member's hands	Deduction allowed	Deduction not allowed
Member contribution	5%	5%	
Employer contribution of 10%, is made up of			
• retirement savings contribution	6%	6%	
• administration costs (including commission and investment advice fee)	1%	1%	
• death insurance benefit provided by the fund (approved)	1%	1%	
• employer-owned disability benefit (unapproved)	1%		*1%
• employer-owned funeral benefit (unapproved)	1%		*1%
TOTAL	15%	13%	*2%

* Although it will not be allowed for the member, the employer will still qualify for a deduction.

5. Retirement annuity funds

- The employer may elect to allow a deduction for the member's contributions to a retirement annuity fund if the payment of the contribution is not facilitated by the employer, in terms of paragraph 2(4)(*b*) of the Fourth Schedule to the Income Tax Act. The employer should only do this if they are convinced that the member has actually paid the contribution. It will, for instance, not be prudent for the employer to make monthly deductions on the strength of a document stating what the member's contributions for that year will be. If on the other hand, the member gives the employer a statement at the end of the tax year, reflecting what their contributions for that tax year were, the employer could (but does not have to), allow for the deductions, subject to the overall allowable maximums of 27,5% or R350 000, whichever is the lower.
- Where the employer makes the retirement annuity fund contribution on behalf of the employee, the employer must take those contributions into account under paragraph 2(4)(*b*A)) of the Fourth Schedule to the Income Tax Act.

6. Defined benefit or hybrid fund

- The fringe benefit in a defined contribution fund is the amount that the employer contributes for a specific member. If a pension, provident or retirement annuity fund has a fund member category that is entitled to benefits consisting of components other than only defined contribution components, in other words, if the fund is a defined benefit fund or a fund that has elements of both a defined contribution and a defined benefit fund (hereinafter referred to as a hybrid fund), it's not so simple. In this case the fringe benefit calculation for this fund member category has to be done by the fund's valuator, using a prescribed formula. This formula is set out in paragraph 12D of the Seventh Schedule to the Income Tax Act. The Minister of Finance has also issued regulations prescribing how the fund must determine all fund member category factors. These regulations were published as No. R. 17 in Government Gazette No. 39582 on 7 January 2016.
- A defined benefit fund or a hybrid fund must provide a contribution certificate to the employer for his employee-members. This must be done by no later than one month before the commencement of the year of assessment, in other words by the end of January, or, where the fund rules are amended and it affects the members' benefits, no later than one month after the effective date of the amendment. Affected employers must make sure that they get these certificates so that they know which fringe benefit to apply for the members concerned.

7. Action steps

- How does the employer ensure that all of these things are done correctly? Firstly, they should consult with their pay-roll administrators to see whether they can accommodate these changes. Secondly, they should liaise with their financial adviser regarding possible changes to their employee benefits structure. They need to consider whether the insurance benefits that they provide still meet the needs of their employees and also take into account that members might want to increase their contributions towards their retirement fund to boost their retirement benefits. This can be done in three different ways:
  i. Increase the pensionable salary. Typically, the salary on which employment-based retirement fund contributions is based, is around 80% of the member's remuneration. The fund rules usually don't specify what this level should be, so if the employer, in consultation with the members, decide to increase this, it would not require an amendment to the fund rules or the scheme's special rules under the FundsAtWork Umbrella Fund.
  ii. Increase the contribution rates. The average combined member and employer contribution rates is around 10%. Taking into account the annual deduction limit of R350 000, there is a significant opportunity for maximising the allowable deductions of 27,5%. If the employer decides to change the contribution rates, it would require changes to the fund rules or the

scheme's special rules under the FundsAtWork Umbrella Fund. To avoid a bottleneck, employers should request these rule changes well in advance.

iii. Additional voluntary contributions (AVCs). Members should be encouraged to make AVCs to their pension or provident funds, as these contributions will qualify as a deduction in the same month, provided that it is under the annual deduction limit of 27,5% or R350 000, whichever is the lower.

- Where the employer chooses to increase contributions or restructure the retirement scheme, they should advise the fund as soon as possible so that the relevant rules can be changed in time.

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