Reduce Tax Impact on Employee Compensation Through Retirement Benefit Schemes

Presentation to Pakistan Society of Human Resource Management

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Composition of Employee Compensation

- Amounts Paid in Cash (including salaries)
- Benefits
  - Includes Retirement Benefits
- The value of retirement savings is unfortunately not often appreciated by younger employees
  - However this is a very important part of overall compensation, especially as the family unit (children supporting parents model) is under stress, both from a family value perspective as well as due to children often being away from where parents live
- There is also significant tax advantages which the retirement benefits part of overall compensation has over other forms of emoluments

Contents of Presentation

- This presentation focuses on the taxation aspects of retirement schemes
- However it is necessary to briefly focus on the need for retirement savings and the forms which are prevalent in Pakistan

Sources of Retirement Income

International retirement benefit models identify three major sources for the provision of retirement income

Government provided social security

Employer Provided Benefits / Occupation Schemes

Personal Savings

The Needs of Employees

- The table summarizes the risks an employee faces and benefit plans that may be available to meet those needs:

Category of Risks / Needs	Group Life	Group Acc.	Medical Expense	PF	Gratuity	Pension	Benevolent Funds
Death	✓	✓			✓	✓	✓
Disability		✓			✓	✓	✓
Medical expenses		✓	✓				
Retirement				✓	✓	✓	
Capital Accumulation				✓	✓	✓	

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Medical expenses		✓	✓				
Retirement				✓	✓	✓	
Capital Accumulation				✓	✓	✓	

Design Considerations

- Retirement schemes need to be designed so as to give a Reasonable Replacement Ratio (RRR) for a reasonably long period of service such as 25 to 30 years. Factors which impact the determination of how much include
  - Market practices – industry and benchmark
  - Cash vs. Deferred compensation objectives?
  - HR retention policy for different categories of people (PF vs. Gratuity vs. Pension – vesting schedules)
  - Union negotiations
- In general terms there needs to be higher RR for lower paid and vice versa

Types of Schemes

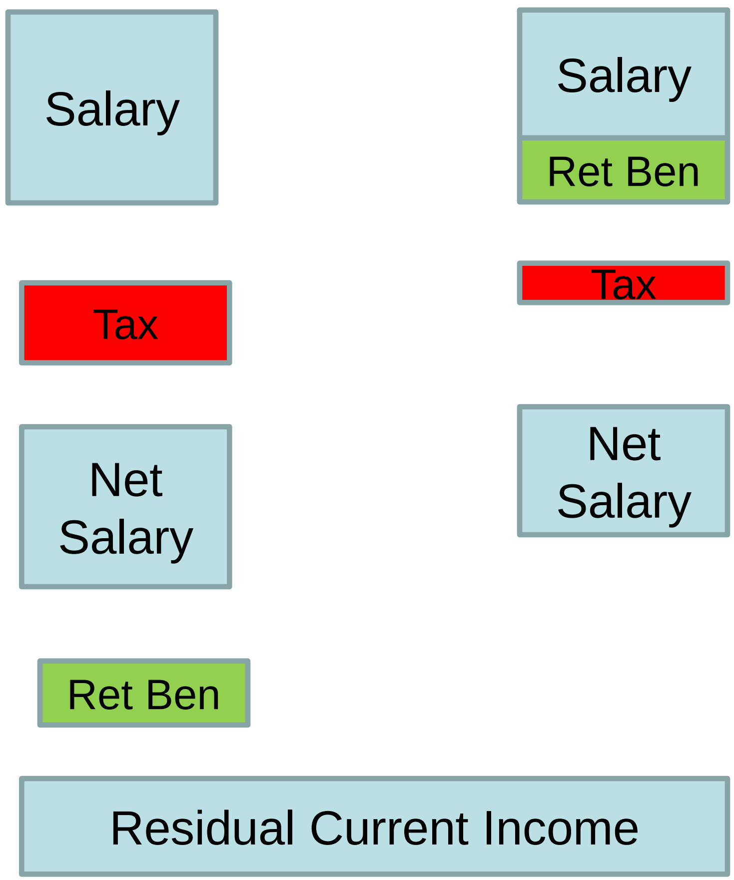
Retirement Benefit Plans can be segregated into two broad categories:

- Defined Benefit (DB) Plans: where the benefit may be defined as a multiple of years of service and salary. Includes
  - Gratuity Schemes – lump sum benefit
  - Pension Schemes – retirement income (with some commutation)

- Defined Contribution (DC) Plans: where the benefits are determined by contributions to a fund together with investment earnings thereon.

Although defined benefit schemes are obviously more appropriate from an adequacy of employee benefit perspective, due to their high (and often difficult to control) cost aspect these are slowly fading away.

Tax Impact



- The tax benefits of retirement schemes emanate mainly from the fact that, if designed properly and funded the cost is deductible for tax purposes

- Post salary retirement savings schemes also have some tax benefits but these are not as efficient as will be discussed later

Introduction

If designed properly retirement schemes are :

- The employer contribution is tax **exempt**;
- The investment income is tax **exempt**; and
- The benefit amount received at the end is also tax **exempt**.

Schemes such as those under the Voluntary Pension Fund Rules also exist where employees choose to save themselves. In this case:

- The employee contribution has a tax credit – however based on average tax rate and therefore not as beneficial as the corporate tax rate exemption in the case of employer sponsored schemes;
- The investment income is tax **exempt**; but
- The benefit is taxable (albeit at a lower rate if the benefit is taken post retirement).

Gratuity Benefit Scheme (GBS)

- **<u>Employer's perspective:</u>**

- For an approved and funded scheme, annual contributions up to a maximum of 8.33% of basic salaries of the employees qualify as admissible expenditure that are exempt from tax.

- In contrast, annual provisions made in an approved but unfunded scheme are not regarded as tax-exempt expense; however, the actual payments to departing employees are allowed as an admissible expense.

- For an unapproved and unfunded scheme, gratuity payment is tax deductible in the hands of the employer.

- Further, as mentioned above, the expected return on plan assets of a funded scheme tend to offset the interest cost element of gratuity expense and hence help to reduce the cost for the next year.

Gratuity Benefit Scheme (GBS)

- **<u>Employee's perspective:</u>**

- Any amount received by an employee from a funded scheme is exempt from tax.

- As against this, gratuity received under an approved but unfunded scheme are exempt from tax up to a maximum of Rs. 200,000. Any amount received in excess of Rs. 200,000 is subject to tax at the preceding 3 years' average tax rate.

- For an unapproved and unfunded scheme, the maximum limit for tax exemption is Rs. 75,000, or 50% of the amount received, whichever is less. The balance is taxable at 3 years' average rate of tax.

Provident Fund Benefit Scheme (PF)

- **<u>Employer’s perspective:</u>**

- For an approved provident fund scheme, monthly contributions are up to a maximum of 10% of basic salaries of the employees qualify as admissible expenditure that are exempt from tax. The return earned on the investments of the provident fund scheme is fully exempt from tax.

- *There is a limit of Rs. 100,000 on the “exempt” contribution, so that employer contributions up to Rs. 100,000 would be exempt.*

- **<u>Employee’s perspective:</u>**

- Employees contributions are on after Tax salaries

- Amount received by an employee from a provident fund scheme at the time of retirement is exempt from tax.

- Maximum interest that can be credited in a year is 16% of the overall fund value. A higher rate would attract taxes. However the method of accruing interest is not defined in the rules.

Provident Fund Benefit Scheme (PF)

- Employer contributions may not exceed the employees contribution. So there can be a case where employee is contributing say 5% towards the PF but the employer is contributing nothing, such schemes are called General Provident Fund. However the reverse is not possible.

- Employees have an option to make additional contribution to the fund. Since the employees contribute from after tax income, they do not get any tax benefits on the additional contributions. However, the income earned on PF is tax exempted, so employees can earn tax free income on additional contributions.

- There are two types of withdrawals as per the rules, one is Permanent Withdrawal (PW which is non-repayable); the other is Temporary Withdrawal (TW) loan which the employee has to repay. Laws have clearly stated on which condition employees are eligible for PW’s and on what conditions for TW’s. The maximum period for which TW is allowed is 4 years.

- The interest to be charged on TW’s could either be one of the two options, at the discretion of the Trustees:

    - 1% higher than last audited rate; or
    - Flat 16% for the entire loan tenure

Pension Fund Benefit Scheme

- **Employer's perspective:**

- For an approved and funded scheme, annual contributions up to a maximum of 20% of basic salaries of the employees qualify as admissible expenditure that are exempt from tax.

- In contrast, annual provisions made in an approved but unfunded scheme are not regarded as tax-exempt expense; however, the actual payments to departing employees as lump sum commutation and monthly annuity for life are allowed as an admissible expense.

- The expected return on plan assets of a funded scheme tend to offset the interest cost element of pension expense and hence help to reduce the cost for the next year.

- **Employee's perspective:**

- Any amount received by an employee from an approved scheme at the time of retirement and monthly annuity for life is exempt from tax.

Private Retirement Savings

- Various forms exist (where some tax credit on contributions given)
  - VPS
  - Life insurance policies
  - Investment in mutual funds
- These cannot, however, compare with employer sponsored schemes as significant charges are built in
  - Hence the value to employees is always considerably less than those of employer sponsored schemes
- VPS also has a tax disadvantage as discussed earlier

Comparison of Retirement Benefits

Particulars		Gratuity (DB)	Provident Fund (DC)	Pension (DB)	VPS (DC)
Contribution by employer	Benefit to employer	Allowed as deductible expense (upto 8.33% of basic salary)	Allowed as deductible expense (upto 10% of basic) subject to a max Rs. 100,000	Allowed as deductible expense (upto 20% of basic)	Allowed as deductible expense (upto 20% of basic)
	Benefit to employee	Not included in taxable income	Not included in taxable income	Not included in taxable income	Included in taxable income, tax credit allowed on same

Comparison of Retirement Benefits

Particulars		Gratuity (DB)	Provident Fund (DC)	Pension (DB)	VPS (DC)
Contribution by employee	Benefit to employee	If any, included in taxable income	Included in taxable income	If any, included in taxable income	Tax credit allowed subject to certain restrictions
At time of profit credit	Benefit to employee	No taxability on employees	No taxability on employees (subject to a ceiling on the rate of income being credited)	No taxability on employees	No taxability on employees

Comparison of Retirement Benefits

Particulars		Gratuity (DB)	Provident Fund (DC)	Pension (DB)	VPS (DC)
At time of redemption / payment of accumulated balances	Benefit to employee	Payments from approved funded scheme are fully exempt. Payments from approved unfunded scheme are exempt upto Rs. 200K. Payments from unapproved unfunded scheme are exempt upto Rs. 75K	Accumulated balance payable to an employee from a recognized provident fund is fully exempt	Monthy Pension is fully exempt One time lump sum Commutation is also fully exempt from approved pension scheme	25% lump sum exempt on death, disability, retirement. Withdrawal in excess of 25% or before retirement are taxable. Monthly annuity payment is also taxable at last 3 yrs avg tax rate

Thank You