Conversion of a Gratuity Benefit to a Registered Retirement Benefits Arrangement and the Advantages

The main consideration and concern for both employer and employees in converting/transferring the Gratuity accrued to the employees into a Registered Retirement Benefits arrangement centers on the tax treatment of these amounts. There are various options available for treating of taxation on Gratuity conversion/transfer into a Registered Retirement Benefit Arrangement.

We shall also take a look at the advantages of the Registered Retirement Benefits arrangement over the Gratuity arrangement

A. Introduction

Gratuity, as you already know, is normally taxable as employment income. However, by the *legal notice No 82of 2010*, it was provided that effectively, any conversion and payment of gratuities into a registered pensions or provident fund, will enjoy a tax free benefit. This was intended to defer taxation on some of the gratuity as long as it is to be transferred into a Registered Retirement Benefit Scheme**.** The tax free amount is currently at **Kshs 240,000 per year of income per employee**.

The change in the law, in essence provides that, for an employer who sets up or joins a Registered Retirement Benefit Scheme and transfers or pays the intended gratuities into the scheme as part of its employees contribution, they allow their employees to enjoy the tax free benefits associated with being a member of a Registered Retirement Benefit Scheme.

It should also be noted that for all intents and purposes, saving for retirement is being encouraged and advised by the government hence the various tax benefits accorded a member of a Registered Retirement Benefit Scheme and also an Employer contributing in respect of his Employees.

An important point to note is that the scheme member accounts in the scheme are strictly on **cash basis**. This implies that the individual member account is only credited if and when the funds in respect to the member are actually received from the employer. This concept is to ensure that a member's benefits are fully represented/ funded.

B. Tax Treatment

The new law did not in any way change the way gratuities are taxed but rather, it only sought to introduce an allowable deduction in respect of conversion / transfer of gratuities into a registered retirement benefit scheme. Under section 5(2) of the Retirement Benefits Act provision, gratuities are taxable over a five year period spread backwards. Under the new provision in section 5(4), the tax free allowance will be against each of those back years where the gratuities will be taxed.

Scenario 1

If the beneficiary of the Gratuity opts to convert/transfer all of his/her gratuity into a Registered Retirement Benefit Scheme, then the gratuity will enjoy a tax free benefit of up to Kshs 240,000 per year per employee and applicable to for five years of the gratuity spread.

Illustration:

Considering that an employee's gratuity of Kshs 4,000,000 which is in respect of 8 years of service and is payable on 30th June 2012, ordinarily, this would be spread backwards at the rate of KShs 500,000 per annum (4,000,000/8) and will thus be taxed as follows:

2011 – Kshs 500,000

2010 – Kshs 500,000

2009 – Kshs 500,000

2008 – Kshs 500,000

2007 - Kshs 2,000,000,

all these amounts being taxed fully alongside any other employment income for the beneficiary.

If however, the beneficiary of the Gratuity decides to remit the entire Gratuity into a Registered Retirement Benefit Scheme, the amounts will be taxed as follows:

Year of Taxation	Gratuity Spread Amount(KShs)	Amount transferred into registered RBS(KShs)	Taxable Amount(KShs)
2011	500,000	240,000	260,000
2010	500,000	240,000	260,000
2009	500,000	240,000	260,000
2008	500,000	240,000	260,000
2007	2,000,000	240,000	1,740,000

The amounts, having been transferred into the scheme, will be treated as if they are contributions made into the scheme by a member. The cumulative tax free amount of Kshs 240,000 is treated as a **Tax Exempt** contribution and the remaining taxed amount is treated as a **Non- Tax Exempt** amount.

Scenario 2

However, another scenario may arise where the beneficiary may choose to withdraw part of the gratuity in cash and transfer the other part into a Registered Retirement Benefit Scheme. "Sadly" most beneficiaries take this option loosing out on the tax benefits envisaged. Here, it should be noted that only the portion of gratuity that is converted/ transferred into the Registered Retirement Benefit Scheme enjoys the tax free amount of Kshs 240,000. The withdrawn portion is taxed ordinarily as part of employment income.

C. Transfer of Gratuity Into the Registered Retirement Benefit Scheme

Option 1

Since the gratuity is unfunded, it may provide cashflow challenges if the company is asked to transfer the whole amount as a one-off lump sum into the scheme. This then gives that, as the employer, having expressly provided and documented, may opt to pay in defined installments into a the beneficiary's scheme account the amount of gratuity due to him/ her over a specified period of time. If this is the case, then it is safe to advice that the installments will also enjoy the tax free lump sum of up to Kshs 240,000 per annum or Kshs 20,000 per month if the installments are made on a month on month basis.

Option 2

If the employer is able to transfer the total accumulated amount of the gratuity into the beneficiaries scheme accounts, then it will be a typical either Scenario 1 or Scenario 2 will be used to determine the taxable amounts and the amounts to be transferred to each members' scheme account.

The employer should;

- ensure that the Employees are well informed of the position and all the options available to them. (*a separate gratuity termination agreement between the Employer and Employee will be provided when necessary*)
- terminate the gratuity arrangement and compute each employee's accumulated gratuity to the date of termination,
- ensure that the terms of employment are in line with the RBA rule on eligible Employees where the taxation position on contributions will be subject to limits under section 22A of the income tax act and,
- apply to the KRA and have the gratuity payment crystallized at an effective date if the gratuity is to be paid in installments. This is to ensure that the 5 years that the tax free amount is attributed do not lapse before completion of the payment of the gratuity installments.

D. Advantages of Registered Retirement Benefit Scheme Over Gratuity

i. Tax Advantages

Gratuities, on payment, are treated just as another part of the employment income for the Employee. It will be taxed under the applicable PAYE rates and no tax benefits are considered.

Registered Retirement Benefit arrangement on the other hand enjoy a two fold tax advantage;

a) on contribution, the amounts contributed into a Registered Retirement Benefit Scheme attract a tax free amount of up to Kshs 240,000 per year or Kshs 20,000 per month.
b) on withdrawal, the amounts withdrawn attract a tax free amount of Kshs 60,000 per annum for a full year of membership in a Registered Retirement Benefit Scheme. this is however, subject to a maximum of 10 years, Kshs 600,000
c) the investment income accumulated for the Tax exempt portion of the contributions is tax free.
d) any amounts paid by an employer in respect of its employees' into a registered RBS s retirement benefits contributions are treated as a tax allowable expense in the company's books of account.

ii. Secure future after employment

Gratuities are paid to an employee after the end of an agreed period even if it is during the productive years of the employee, pensions on the other hand will ensure that an Employee enjoys some income once he/ she is past the 'productive" age and at home on retirement.

Studies have shows, and from pensions management experience that the monthly pensions contributions made by a member during his/her employment period may seem trivial in the short-term but in the long-term, accumulate a value at least equivalent to and probably greater than a gratuity amount fit to sustain a more than decent lifestyle.

iii. Sound investment and management

Gratuities, once paid out to an Employee, the benefit amount is for the Employee to invest/use as he/she deems fit. Without proper planning and sound knowledge or acumen for investments, the amount can end up being "misused"

Registered Retirement Benefit arrangement contributions made during the employment period are well invested by well trained Investment Managers e.g. Old Mutual Asset Managers and subject to the close supervision of the Pensions Regulator, RBA, and other key players in the pensions industry. This guarantees that the contributions made will be experiencing an investment growth as the Contributor sits back and watches.

E. Conclusion

For both the Employer and Employee, the transfer of benefits into a **Registered Retirement Benefit Scheme** is a safe and encouraged option. The tax free benefits derived from membership and subsequent contribution to a registered RBS are an advantage not to be dismissed

The tax free benefit on the gratuities can only be enjoyed if and only if the gratuities are in fact transferred into a registered RBS.

Since the gratuities are unfunded, a one-off lump sum payment in respect of all the employees may prove difficult. However, an arrangement can be reached upon and documented to detail how these amounts will be remitted into individual member scheme accounts. This documented arrangement must then be lodged with the KRA and RBA as proof of level of compliance.

In addition, the full amount of gratuity is an allowable tax expense to the employer regardless of the payment procedure and options.