Tax Avoidance Using Early Pension Voluntary Contributions Withdrawals

Background

After only 13 years of far-reaching pensions law reform, the assets under management by the pension fund management industry are today roughly 85% of the Federal annual budget in value.

Employees and employers to which the Pension Reform Act, 2014 (the "**Act**") apply are commanded to contribute to the contributory pension scheme ("**CPS**") 8% and 10% of the employee's monthly emoluments respectively ("**Compulsory Contributions**") for remittance to the employee's retirement savings account ("**RSA**"). Section 4(1) the Act. In addition, the Act provides for voluntary contributions to the RSA ("**VC**") whereby in addition to the Compulsory Contributions, the employee may make additional contributions to his RSA from his/her monthly emoluments. Section 4(3) the Act.

A primary characteristic of a VC is that it is deducted from the employee's salary before tax and is thus not subject to the imposition of tax under the Personal Income Tax Act ("**PITA**"). Further, employees making VCs have historically been at liberty to decide the amount and frequency of the VCs, say monthly, quarterly, bi-annually or annually. In addition, the Act does not prescribe any specific limits or conditions for the withdrawals of VC. While contributions to RSA form part of tax deductible expenses in the computation of tax payable by an employer or employee under the relevant income tax law (s. 10 of the Act), only the interest earned on any VC, not the principal amount, is subject to tax at the time of withdrawal and then only where such withdrawal is made within 5 years from the date the voluntary contribution was made. Section 10(4) of the Act. Accordingly, VC contributors, by withdrawing the principal amount even before the 5-year can enjoy some tax relief with the same not being reversed or duly accounted for.

The aforementioned features of VC have made VC an attractive tax avoidance mechanism to employees and employers alike. Indeed, many employees have taken advantage of this incentive to put away a significant portion of their income as VCs, thereby taking away such income from the purview of PAYE tax, and, thereafter, within a short while, proceed to withdraw the same in a manner suggesting that such VCs were made primarily to avoid payment of PAYE. This has not gone unnoticed by the regulators and tax authorities.

New Tax Regulations

Against the backdrop of this, both the Joint Tax Board ("**JTB**") and the Lagos State Internal Revenue Service ("**LIRS**") on the same day, August 21, 2017, issued separate notices seeking to clarify the tax treatment of VCs. By the LIRS notice, majorly premised on the provisions of 10(1) and 16 of the Act, the LIRS stated that:

a. any repayment made by a pension fund administrator ("**PFA**") to individuals that does not meet the relevant conditions in Section 16 of the Act[1] will be considered to fall outside the tax exemption granted in Section 10(3)[2] of the Act;

b. it will periodically audit withdrawals of voluntary contributions authorized by the respective PFAs and will rely on the provisions of Section 17 of the PITA[3] to make adjustments where it deems such a transaction fictitious or artificial;

c. it will enforce the law with respect of the recovery of tax due which shall include, but not be limited, to interest and penalties; and

d. individuals claiming tax relief on VCs will be required to annually, submit alongside their income tax return, a copy of their RSA account statements for the relevant tax year and any other period requested by them.

The JTB notice on the other hand, was made on the legal backdrop of s. 5(8) of the Labour Act which states that "*notwithstanding any other provisions of the Act, the total amount of deductions that may be made from the wages of a worker in any one month shall not exceed one third of the wages of the worker for that month*". On this basis, the JTB limited the aggregate of Statutory Contributions, VCs and any other deductions to an amount not exceeding one-third of the employee's salary. By the notice, the JTB equally reiterated their reliance on Section 16 of the Act and Section 17 of the PITA.

Constitutional Challenges

(These two notices are at least suspect). Neither the JTB nor the LIRS is constitutionally permitted to amend the provisions of a statute or even make pronouncements or regulations that have the effect of varying provisions of statutes as a matter of law. The PITA sets out the functions of the JTB and a State Board of Internal Revenue ("**State BIR**") whose membership includes the State BIR of all states of the Federation. Section 86 of the PITA provides that the JTB shall "exercise the powers or duties conferred on it by the express provision of the PITA"; "use its best endeavours to provide uniformity both in the application of the PITA, and in the incidence of tax on individuals throughout Nigeria"; and "<u>impose its decisions on matters of procedure and interpretation of the PITA on any State for purposes of conforming with the agreed procedure or interpretation</u>"

[1] The conditions include that (a) an employee shall not be allowed to make a withdrawal from his RSA before attaining the age of 50 years; (b)where the employee retires, disengages on the advice that the employee is no longer capable of carrying out the function of his office, due to total or permanent disability before the age of 50 years in accordance with the terms of his engagement, (c) an employee who disengages or is disengaged from employment before the age of 50 years is unable to secure another employment within four (4) months, may make withdrawals from the RSA.

[2] This provision explicitly stated that any amount payable as a retirement benefit under the Act shall not be taxable.

[3] This provision is to the effect that where a tax authority believes that any transaction which reduces or would reduce the amount of tax payable is artificial or fictitious, the tax authority may disregard the transaction or direct that such adjustments be made as respects the income of the individual as the tax authority considers appropriate so as to counteract the reduction of liability to tax effected or reduction which would otherwise be affected by the transaction.

(emphasis supplied). Section 88 of the PITA provides that the State BIR is required to "ensure the effective and optimum collection of all taxes and penalties due to the Government under the relevant laws" and "make recommendations, where appropriate to the Joint Tax Board on tax policy, tax reform, tax legislation, tax treaties and exemption as may be required from time to time". These respective functions do not extend to enacting or varying laws but providing policy explanatory statements that will guide the effectuation of existing laws. Where however, policy statements of the State Board of Internal Revenue conflict with that of the JTB, that of the JTB will take precedence over that of the State BIR to the extent that such policy complies with applicable law as the JTB is mandated to ensure that it uses its best endeavours to provide uniformity in the application of the PITA across the states of the Federation.

Interpretation Challenges

Although seeking to address the tax avoidance mischief with VCs, the LIRS and the JTB notices are premised on flawed interpretations of the respective statutes that the LIRS and the JTB sought to rely on. Firstly, in relation to the JTB notice, the application of the Labour Act is restricted to blue-collar workers and does not extend to persons exercising administrative, executive, technical, or professional functions,[4] thus the restriction on the aggregate allowable deductions can apply only to blue-collar workers.

Secondly, s. 16 of the Act does not apply to VCs (as provided for in section 4(3) of the Act) but to Compulsory Contributions only. Further, returns, interest and income earned on VC withdrawals are only subject to tax when withdrawals are made within 5 years (s. 10(4) of the Act). Accordingly, the imposition of tax on all withdrawals made from the VC as indicated in both notices would be inconsistent with s. 10 of the Act.

Reliance should have been placed instead on section 17 of PITA as it provides a more concrete basis for the aims of the tax authorities. Section 17 of the PITA provides that where a tax authority believes that any transaction which reduces or would reduce the amount of tax payable is artificial or fictitious, the tax authority may disregard the transaction or direct that such adjustments be made as respects the income of the individual as the tax authority considers appropriate so as to counteract the reduction of liability to tax effected or reduction which would otherwise be affected by the transaction. On the basis of section 17 of PITA, the voluntary contributions can be analyzed, and where found wanting, classified as fictitious and/or artificial and the tax authority can proceed to make the necessary adjustments thereon.

New Pension Regulations

A better approach to dealing with the issue of early withdrawals of VCs has come from PENCOM. Following the earlier release of draft guidelines to PFAs and pension fund custodians ("**PFCs"**), PENCOM, on November 16, 2017, released a final circular titled "Withdrawals from Voluntary Contributions" which will become effective on December 1, 2017 (the "**Circular**"). The Circular amongst others state that:

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[4] Section 91(1) of the Labour Act, (definition of *"worker"*). *Evans Bros. (Nig.) Pub, Ltd. v. Falaiye* (2003) 13 NWLR (Pt. 838) 564.

a. VC withdrawals should only be made once in two years and subsequent withdrawals shall be based only on additional contributions made into the RSA after the date of the last withdrawal;

b. VCs should be segregated as (i) 50% as contingent accessible for withdrawal within the 2-year period and (ii) the remaining fixed as pension and accessible upon retirement;

c. in accordance with section 10(4) of the Act, interest earned on withdrawals made before the expiration of the 5-year period with be subject to the imposition of taxes;

d. exempted contributors, which include members of the armed forces, intelligence and secret services of the Federation, who make VCs are permitted to withdraw all of the VCs made once every two years, provided however that both the principal and interest are subject to tax where the withdrawals are made within five years of the contribution;

e. in compliance with s. 10(1)(a) of the Money Laundering (Prohibition) Act, 2011 (as amended), PFAs and PFCs are required to report all VCs in excess of ₦5,000,000 in a single transaction or lodgement;

f. all tax deductions made pursuant to the Circular is required to be remitted to the relevant tax authorities within 21 days of the end of the month of deduction and render returns of such remittance to the PENCOM on a biannual basis.

In principle, PENCOM has stated that VC accounts are non-obligatory means of enhancing one's retirement benefits and going forward, should not be operated as if they are bank savings accounts.

The Circular will in no small measure tackle the mischief of tax avoidance through VCs and the government would have plugged another loophole for tax leakages especially in view of the governments drive to enhance its non-oil revenues.

Contact

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