GRAYISSUE

February – the end of the tax year and the opportunity to make use of tax breaks from retirement annuities

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Retirement annuity funds (RAs) offer tax incentives to encourage individuals to save for their retirement. As February signals the end of the tax year, it is also the last opportunity for the year to make use of retirement annuity tax breaks. This may be particularly relevant if:

- You have contributed less than the maximum tax deductable amount.
- A large portion of your income is variable and this is not taken into account with your current pension or provident fund contributions, e.g. you received a bonus.
- You are not a member of a pension or provident fund (e.g. you are self employed) and want to save for retirement.

RAs have a number of clear benefits that make them very attractive investment vehicles. In addition, RAs that give you access to a range of unit trusts offer increased flexibility, choice and value for money.

Growth is generated on pre-tax money and benefits the investor via attractive tax breaks at retirement

RAs essentially defer tax until retirement. Contributions to an RA are tax deductible to the greater of R3 500 or 15% of your non-retirement funding income (see text box) and therefore, within these limits, use pre-tax money. Investment growth is then generated off this pre-tax base and this growth is also tax-free. In effect, the tax break gives you the investment benefit of the difference between pre- and post-tax contributions for the duration of the RA, and as shown in **Graph 1**, the effect can be quite dramatic.

However, deferring tax and generating investment returns off pre-tax money is not beneficial unless the tax schedules at retirement allow investors to use this 'tax-free growth'. RAs allow for this: when a member retires from an RA, he/she can withdraw a lump-sum benefit of one-third of the capital. This is taxed favourably: the first R300 000 of total pension withdrawals (including RA withdrawals) is tax free, the next R300 000 is taxed at 18%, and the following R300 000 at 27%. Above R900 000 the tax rate is 36%, which is still below the maximum 40% marginal rate for individuals. Retiring members must use the remaining two-thirds of their RA capital to purchase a pension-providing vehicle such as a living annuity or a guaranteed life annuity. The tax rates used for payments from this annuity are based on the member's marginal tax rate after retirement, which may be lower than when they are working.

Flexibility, choice and value for money

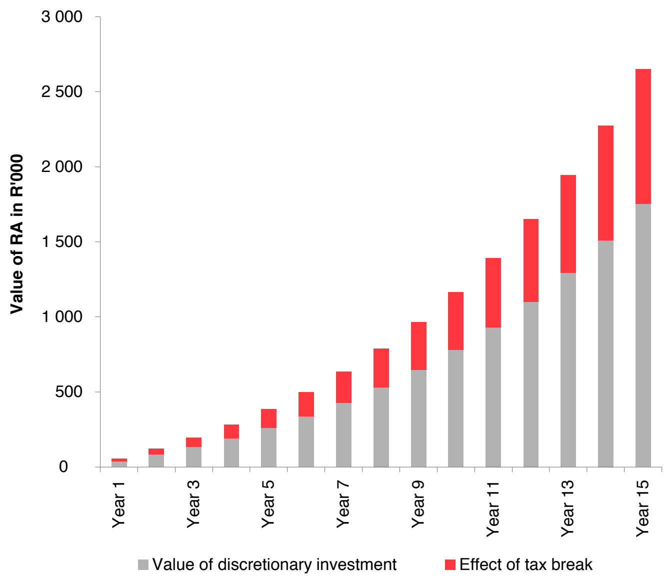
RAs with an underlying investment in unit trusts offer investors flexibility and choice. You can choose a combination of unit trusts that best suits your needs and risk profile. You can switch between unit trusts at no additional cost when and if your needs change. Most unit trust based-RAs offer low product fees, no penalties for surrender or discontinuation and adviser fees are negotiated and transparent. Finally, if you change jobs your retirement annuity continues without any obligation to transfer.

RAs have other benefits that should be considered:

- They encourage retirement savings. This is good in the South African context where people under save, especially for retirement. The rigidity of the RA reduces the temptation to take payouts when times are tough (you cannot access your money until you turn 55 unless you are permanently disabled, the value of your savings is under R7 000 or you are emigrating).
- They offer estate planning benefits. Your RA does not form part of your estate when you die (unless you have no dependants or nominated beneficiaries), so any amounts paid out to your beneficiaries will not be subject to estate duty. If your beneficiaries invest the proceeds into an annuity, the income they receive will be taxed at their marginal tax rate. This does not apply if they elect a lump sum payment, in which case the benefit will be taxed according to the tax schedules, applicable at the time.
- The investment cannot be attached by creditors.

If you are planning to start an RA, or make use of the tax concession for this tax year, please ensure that you invest prior to the end of February.

GRAPH 1 | Effect of tax benefits to RA pre retirement*



* Assumes R50 000 invested annually increasing by inflation (6% per year); real investment return for period of 5% with the income reinvested; of the growth 6% is income that would have been taxed; assumes an average individual tax rate of 31%.

Source: Allan Gray research

What is non-retirement funding income?

If you are self employed, or your employer does not offer a pension/provident fund, your income is considered 'non-retirement funding'. If you are a member of your employer's pension/provident fund, your income is known as 'retirement funding income'.

However, you may still earn non-retirement funding income, such as a bonus or car/entertainment allowance, and can contribute the greater of: 15% of your non-retirement funding income, R1 750, or R3 500 less your allowable pension fund contribution, to an RA tax free.

Commentary by Rob Formby, director of retail operations, Allan Gray