TAX AMENDMENTS AND RETIREMENT ANNUITY CONTRIBUTIONS

As from March 2016 the new deductible amounts for approved Retirement Funds became effective. The only portion of the amendments that was delayed was the enforced annuitisation of Provident Fund benefits. This will hopefully be resolved in the next few tax years, but is not relevant for the purposes of this article which deals primarily with Retirement Annuity Fund ("RA") contributions.

The key changes to the tax deductible contribution limits for RA's are summarized in the table below:

	Deductible Contribution %	Cap
Old Regulations	15%pa	N/A
New Regulations	27.5%pa	R350 000pa

For most people investing in an RA the increased deductible limit is good news. But what does it mean for self employed professionals who have historically been contributing more than the new cap?

Our client, Dr X, has run a very successful medical practice for some years. He is now 45 years of age and is married with two teenage children. Having done a detailed budgeting exercise together with his financial adviser 3 years ago, he has been contributing R500 000 per year to an RA. This amount was within the old 15% deductible limit and, provided he continued with the plan until he turned 60 (15 years time), according to their calculations the final lump sum amount should enable Dr X and his wife to retire fairly comfortably.

Dr X is now concerned that he can no longer deduct the full R500 000. As from the current tax year this amount will be limited to R350 000 per annum. What should he do with the extra R150 000 for the next 15 years?

Simplistically speaking, Dr X has 3 options:

1. Reduce the contribution to R350 000pa and spend the balance as the deduction is no longer available.

2. Continue with the current R500 000 annual outlay, but as the amount above the cap is no longer tax deductible, pay the tax man his share first (i.e. R60 000pa assuming an effective 40% tax rate) and continue investing the balance in the RA. His annual contribution to the RA thus becomes R440 000.

3. Continue with the current R500 000 annual outlay, pay the taxman his share first and then take the remaining R90 000pa and invest the first R30 000pa in a Tax Free Savings Account ("TFSA") and the remaining R60 000pa in another vehicle such as a unit trust.

Being a disciplined saver Dr X is not keen to pursue option 1 as it seems very short-sighted and he is unlikely to meet his future retirement objectives. Option 3 appears the best alternative as

far as he is concerned. Even though he loses the initial tax deduction at least he benefits from the tax free build-up in the TFSA as well as some felxibility. There will be tax on interest and dividends within the ordinary unit trust investment over the period, but at least he has full access to this money at any time and the final investment lump sum allows for greater flexibility at his retirement. This seems the best he can do in the light of the tax amendments.

Whilst this may be a good solution, Dr X would be well advised not to dismiss option 2 too quickly. Although at first it appears as if he is wasting money on a reduced tax opportunity, this may not be the case. This is because the new law allows for any amounts that do not qualify as a tax deduction during the build-up phase prior to retirement to be set-off against taxable amounts after retirement date. This includes taxable lump sums as well as any annuity income generated by those lump sums. So, by way of example, Dr X could reduce the tax payable on his monthly annuity significantly during the first few years of retirement. Other potential benefits of the RA versus a straight unit trust investment are set out in the block at the end of this article.

We can illustrate the differences by way of the table below assuming investment for a 15 year period. For comparative purposes we assume that the inflation rate over the period is 6%pa and that the investment grows at a rate of inflation + 5%, that is 11%pa after all fees. This growth rate will apply to both the RA and the TFSA, but the ordinary unit trust would "lose" some of this annual return due to regular tax on interest and dividends. We assume this cost to be 1%pa which means that the net growth on this portion of the investment is reduced to 10%pa.

	Option 2 - final benefit	**Option 3 - final benefit**
RA Build Up	16,672,103	13,261,931
Tax Fee Savings Account	N/A	1,136,724
Ordinary Unit Trust	N/A	2,072,352
Total at Retirement	**16,672,103**	**16,471,007**
Tax Offset available	1,35 million	N/A

The table shows that from a pure investment perspective Option 2 produces the slightly better result. Bear in mind that the tax implications for the final lump sum amounts are different in that the TFSA and ordinary unit trust lump sums are free from tax at that point (there will be CGT on any future sale of units from the latter over time), whereas the lump sum maturity amounts from the RA are subject to the tax rules governing retirement funds. However, if Dr X sees the final lump sums as a source to generate future income then option 2 has a unique advantage. This is because the unclaimed tax benefit on any contribution can now be offset against taxable amounts (R90 000 X 15 years = R1,35 million). So, by way of example, should Dr X use the full lump sum to buy an annuity at retirement, then the first R1,35 million of the annuity payments would be free of tax. If he was drawing R40 000 per month this offset would last for nearly the first 3 years of his retirement!

This article does not attempt to cover every possible alternative. For instance Dr X could elect Option 2, but rather invest the first R30 000 every year in a TFSA, and then only continue investing the balance of R60 000 in the RA. He thus combines the potential future tax offset

benefits of the RA with the flexibility of the TFSA. Each individual investor's personal circumstances must be considered.

The key principle that emerges is that the new laws have introduced some very attractive tax planning opportunities for investors. Advice from a professional financial adviser is strongly recommended.

Comparison of issues to consider	
Retirement Annuity	**Direct Unit Trust**
Investment build-up is free of all taxes	Dividends and interest attract tax each year (after exemptions)
Investment value is not subject to Estate Duty on death	Subject to Estate Duty on death
Lump sum amounts at retirement are subject to tax free ceilings. No Capital Gains Tax	Capital Gains Tax will apply on any amount cashed in (after exemptions)
Regulation 28 limitations apply to asset allocation while in the RA	No asset allocation limitations
Protection from creditors on insolvency	No specific protection
No access prior to age 55	Access at any time