LEVERAGE

Legal and technical update: July 2019

At a glance

Financial Planning and Advice

Retirement planning is the focus this month, to remind our advisers and clients that it is not just an event that requires attention in February to capitalise on tax savings. A focus point of any financial plan, it should also be reviewed often. It is especially important when dealing with business owners responsible for their own retirement destiny, as many view the business as the retirement plan, which is risky business.

In this edition, Misha Badassy, legal adviser in KZN gives us a recap of the retirement vehicles used when doing retirement planning.

Ivan Matee, legal adviser in Gauteng, sheds light on the retirement needs of farmers and sole business owners, and provides a potential solution to assist these clients to meet their retirement needs.

Happy reading!

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Using retirement funds as a primary retirement planning vehicle

By Misha Badassy, Legal Adviser, MIS KZN

One of the most challenging tasks for a financial planner is to advise on something that is intangible, let alone something that one cannot reap the benefits of over the short term. Without the individual's insight into its potential value when they no longer enjoy a steady income, advising such an individual remains a challenge. For many people, retirement remains an abstract concept. South Africans are not making adequate financial provision for this stage of their lives, while they are not taking full advantage of the tax benefits of saving for retirement using retirement planning vehicles.

From there this article, which focuses on retirement planning, specifically on retirement planning vehicles, tax and legislative efficiencies, as well as the advantage of initiating retirement planning as soon as possible to maximise the benefits.

Retirement planning vehicles

The most common retirement planning vehicles include pension, provident, retirement annuity, and preservation funds. However, there are other platforms that can also be used to save for retirement, such as tax-free savings accounts, unit trusts and endowments. One does not have to select one at the exclusion of others – most retirement plans will consist out of a combination of these vehicles.

A retirement annuity is a retirement fund used by individuals, as an employer/employee relationship is not required to qualify for membership. Pension and provident funds, on the other hand, are employment-based retirement funds and membership is generally a condition of employment. A preservation fund is a retirement vehicle specifically designed to preserve benefits for retirement. Proceeds of pension or provident funds may be transferred to a preservation fund in the event of dismissal, retrenchment, or resignation. A recent amendment to the Income Tax Act resulted in the ability to preserve retirement benefits as well, either by transferring it to a retirement annuity or a preservation fund.

Once a person reaches retirement, a compulsory annuity is a common vehicle used to cater for post-retirement income. More on this later.

Tax efficiency

The legislation that govern these vehicles include the Pension Funds Act, Income Tax Act, Long Term Insurance Act and Estate Duty Act.

Retirement funds are exempt from income tax (which includes capital gains tax (CGT) and dividends withholding tax (DWT)), and all income earned while invested in the retirement fund accrues tax-free. When a portfolio used in the retirement vehicle is invested in dual listed shares (listed on the SA stock exchange and a foreign exchange) a small DWT implication can be experienced due to the foreign dividends taxes being withheld abroad. Even though it is reflected on the statement, it was in fact withheld abroad. Another benefit is that it is not included in the dutiable estate for estate duty purposes.

Contributions to retirement funds are tax deductible, up to certain limits. The maximum tax deduction in a tax year is limited to the greater of 27.5% of taxable income or remuneration, subject to an annual ceiling of R350 000. This include contributions made during the current tax year and contributions rolled over from the previous tax year (disallowed contributions).

If disallowed contributions have still not been deducted when the member retires, it will be deducted from any retirement fund lump sum to determine the taxable lump sum. If a surplus of disallowed contributions remain after lump sums were taken, it will be offset against compulsory annuity income as an exemption.

From 1 January 2016, all disallowed contributions as at the date of death of a taxpayer will be included as an asset in the estate of the deceased – this was introduced to deter people from using retirement funds to avoid paying estate duty.

All of the above tax advantages and incentives are aimed at encouraging individuals to save for retirement.

Example: Tax savings and maximising an RA contribution

Mr. X who is 30 years old, earns a salary of R500 000 per year. Let us take a look at the difference in savings if he chooses his retirement savings at 15% versus the maximum savings of 27.5%. We ignore other deductions for illustrative purposes.

Scenario 1: Mr. X's retirement savings contributions at 15%

Salary: R500 000

Retirement contribution: R500 000 x 15% = R75 000

Taxable Income: R500 000 – R75 000 = R425 000

Annual tax paid: R86 655 (using 2019/20 tax tables)

Scenario 2: Mr. X's retirement savings contributions at 27.5%

Salary: R500 000

Retirement contribution: R500 000 x 27.5% = R137 500

Taxable income: R500 000 – R137 500 = R362 500

Annual tax paid: R72 194.50 (using 2019/20 tax tables)

By taking advantage of the tax deduction limits, Mr. X can save an additional R14 460.50 on his annual taxes.

One must consider the impact of the larger contribution on the cash flow of the client as in some cases, even though the tax saving is attractive, the client's cash flow might not allow for such a saving.

Protection against creditors

Section 37A of the Pension Funds Act determines that pension benefits are not reducible, transferable, or executable. In terms of Section 37B, pension benefits do not form part of the assets in the insolvent estate of members and may not in any way be attached or appropriated by the trustee of the insolvent estate

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or by the creditors. Therefore the member's benefit is protected while invested in the retirement fund.

Section 37D permits certain deductions from a member's retirement fund benefit. These include amounts due in respect of housing loans granted by the fund/employer or for which the fund/employer agreed to stand surety, pension interests awarded to former spouses on divorce, maintenance claims awarded against the member and the fund, damages due to an employer caused by a member's misconduct, or any other amounts specifically approved by the Registrar.

Regulation 28

Regulation 28 of the Pension Funds Act limits the extent to which retirement funds may invest in particular assets or in particular asset classes such as equities, bonds, property, and cash. The most important Regulation 28 asset class limits are: equity 75%, listed property 25% and offshore assets 30%. Regulation 28 effectively forces investors to diversify their investment into a mix of asset classes.

Access to retirement funds

Members of retirement annuities must wait until the minimum age of 55 before they can retire from the fund and access the funds. There are exceptions when members can gain access, namely if the paid-up value is less than R7 000, the member emigrates, or the member becomes permanently disabled. Divorce is another exception, however it benefits the member's former spouse and not the member. In the case of divorce, the court can make an order in terms of which the non-member spouse may be allowed access to a portion of the benefit.

The retirement date, in respect of pension and provident funds, is determined by the fund rules and is generally from the age of 55 onwards. The retirement date for income tax purposes is the day on which the member formally retires from the fund. If a member resigns or is retrenched prior to retirement, the entire resignation benefit will be accessible.

There are two types of preservation funds, namely pension preservation, and provident preservation funds. Practice Note 1/2012 states: "A member exiting their former occupational fund can access a portion of their benefit in cash before transferring to the pension preservation fund or provident preservation fund. Such a transfer is tax-neutral and does not preclude the member from accessing a further once-off withdrawal benefit in the pension preservation fund or provident preservation fund."

At retirement, the rules of pension, retirement annuity, or pension preservation funds regulate that the member may take up to one-third of the funds in cash, and the remaining funds must be applied to provide for a monthly pension. If the value of the retirement benefit is less than R247 500 (de minimis rule) the full amount can be taken as a lump sum.

Provident funds (including provident preservation funds) still allow for full accessibility at retirement.

Income-providing investments post retirement

The funds remaining in the retirement fund (after the lump sum was taken) is commonly referred to as compulsory funds and must be transferred to a compulsory annuity to provide a monthly income. There are various options available – the most common are a traditional life annuity and a living annuity.

The traditional life annuity provides for a fixed income for the lifetime of the annuitant. The investment risk is carried by the insurer and not the annuitant, as the income is determined at inception of the annuity and will then be payable as per the contractual provisions. When investing in a traditional life annuity, there are different options:

- Fixed annuity (single life)

  The investor receives a fixed annuity amount, determined at a rate of interest fixed in the agreement. The annuity will continue to pay until the death of the investor. It does provide the option to have a guaranteed period, which can be up to 15 years. The longer the guaranteed period is, the smaller the initial annuity will be. If the investor dies before the guaranteed period has expired, the annuity will continue to pay for the balance of the guaranteed period.

- Fixed annuities (joint life)

  This option will pay until the death of the investor, after which it will continue to pay the surviving spouse until the death of such spouse (it can be any other person). If a guaranteed period is built in and the investor and his or her spouse both die before the guaranteed period has expired, the annuity will continue for the balance of the guaranteed period in favour of the nominated beneficiary.

- Capital preservation plan

  A combination of a compulsory annuity and a life insurance policy, the investor selects a fixed annuity and uses a portion of that annuity that is payable every month to pay for the premiums on a life policy. In the event of death, it will pay a death benefit equal to the amount invested in the annuity on retirement.

Where a living annuity is selected, the annuitant will carry the investment risk attached to the investment, but the capital in the underlying investment is never lost and will be available for beneficiaries upon the death of the annuitant. The income is selected by the annuitant and can be reviewed annually; it may not be less than 2.5% and not more than 17.5% (per annum) of the capital amount. As mentioned, the annuitant chooses the underlying assets and there are no guarantees. An annuitant may commute the living annuity in full if the value of the annuity falls below R50 000, where any value of the annuity was previously commuted for a single sum, and R 75 000 where a lump sum was not previously taken.

Emigration

Members belonging to pension, provident fund, and retirement annuities who decide to emigrate before reaching the retirement age may withdraw their benefit.

As from 1 March 2019, this rule includes members of preservation funds.

Retirement lump sums and taxation

There are two categories of lump sum benefits: withdrawal lump sums and retirement/death lump sums, including severance benefit lump sums. The tax tables that apply are as follows:

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Withdrawal benefit

Taxable income (R)	Rate of tax (R)
0 – 25 000	0%
25 001 - 660 000	18% of taxable income above 25 000
660 001 - 990 000	114 300 + 27% of taxable income above 660 000
990 001 and above	203 400 + 36% of taxable income above 990 000

Retirement and death benefits or severance benefits

Taxable income (R)	Rate of tax (R)
0 – 500 000	0% of taxable income
500 001 - 700 000	18% of taxable income above 500 000
700 001 – 1 050 000	36 000 + 27% of taxable income above 700 000
1 050 001 and above	130 500 + 36% of taxable income above 1 050 000

Each time a member takes a lump sum, it is aggregated to those taken before when calculating the tax payable. Therefore, each lump sum taken will potentially move the taxpayer into a higher tax bracket, as per the tax table. Aggregation applies in respect of the following lump sums:

- Retirement lump sums lump sums received on or after 1 October 2007;
- Withdrawal lump sums lump sums received on or after 1 March 2009; and
- Severance benefit lump sums received after 1 March 2011.

When determining the tax payable, a tax credit will be awarded for the lump sums received before (where tax was potentially paid). However, the tax credit is not necessarily equal to the actual tax paid, as it is calculated using the relevant tax table in this last instance.

Options at resignation:

Upon resignation from an employer, the member of a pension or provident fund can elect to withdraw the benefit as a lump sum. However, they will be subjected to the withdrawal tax tables. To avoid this,it is recommended that members rather transfer to an approved fund and preserve their benefits.

The following table represents the tax-free transfers:

	APPROVED FUND	TO APPROVED FUND
1.	Pension fund	1,2,5
2.	Preservation pension	1,2,5
3.	Provident fund	1, 2, 3, 4, 5
4.	Preservation provident	1, 2, 3, 4, 5
5.	Retirement Annuity	5

Note – when a member transfers from a provident fund to a pension fund or a retirement annuity, the member must be made aware that the rules of the pension or retirement annuity fund will apply. In terms of these rules, the member may be restricted from accessing a maximum of one third at retirement. Where a member of a pension fund transfers to a provident preservation fund, that transfer will be subject to tax.

Options at retrenchment:

A severance benefit will be taxed according to the retirement lump sum scale. The retrenched employee will not have a choice in the matter and cannot transfer the severance benefit to any other fund to prevent or delay taxation.

Options at retirement:

When members access their retirement benefit they are taxed according to the retirement tax table. The compulsory portion, invested in a compulsory annuity, will provide a monthly pension.

Formula to determine tax payable on lump sums:

1. Determine the lump sum;
2. Aggregate previous withdrawal/ retirement/severance benefits. Take note of the transaction date;
3. Deduct previously disallowed contributions;
4. Deduct pre-1998 benefits if the fund is from a public fund;
5. This results in the taxable lump sum. Take note to apply the correct scale;
6. Calculate tax previously paid on the amount that was aggregated (using current tax table); and
7. Deduct the tax as calculated in step 6, from the tax calculated in step 5.

Example

Mr. X resigns from ABC Pension Fund on 1 August 2018. He takes his full retirement fund interest of R100 000 in cash. Disallowed contributions of R50 000 rolled over. In October 2008 he resigned from a fund and accessed an amount of R100 000, on which he paid tax. In June 2009, he resigned from another pension fund and received a benefit to the sum of R500 000.

The calculation on the after tax amount that he will receive from the sum of R100 000 will be as follows:

R100 000 + R500 000 (previous lump sums = R 600 000.

(NB: We ignore the sum of R100 000 taken in October 2008, as we only take into account withdrawals received on or after 1 March 2009.)

R600 000 – R50 000(disallowed contributions) = R 550 000.

Tax payable on R550 000 = R94 500.

Tax payable on R500 000 = R85 500 (using the same tax table as above to determine tax on previously received lump sums).

R94 500 – R85 500 = R9 000 tax payable.

The after tax lump sum is

R 100 000 – R9 000 = R91 000.

Alternative retirement planning: focus on farmers

By Ivan Matee, Legal Adviser, Financial Planning and Advice

According to a recent survey, at least 51% of South African retirees cannot make ends meet: 33% still have debt, and 53% still support adult dependants. The survey further indicates that most South Africans cannot afford to retire and are forced to continue working after retirement. The findings are supported and confirmed in the latest index by Momentum and Unisa on financial wellness of South African households. The Momentum/Unisa survey confirms that only 17% of households indicated that they have enough money to retire.

Feldman D.C., in his article titled "The decision to retire early", defines retirement planning as the exit from an organisational position or career path of considerable duration, taken by an individual after middle age with the intention of reduced psychological commitment to work thereafter. A concern about an adequate income during retirement is an important factor that influences many individuals when choosing a retirement age.

Research has also shown that finances are the strongest single predictor of the decision to retire. People are generally more likely to leave the workforce if they can financially afford to retire.

Though retirement planning works differently for each individual group, however, the purpose of this article is to highlight the challenges unique to farmers and provide an alternative retirement solutions.

Farming in a nutshell

Farmers pour their hearts and souls into their farming businesses. Most farmers plough profits generated from their farming activities back into their farming business, and don't have separate savings for retirement. Also, they don't earn a monthly salary, but derive their income from profits made during the sale of livestock or harvests. As their income depends on what they have to sell, it is variable: seasonal, quarterly, or even annually.

Generally, farmers work on the farm until they pass away, or are prevented from working owing to ill health. Those who don't have retirement plans in place should consider the impact of an economic downturn or the negative effect that other developments may have on the farming sector. Like other business owners, farmers want the farm to continue after their retirement or death, but as the sole business owner, the farmer has to identify a possible successor or buyer. Where a son is involved in the business and wishes to continue with it post the farmer's death, succession planning can be solved for within the family.

Contributing to a retirement annuity fund.

A retirement plan is part of a comprehensive financial plan, while the correct financial product forms the cornerstone of such a plan. As farmers are generally self-employed and operate the farm as a sole proprietor, they don't belong to an employer-provided pension or provident fund. Therefore, when considering a financial product that best suits a farmer's retirement plan, a retirement annuity is a viable alternative that also best suits a farmer's retirement plan. Bigger farms may be able to set up a retirement benefit for all employees, including the farmer/owner of the business.

Whenever the farmer receives profits or an income from the farm, they can contribute to a retirement annuity fund. As a retirement fund for natural person that is not linked to employment, contributing to a retirement fund makes it possible for the farmer to accumulate retirement capital.

Monthly, annual or ad hoc contributions can be made, and these contributions may be tax deductible (within the legislated limits): the maximum contributions to all retirement funds that may be deducted in a year of assessment is equal to the lesser of:

- R 350 000, or
- 27.5% of the lesser of:
  - Remuneration (as defined in the Fourth Schedule to the Income Tax Act and excluding retirement fund lump sums and severance benefits); or
  - Taxable income(as defined by the Income Tax Act, but excluding retirement fund lump sums, severance benefits and disregarding the tax deductions claimed for donations made to a public benefit organisation, but including taxable capital gains); or
  - Taxable income excluding taxable gains.

Upon reaching retirement age, which is anytime from the age of 55 years, the member may access the accumulated savings. The member will be entitled to a maximum of one-third as a cash lump sum (subject to tax), while the remaining two-thirds will be applied to provide the member with an annuity for their lifetime.

A living buy-and-sell: an alternative retirement plan for farmers.

A living buy-and-sell is another retirement option for farmers and business owners who would like to retire at some point. They would usually enter into a living buy-and-sell with a son, family member, or another buyer interested in purchasing the farm but cannot afford to do so financially.

To build up capital to one day fund the buy-and-sell, the parties will usually use an investment product such as an endowment or a sinking fund. A linked flexible investment into collective investment schemes can also fulfil this purpose. In the case of an endowment or a sinking fund, the owner of such a product will be the intended purchaser.

The investment will pay out at maturity, timed to coincide with the farmer or business owner's desired retirement date. This option is suitable for people who do not have retirement savings, or who do not have not have sufficient savings. At maturity, and when the farmer/business owner

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reaches the retirement date, the purchaser will use the proceeds of the investment to purchase the farm, a portion thereof, or the business interest from the farmer or business owner.

The structure of a living buy-and-sell is different to a normal buy-and-sell arrangement funded by a risk policy only payable at death or disability of the business owner. However, it is often a solution used in conjunction with a traditional buy-and-sell arrangement, therefore providing not only for the sale of the farm or business upon death or disability, but also on retirement.

When implementing the living buy-and-sell structure, the purchaser (owner of the investment) can agree to sign a security session in respect of the investment vehicle and in favour of the farm owner/business owner to be barred from surrendering the investment or using the investment for other purposes. Upon maturity of the investment, the cessionary will cancel the cession and the maturity lump sum will be payable to the purchaser, who will be obligated to purchase the farm from the farmer or the business from the business owner at retirement in terms of the binding agreement between the parties.

The following case study can be used to illustrate the structure of a living buy- and-sell:

Frans Rashilo, aged 48, is a businessman and the owner of a farm located in the Harrismith. He works closely with his son Matome Rashilo, whom he wishes to see take over the farming business when he retires at age 60. Frans is very aware that he hasn't provided sufficiently for retirement. As he regards his farm as his retirement plan, he is hoping to use the proceeds of the sale of his farming business to fund his retirement.

Frans and Matome agrees to enter into an agreement in terms of which he increases his son's salary to enable him to afford to pay the premiums in the endowment policy owned by Matome. The salary will be structured in such a way that it will be sufficient to cover premiums and additional tax expenses occasioned by the increase of his salary. (A structure similar to a preferred compensation scheme can be used.)

The endowment will mature when Frans reaches his retirement age of 60 in 12 years' time. To avoid the son from surrendering the investment, Matome agrees to sign a security cession in favour of his father. This will also be dealt with in terms of the agreement that will formalise the transaction.

At maturity of the investment, Frans Rashilo will agree to cancel the collateral cession so that the maturity lump sum can be paid to his son to enable him to use the proceeds thereof to purchase his farm. The father will then use the proceeds of the sale of the farm to fund his retirement and the son will be the sole owner of the farming business. It is important to remember that the sale of a business will result in capital gains tax consequences that must be provided for.

Conclusion

Retirement planning is much more complex than simply contributing to a pension, provident, and/or a retirement annuity fund. It requires knowledge of the tax laws, compound interest, present, and future value of the money and investment strategies. When farmers or business owners choose alternative retirement planning by following the living buy-and-sell solution, it is important that they seek proper tax advice from a tax practitioner. In addition, they should consult with an accredited financial adviser to explain capital gains tax and income tax implications triggered by the sale of the farm. To ensure it is provided for, such costs should be included in the plan.

Financial advisers can play a pivotal role in equipping farmers and business owners with the necessary knowledge about and skills for proper retirement planning, while they can also assist with and encourage early saving and investment to ensure financial independence at retirement.

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