ASAP

Legal and Technical Update

Retirement Annuities as an Investment Alternative

We are often faced with clients that receive a lump sum later in life without having an immediate need for the capital and or the income. They wish to protect the capital against unnecessary taxes and want to protect it for their beneficiaries, whilst knowing that it is available to substitute their income if the need arises.

In most instances voluntary investment alternatives will be considered without giving a second thought to a retirement annuity (RA) – the client is already retired so why would they want a retirement product? Well, maybe they do not need it, but maybe it is the perfect match. This article will illustrate the RA as an investment alternative by using an example.

Please note that this is for information purposes only and is not intended to be advice and even if a client's circumstances is exactly the same as that used in this example, one has to consider the client's overall financial plan, needs and objectives and then determine if this alternative can be suitable for the client.

The article will aim to be objective, highlighting the benefits and the disadvantages.

Example:

Mrs. Retired's husband passed away recently, leaving her financially comfortable. She will continue to receive his pension for the duration of her life, amounting to R15 000 per month. She receives a monthly income of R10 000 from her own retirement related conventional life annuity. She is the sole beneficiary on his living annuity which is valued at R5 000 000 and she has opted to retain it in the form of a living annuity and to receive a minimum income of 2.5%, which is equal to R10 416 per month. She does not have any debt and she owns the property – all income is purely for living expenses, as she has a subsidised medical scheme as well.

Mrs. Retired also received the proceeds from her husband's life policy of R3 500 000. She wants to invest this as she does not need the capital or the income – she has enough income as it is and the capacity to increase her income by increasing the drawdown from the living annuity if necessary, so it is a long term investment.

The RA as an investment option

Investment term

The investment has a long term and can continue for the duration of her lifetime. She can elect to retire from the RA if she requires access to the funds or alternatively it will become due upon her death.

Liquidity

During her lifetime the investment is not liquid and if she retires from the RA she will only have access to a maximum of one third of the value as a lump sum. The remaining funds must be applied to provide her with a monthly pension. This is achieved by investing it in a compulsory annuity like a living annuity.

Upon her death, her dependents/beneficiaries will have the choice of either receiving their portion as a lump sum or to convert it to a living/conventional life annuity to provide an income. Each beneficiary can make their own choice and where an annuity is selected, the annuity will be in their name irrespective of their age (they do not have to be at retirement age to utilize the annuity option).

Investment risk

The underlying investment in the RA is governed by Regulation 28 to the Pension Funds Act that prescribes certain limits for certain asset classes to manage the investment risk in the investment.

Income tax

<u>Tax on investment returns</u>

During the investment term, there is no income tax payable in the RA. All investment returns realized in the investment will be free of income tax, capital gains tax and dividends withholding tax (DWT). (Note that where there are underlying dual listed investments, a foreign DWT component can apply, that is payable and recouped in the foreign jurisdiction where the fund's assets are situated.)

Therefore, if one compares the investment returns of the exact same underlying investment in another financial product (excluding a Tax Free Investment), the after tax returns should be better in the RA.

<u>Tax deductibility iro the contribution made to the RA</u>

Members of retirement funds are entitled to deduct all contributions made to ALL retirement funds (including pension, provident and retirement annuity funds) and include those contributions made by the employer on their behalf (that was included in their income as a fringe benefit).

In terms of section 11F of the Income Tax Act, the taxpayer will be entitled to a tax deduction equal to the lesser of:

- R350 000 (annual cap); or
- 27.5% of the greater of:
    - remuneration (excludes retirement fund and severance benefit lump sums), or
    - taxable income (which includes all income related to trade, any passive income and taxable capital gains and excludes retirement fund and severance benefit lump sums, this retirement fund contribution and donation deduction); or
- Taxable income excluding this retirement fund contribution and excluding taxable capital gains.

Mrs. Retired's tax deduction:

The deduction she will be entitled to each year, will be the lesser of:

- R350 000,
- R116 872 ((27.5% of (R35 416 x12) – her total income is remuneration)
- R424 992 ((R35 416 x 12) – her total income is taxable)

Therefore she will be able to deduct R116 872 for this tax year, based on the current income.

The disallowed contributions of R3 500 000 – R116 872 = R3 383 128, will roll over to the following year to be deducted again during that following tax year.

Disallowed contributions

The disallowed contribution that rolls over to the following tax year, will either be available in that following tax year as a:

- Deduction against any retirement fund lump sum to determine the taxable lump sum, or
- Section10C exemption, or
- Section 11F deduction (as above).

The section 10C exemption is relevant insofar the client receives income from compulsory annuities. This includes living annuities and conventional annuities stemming from pension, pension preservation, retirement annuities, provide and provident preservation funds.

In the case of Mrs. Retired, the R20 416 she receives from compulsory annuities will enjoy the exemption. Therefore, in the following tax year, after the first deduction was made as illustrated above, she will firstly enjoy the exemption and then the remainder of the disallowed contribution can be deducted in terms of section 11F. It is assumed the income remains unchanged in the following tax year, the calculation will be as follows:

Disallowed contribution that rolled over from the previous year is R3 373 128.

The income tax calculation will be as follows:

Pension	R180 000
Living annuity	R124 992
Compulsory Annuity	R120 000
Gross income	R424 992
Less exempt income:	
Section 10C	R224 992 (living annuity and conventional life annuity)
Income	R180 000
Less 11F deduction	R116 872 (disallowed contribution that rolled over)
Taxable income	R 63 128

Disallowed contribution that rolls over to the following year:	
Disallowed contribution beginning of tax year	R3 373 128
Less s10C exemption	R 224 992
Less s 11F deduction	R 116 872
Carried over amount	R3 031 264

Note – the insurer/administrator paying the annuity income is obliged to withhold PAYE. Therefore the exemption will only be accounted for at the end of the tax year, in which case the client should receive a tax refund (depending on the rest of the client's tax affairs). Alternatively the client can approach SARS to issue a nil tax directive iro the annuity income, on the basis of the disallowed contributions available, to instruct the insurer/administrator to refrain from withholding the PAYE. The client will have to obtain the directive and it is an annual process.

Retirement from the RA by the member

The client will be able to retire from the RA, which will allow access to a maximum of one third as a lump sum. This lump sum will be subject to income tax according to the Second Schedule to the Income Tax Act.

To determine the taxable lump sum the disallowed contribution that is remaining at this time will be allowed as a deduction.

In the case of Mrs. Retire, if one assumes she retires and elects to withdraw R1 000 000 as a lump sum, this amount is less than the rolled over disallowed contribution, and therefore it will not be subject to income tax.

Only if the lump sum exceeds the available disallowed contribution, will a portion be taxable. The retirement tax table will apply to determine the tax payable on the taxable lump sum and one must remember that aggregation of previous lump sums received will apply. The lump sums that count towards aggregation is:

- Retirement lump sums received after 1 October 2007,
- Withdrawal lump sums received after 1 March 2009, and
- Severance benefits received after 1 March 2011.

The portion transferred to an annuity will not result in any tax being payable on the transfer amount. The income is however gross income and therefore taxable.

Death of the member

Where a lump sum is selected by a beneficiary, income tax may be payable in terms of the Second Schedule of the Income Tax Act. Upon death it is deemed that the member receives the lump sum the day immediately prior to death, resulting in the member of the RA being the taxpayer and not the beneficiaries. Therefore the tax will be determined as explained above, using the deceased member's disallowed contributions and previous lump sums to determine the taxable lump sum. The after tax death benefit will then be split amongst the beneficiaries.

If the beneficiary selects a living annuity instead of the lump sum, the transfer to the annuity will not result in any income tax. The income payable to that beneficiary in future, will however be part of their gross income and therefore taxable.

Practical note – if a beneficiary selects a lump sum, the fund will request a tax directive and the fund will then deduct the tax from the overall death benefit. The net death benefit will then be split amongst the beneficiaries.

It is important to remember that the disallowed contribution is only available to the person that made the actual contributions to the retirement fund – therefore, if there is a remaining disallowed contribution and the beneficiary elects a lump sum, the disallowed contribution will be considered when calculating the income tax as the deceased member (the person that made the contribution) is the taxpayer. If the beneficiaries elect the annuity option, the disallowed contribution will be lost for future use.

Estate duty

Upon death, the funds in a retirement fund or a compulsory annuity will not form part of the dutiable estate of the deceased. Therefore, the funds in the RA will not form part of the estate for estate duty purposes, and if it was transferred to an annuity, it will also not form part of the estate. Section 3(2)(bA) of the Estate Duty Act does however determine that any disallowed contribution that is still available on the date of death will be included in the estate when calculating the dutiable estate. This was introduced to prevent people from using retirement funds solely to avoid estate duty.

Should Mrs Retire die after the second tax year, as illustrated above, it will result in the remaining disallowed contribution of R3 031 264 being part of her estate for estate duty purposes. The normal estate duty calculation will apply, so if this is her only dutiable estate, the abatement of R3 500 000 will neutralize that amount and result in no estate duty being payable.

Summary:

The following table will summarise the benefits and disadvantages when considering the RA as an investment vehicle:

Benefits	**Disadvantages**
The contribution is tax deductible.	The investment amount will never again be fully accessible by the investor.
The investment returns are tax-free.	A maximum of one third will be accessible as a lump sum during the lifetime of the investor.
The disallowed contribution will be available as an exemption against compulsory annuity income.	The investor is limited iro the regulation 28 investment guidelines.
The RA death benefit is excluded from the deceased estate for estate duty purposes.	The lump sum will potentially be subject to income tax both for the investor or the beneficiaries.
The beneficiaries can access the full value as a lump sum, but can also apply it towards a compulsory annuity.	The disallowed contribution remaining upon death will be included in the deceased estate for estate duty purposes.