ASAP

Legal and Technical Update

The tax free investment (TFI)

The tax-free investment was introduced on 1 March 2015. Section 12T of the Income Tax Act defines the TFI as:

- a financial instrument,
- that is administered by a person or entity as prescribed in the regulations,
- held by a natural person, or
- a deceased or insolvent estate of that natural person.

Therefore, only natural persons or their insolvent or deceased estates can invest in TFIs. Companies, close corporations and trusts are excluded from the definition and cannot invest in the TFI.

TFIs can only be offered by banks, long term insurers, managers of collective investment schemes (excluding managers of participation bonds), mutual banks, co-ops and the government of South Africa.

Therefore an investor will not be able to invest directly in shares as a TFI alternative or in any investment not offered by the prescribed service providers.

Liquidity and the investment term

In terms of the regulations, a TFI with a maturity date must make payment to the investor within 32 days, and where there is no maturity date, within 7 days after the request for payment is made by the investor. Note:

- Where an amount is withdrawn from a TFI, it may not be paid into a third party's account – it may only be paid into that investor's account.
- Where a withdrawal is made from a TFI, that withdrawal amount cannot be reinvested in another TFI. Any investment into another TFI will be seen as a new investment using and reducing the annual contribution limit.

Contribution limits

Contributions to the TFI are limited to:

- an annual aggregate amount of R33 000 during any year of assessment (from 1 March 2017) (increased from R30 000),
- with an overall lifetime limit equal to an aggregate amount of R500 000.

Where an investor exceeds this contribution limit in any year of assessment, an amount equal to 40% of that excess amount is deemed to be an amount of normal tax payable in respect of that year of assessment.

The regulations prohibit the product provider from accepting contributions from investors in excess of the contribution limits.

Example:

Richard has a Momentum TFI. He invested R33 000 into the investment during the year of assessment ending 28 February 2017.

During the same year he invests an additional R20 000 into another TFI with another product provider.

Richard will have to pay additional income tax equal to:
= R53 000 – R33 000
= R20 000 x 40%
= R8 000

The same principle will apply in respect of the overall limit. If a person exceeds the R500 000 overall contribution limit during any year of assessment, an amount equal to 40% of that excess amount is deemed to be an amount of normal tax payable by that person during that year of assessment.

Note – if the annual contribution limit is not used during a tax year, it cannot be carried forward to the following tax year. If it is not used, that opportunity will be lost.

Example:

Angela invested R21 000 in a Momentum TFI during the tax year that ended 28 February 2017. The remaining R9 000 of the annual R30 000 contribution limit (2016/17) that she did not use will be lost and is not carried forward to the following year of assessment.

Transfers between investments

Transfers between TFI are allowed from 1 March 2018. It is important to consult with the administrators when contemplating a transfer as the processes may differ.

Restrictions on asset classes

No more than 10% of the total value of the TFI may come from shares in a single company or from one commodity and not less than 80% of any shares must be listed on a recognised exchange as defined in paragraph 1 of the Eighth Schedule to the Income Tax Act.

Where any part of the value of a TFI is determined directly or indirectly with reference to any commodity, not more than 10 per cent of the value of that TFI may be derived from that commodity.

Where any part of the value of a TFI is determined directly or indirectly with reference to any financial instrument issued by any company and that financial instrument is not a share not more than 10 per cent of the value of that tax free investment may be derived from those financial instruments
Where part of a TFI is invested in financial instruments issued by any public entity, municipality or foreign government which has been assigned a foreign currency sovereign rating lower than that of South Africa, no more that 30% of the total value of that TFI may come from those financial instruments.

Note - the above restrictions do not apply to collective investment schemes.

A derivative instrument may be utilised as an asset underlying a TFI only to the extent that the derivative is utilised for the purposes of reducing the risk of loss or reducing cost (without any increase in risk of loss) in respect of the TFI.

Income Tax Exemption

Section 12T determines that an income tax exemption shall apply in respect of any amount received by a natural person in respect of a TFI – this includes any interest earned.

Note – interest earned in a TFI will not impact the overall annual interest exemption available to natural persons.

A capital gains tax exclusion applies in respect of any capital gain or loss resulting from the disposal of a TFI during any year of assessment. Therefore the capital gains or losses stemming from the disposal of a TFI will be ignored when determining the taxable capital gain in any year of assessment.

Fees

There is an administrative restriction on how fees are expressed and how it is calculated.

Performance fees on investment performance are not allowed. Time based fees are also prohibited – fees may not be based on the time period for which the investment is held.

Where withdrawals are made, there are restrictions on the exit fees that can be charged. In the event of a fixed deposit or a financial instrument or policy that offers a guaranteed return, the exit fee is capped at the greater of:

- R300, or
- a penalty based on a formula that takes the following into consideration:
  - the total amount invested
  - the years remaining until the maturity date of that financial instrument, and
  - the interest rate in respect of the financial instrument on the date that the financial instrument is acquired.

In any other instance the fee is limited to R300.

Transacting capabilities

A TFI cannot be used as an account against which debit orders or stop-orders may be debited, from which credit or debit card payments are made and it may also not be accessible at any automatic teller or similar device.

Other restrictions

- No existing investment or account may be converted to a TFI.
- A TFI may not provide any risk benefits. It is a pure investment vehicle.
- Where an endowment policy is used as a TFI, it will not be subject to the normal restrictions applicable to endowment policies, i.e. the term restriction, the limitation on premium increases, etc.