Using a retirement annuity as an estate planning tool

Additional contributions to an RA provide opportunities for astute financial planning.

It's RA-season again!!!!! It is the season when taxpayers will be assessing their potential tax liability for the 2007/2008 tax year and making contributions towards their retirement savings by way of tax-deductible retirement annuity contributions.

While the focus is usually on income tax, what about estate planning?

Two of the essential elements of estate planning are:

- Reducing the planner's exposure to taxes (estate duty, donations tax, estate duty, CGT).
- Ensuring that the planner and/or his surviving family members have sufficient income to maintain their standard of living.

How does an RA measure up?

Reducing exposure to taxes

Contributions
Contributions are tax deductible within the following limits:

The greater of R1 750, or
R3 500 – allowable pension fund contributions, or
15% of non-retirement funding taxable income.

Excess contributions can be
- rolled over to subsequent tax years, and thereafter be used to either
    - increase the tax-free portion of any lump sums at retirement, and if still not fully utilised, be
    - deducted from income after retirement as if they were current contributions.

Build-up
Since the abolition of retirement fund tax the build up in retirement annuities is totally tax free.

Consider the following implication – A well constructed investment portfolio will have exposure to the following asset classes: Cash (Fixed interest & long-term bonds), Equity, and Property, with an element of offshore exposure for further risk diversification. When looking at an investor's exposure across these classes the opportunity arises to hold the asset classes with a higher tax exposure - usually cash and property - in the retirement annuity in order to earn tax-free investment on these assets.

At Retirement
At retirement, the member will have the option of electing up to a third as a cash lump sum. Lump sums taken at retirement will be subject to the following generous tax concessions:

The first R300 000 plus contributions not previously deducted is tax-free
The next R300 000 is taxed at 18%
The next R300 000 is taxed at 27%
Any amount thereafter at 36%

Assuming that all contributions qualified for a deduction at a 40% marginal rate – the table below indicates the tax saving …

LUMP SUM	EFFECTIVE TAX RATE	TAX ADVANTAGE
R1 000 000	17.1%	22.9%
R1 500 000	23.40%	16.6%
R8 000 000	33.64%	6.36%
*any disallowed contributions could lower the effective tax rate even further		

Annuity Income
Retirement annuities will provide a protected income source for the member and/or his dependants at death or retirement. Annuity income from the retirement annuity is taxed at the recipient's marginal rate of tax.

The incidence of tax on the annuity can be lessened by :

- Selecting an income percentage rate from as low as 2.5%
- Deducting the remaining excess contributions from the income after retirement.
- On the death of the planner the annuity income can be spread across a number of nominated beneficiaries which may reduce the overall tax burden.

Estate Duty
Contributing to an RA will allow the contribution to be taken out of an estate without attracting donations tax, but with the added benefit of an income tax deduction. On the death of a member, any annuity payable in consequence of membership of a retirement fund will be excluded from the deceased's estate for estate duty purposes. Therefore, in addition to the income tax advantage, the contribution to the retirement annuity will reduce the dutiable value of the planner's estate by 20% (being the current estate duty rate) on the contribution. Any growth on the contribution also takes place outside of the planner's estate.

CGT
Retirement annuities are not subject to CGT

For planners with the correct profile, investing in a single contribution retirement annuity and then electing a living annuity can be likened to being a beneficiary of a Trust.

The amount applied to buy the annuity does not form part of the member's estate for estate duty purposes (lump sums will). A Living Annuity has the following additional benefits:

- A Living Annuity is protected against creditors in the case of insolvency or divorce. With divorce, it's important to note that this does not apply during the build-up phase.
- A beneficiary/ beneficiaries can be nominated to receive an income on the death of the investor.
- The investor can select the underlying assets in which the annuity is to be invested.
- There are currently no prescribed underlying assets.
- No Capital Gains Tax, Income Tax or Retirement Fund Tax is payable on the assets backing the Living Annuities.
- The percentage and frequency of payouts can also be selected. This means that the investor can regulate income flows annually on the anniversary of the contract. The income percentage on all new contracts concluded after 1 March 2007 may not be less than two-and-half percent (2,5%) simple interest rate of return calculation and may not exceed seventeen-and-half per cent (17,5%) simple interest rate of return calculation - subject to the condition that the annuity will be for the life of the annuitant.

The combination of Estate Duty and CGT payable at death poses an enormous threat to the value of a client's estate.

Retirement annuities provide planners with the opportunity to make additional provision for their retirement, together with the potential for saving income tax, estate duty and CGT, as well as ensuring that the member and/or his dependants are provided with a protected income source at death or retirement.