Did You Know

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USING TAX TO BUY FINANCIAL INDEPENDENCE WITH A RETIREMENT ANNUITY (RA)

What is an RA?

An RA is nothing more than a one-person retirement plan. A person applies to become a member of an RA fund, which is approved as such by the Registrar of Pension Funds and the tax authorities. No employer/employee relationship is required to qualify for membership.

RAs are the main savings vehicle for self-employed persons to accumulate funds for retirement in a tax-efficient way. They are also popular as a top-up plan for salaried employees who belong to pension funds to close the income gap at retirement.

Smaller employers often choose RAs for their staff over traditional pension schemes, thereby avoiding the administration and responsibility involved in operating the latter schemes.

Tax Savings

Most people know that contributions to an RA are tax-deductible up to a certain maximum, but few people realise that an RA may actually provide them with an opportunity to save tax in 10 different ways. (The law also does not force you to retire from an RA fund before reaching age 70 anymore so you can now enjoy these tax benefits for longer.) These are as follows:

1. Contributions are tax-deductible up to a certain maximum (e.g. if you fall in the 40% maximum marginal tax bracket then the Receiver is sponsoring 40c in the rand of the contribution towards your retirement.)

2. Disallowed contributions can be carried over to the next year of assessment and, if unused during the contribution period, can be offset at retirement to increase the tax-free portion of the lump sum.

3. The inside build-up of the fund is tax-free. Together with the tax deduction this obviously helps build up more retirement capital.

4. The lump sum at death or retirement is tax-free up to a certain amount, currently R300 000 plus any disallowed contributions less any tax-free amounts from retirement funds that you may have enjoyed in the past. (With effect from 1 March 2009, the R300 000 will also be reduced by lump sum cash withdrawal benefits taken after that date.)

5. The balance of the tax-free lump sum is taxed at 18% on the next R300 000, then 27% on the next R300 000 and thereafter at 36%. Effectively this means that the first R900 000 of the lump sum could be taxed at only 15%.

6. You can deduct a further R1 800 per year in respect of re-instatement contributions under certain conditions.

7. On death, any benefits paid out from a retirement fund, whether by way of lump sum or an annuity, are free of estate duty. (This provides a planning opportunity for the wealthy estate owner to make a large single-premium contribution to an RA to reduce his or her estate for duty purposes.)

8. If you leave your employer and receive a withdrawal benefit from your pension or provident fund, you can preserve your retirement benefit by transferring it into an RA (or preservation fund) tax-free.

9. On retirement, you have a choice between a conventional or a living annuity. Assuming your risk profile, personal circumstances and other financial considerations justifies the decision, by choosing a living annuity you can manage the income you receive (between 2.5% and 17.5% of the capital amount each year) and consequently also manage your income tax position. Very importantly the capital in the living annuity account continues to grow tax-free and only the elected draw-downs are taxable.

10. Most people experience a big increase in medical expenses once they retire. Thankfully, once you have reached age 65, your medical expenses become fully tax-deductible. An RA can be used to build up a fund for post-retirement medical expenses in a tax-efficient way, as we have already seen. On retirement, although the compulsory annuity is fully taxable, to the extent that it used to cover medical expenses it is deductible again. It is therefore, in essence, tax-free.

Conclusion

These tax savings can be substantial and can greatly improve the overall return on your investment.

However, surprisingly the biggest advantage of an RA may not be tax-related at all. For many an RA is a disciplined way of saving on a regular contractual basis (not "if I can spare the cash at the end of the month kind of savings plan" that never works.)The fact that the capital also cannot be accessed before at least age 55 (other than in very limited circumstances e.g. formal emigration or when the capital is so small it would not justify the administration costs) is often a blessing in disguise.

This means that you are more likely to reach retirement with some capital to produce a retirement income to help you become financially independent. Experience shows that many other types of more liquid investments are raided for other instant gratification purposes long before retirement and therefore fail as a retirement plan.

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