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The Inside Story

Has the outlook on tax planning in retirement changed?

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Matthew Lester looks at ways to cut retirement income requirements so that less tax is payable to SARS.

In times gone by the universal approach adopted when retiring or withdrawing from a retirement fund (pension, provident or retirement annuity fund) was ‘take one-third of the capital in cash and the rest as an annuity. When dealing with provident funds, cash in everything.’ Some were even fortunate enough to be able to withdraw their entire accumulated actuarial value from their pension funds. It was all too good to last.

Times have changed. One needs to take into account the cumulative effect of tax reform over the past 20 years.

The way we were

Twenty years ago the key attributes of the tax system relating to retirement funds were as follows:

- The tax exemptions contained in the second schedule of the Income Tax Act, relating to lump sum withdrawal benefits, were substantial when compared to the levels of retirement capital that existed at the time.
- The average tax rate applied to the taxable portion of a retirement lump sum could be manipulated downwards to 18%, regardless of the amount of the taxable withdrawal benefit. ‘Averaging’ could give rise to tax savings even more substantial than the tax-free component of the fund.
- Retirement funds were subject to retirement funds tax, and secondary tax on companies was incurred irrespective of the beneficial owner of the shares in a company.
- Marginal tax rates for individual taxpayers and applied to pension annuities increased rapidly to attain a maximum super-tax rate as high as 45%. The average South African tax rate in 1994 was 34%.
- Interest rates ranged between 16% and 22%, well above the prevailing inflation rates at the time.
- Taxation on interest income could be contained through the use of endowment policies and preference shares.

- Capital gains tax was not even a consideration prior to 1 October 2001.
- Estate duty exposure was contained through the use of trusts. The compliance requirements relating to trusts were simple and trusts were cost-effective.

Applying the above factors, it made good tax sense to withdraw the maximum permissible amount from a retirement fund and contain taxation exposure to 18%. Then form a family trust to contain estate-duty exposure and invest in tax-efficient instruments underpinned by risk-free high interest rates. There was little need to take on the risk inherent to investment in equities.

Today, nearly all of the above has changed

The second schedule of the income tax act was amended in 2007, to provide for a maximum tax exemption on a retirement fund withdrawal benefit lump sum of up to R315 000. Tax at 18% is levied on R315 001 to R630 000. Granted, an average tax rate of 9% on R630 000 remains pretty nifty. But it is by no means the universal solution to most retirement plans.

The ‘averaging formula’ previously applied to the taxable portion of a lump sum has been repealed. Today, instead of engineering an average flat rate of tax of 18%, where the lump sum exceeds R630 001 the tax rate increases to 27% and at R945 000 the maximum rate of 36% is attained.

Latest indications from National Treasury are that increasing tax relief on retirement lump sums is at the bottom of the agenda. National Treasury discussion papers released during 2012 indicate that everything possible will be done to encourage pensioners to retain as much as possible within retirement funds.

National Treasury has also abolished retirement funds tax and secondary tax on companies, leaving yields on retirement capital completely tax free provided it remains within retirement funds. These amendments collectively represent a subsidy to retirement funds of some R15 billion per annum.

An estate duty exemption has been implemented to cover the capital remaining within a retirement fund at time of death.

Legislation is scheduled for implementation by 2014 to contain any tax advantages that were previously inherent to trusts. The additional compliance requirements now imposed on trusts can also lead to substantial cost implications.

The net result of the above is that today, it simply makes limited sense to withdraw taxable lump sums from a retirement fund, potentially pay even more tax on investment income received from the after-tax lump sum, and finally incur estate duty on whatever remains.

But there is more to the story:

- Over the past 15 years, the tax threshold for a pensioner over 65 years of age has been substantially increased to the current level of R104 106. It can be anticipated that this trend will continue. Thus a 20-year pension annuity based on an 8% draw down of capital, an 8% return and 8% inflation, a +/- R2 million living annuity is potentially tax-free.
- Taxable income between R104 106 and R258 750 attracts tax at 25%. This effectively shields annuity income from a +/- R3 million living annuity.
- Taxation on living annuity income withdrawn to fund medical expenses can be all but neutralised by the new medical tax credit system.

Putting it all together in a tax-efficient package:

- Take R630 000 in a lump sum from a retirement fund taxed at an average of 9%.
- Set aside another R2 million within a living annuity to yield a tax-free pension of R104 106.
- Add another R3 million in a living annuity to yield R154 000 per annum taxed at 25%.
- Then set aside R750 000 within a living annuity to cover medical expenses.

Conclusion: R6,38 million in retirement capital is not going to create a tax problem!

The question then becomes: ‘How many South Africans have R6,38 million in retirement capital?’ Answer: ‘Very few.’

The most substantial change

But probably the most important factor is the decline in interest rates over the past 20 years. Basing a 1990s retirement plan on taxable interest rates of 20% was one thing. Trying to achieve the same today on taxable interest rates of 5% is another entirely.

The obvious solution is to switch to equity-based portfolios. This is not news. ‘The stampede to equities’ is now a global reality and is one of the biggest contributing factors to the recent surge in equity indices.

But this creates the risk of substantial market corrections and leaves the man in the street highly vulnerable when trying to ‘go it alone’ by maintaining a private portfolio.

Even if successful, the private investor is left exposed to CGT and income tax. This also increases the administrative and compliance burden.

There is simply no denying that the retirement fund has become a tax haven. Not only from the perspective of tax efficiency on contribution, but also from the perspective of protecting investment returns from taxation and limiting estate duty exposure.

The remaining problem: taxable annuities from retirement funds

The counter argument to all of the above is quite simply ‘all the tax benefits come home to roost, when a taxable annuity is withdrawn from the retirement fund.’

There can be very few situations where the taxation of an annuity exceeds the tax benefit on contribution. Furthermore a tax benefit granted today and repaid some years down the line is of considerable value. Not to mention the value of the tax exemption enjoyed while invested in the retirement fund.

The beauty inherent to using the living annuity principle is that it is possible for the pensioner to withdraw only what is needed for current expenses. The remaining savings are protected within the tax haven of the retirement fund.

This fundamentally changes the tax-planning outlook in retirement planning to ‘how does one cut income requirements to keep SARS out of your pension?’

Tax considerations aside, for many South Africans the unpleasant prospect is quite simply that they have insufficient retirement capital to generate a taxable annuity that will create a tax problem in retirement. Most will have to downsize their lifestyles and/or move in with the kids. But they do not have sufficient retirement capital to create a tax problem.

The high-net-worth individual is left with the following objectives:

- Acknowledge that ‘the higher the annuity withdrawal level, the higher the taxation component’. This can be managed using the living annuity principle.
- If accumulated wealth is available outside of the retirement fund, live as much off capital as possible until the capital is exhausted. This limits taxation exposure on annuities and gradually reduces estate-duty exposure.
- Once capital is reduced, resort to increasing the living annuity component of the required income.

The final question

It is common knowledge that National Treasury has expressed major concerns with regard to the living annuity principle and that amendments can be anticipated in the medium term.

The principle concern is that investors may currently drawdown as much as 17,5% per annum of the accumulated benefit of their living annuity capital. This will inevitably lead to the living annuity being exhausted within five to eight years.

The 17,5% maximum was determined during the high interest rate era of 20 years ago and needs to be re-examined. This does not mean that National Treasury is out to completely abolish the living annuity principle.

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