Did You Know

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TAX DEDUCTIBLE ACCESS TO SHARES THAT PAY MORE DIVIDENDS?

At Present

It's trite law that contributions to a Retirement Annuity (RA) are tax deductible up to certain limits. It's also common knowledge that because a RA is a voluntary pension arrangement and if no investment guarantees are provided on, for example, any policy of assurance linked to the market which is used to underwrite the fund then up to 100% of the member's chosen investment can potentially be in equities.

Not that this is necessarily wise. It depends on the member's personal and financial circumstances but the point is that a large part of a members RA funds can be exposed to equities that also pay dividends. So it's akin to having a share portfolio but being able to claim the purchase price as a tax deduction thereby enhancing the ultimate return.

In Future

What may be less appreciated is that the tax proposal to replace Secondary Tax on Companies (STC) for those companies that declare dividends on their shares with a 10% dividend tax in the hands of the shareholder will mean that all other things being equal retirement funds like RAs should receive more dividends than other shareholders and possibly also more than in the past under the old STC regime.

Why?

The dividend tax rate is 10%.This is currently the same as the STC rate. As this is not a company tax but a tax on dividends payable by the shareholder, the effective South African company tax rate is now simplified and fixed at 28%.

Under the previous STC regime, a company declaring dividends had an effective tax rate of around 35%, when one added the 10% STC to the corporate tax rate of 28%.

An example can best illustrate the point:
Under the new system, South African shareholders will pay a slightly higher effective rate of tax than under STC because the dividend is now declared exclusive of any dividends tax. For example, if a dividend of R100 000 is declared, under STC, that R100 000 is deemed to include the STC. The calculation can simply be described as R100 000 x 10/110, which results in STC of R9 090, leaving a net dividend for distribution to the shareholder of R90 909. Under the new system, the R100 000 will attract a dividend tax of 10%, which is R10 000, and will result in a net dividend of R90 000. The shareholder receives R909 less as a dividend.

invest in your success

But because retirement funds are exempt from the new 10% dividend tax the payer thereof is not obliged to withhold any tax. The fund itself will receive the full gross dividend. This is 10% more than what the ordinary non-exempt shareholder will get. Also because the company tax rate is now a true flat rate of 28% the payment of the dividend itself will also no longer be driven by STC tax considerations but other normal business considerations. So one may also expect companies to pay out more dividends assuming they are still performing well. Again good for retirement funds because this should improve fund returns for the benefit of the member.

Summary

In DYK 2/2009 we gave you 10 reasons why a RA makes good sense tax wise.

Come next year you can add this new reason to the list.

Also remember by having exposure to shares in a RA wrapper you do not pay any capital gains tax when shares are disposed of by the fund unlike if you had owned them in your personal capacity. Again a positive for fund returns.

Having tax deductible exposure to shares that pay more dividends is a new angle to consider going forward which could make RAs tax wise an even better prospect.

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