Denver Keswell
Senior legal advisor

Anil Jugmohan
Investment analyst

Contributing more than R350 000 to your retirement fund?

On 1 March 2016, National Treasury introduced a new way of calculating the tax deduction a member is entitled to when they contribute towards their pension, provident or retirement annuity fund. In previous years, a retirement annuity (RA) member could deduct up to 15% of their net non-retirement funded income from any contribution made towards his/her RA. As of this tax year, the same RA member can deduct up to 27.5% of their remuneration or taxable income (the higher of) towards any or all of their retirement funds. This means for example that a member who contributes 17.5% of the higher of remuneration or taxable income towards their provident fund will still be able to contribute an additional 10% towards either their pension or retirement annuity fund. The amount that a member is entitled to deduct from their taxable income is capped at R350 000 per annum.

Weigh up your options

Where does this leave the retirement fund members who have been contributing more than R350 000 to their retirement fund/s? Should they continue to do so or should they reduce their contributions and instead contribute towards voluntary savings like unit trusts?

The answer may differ for different members based on their financial needs, amount they over-contribute, term to retirement, appetite for risk, etc. While we will focus on tax, it is vital to chat to your financial advisor in order to establish the best solution for your specific needs.

Tax and technicalities

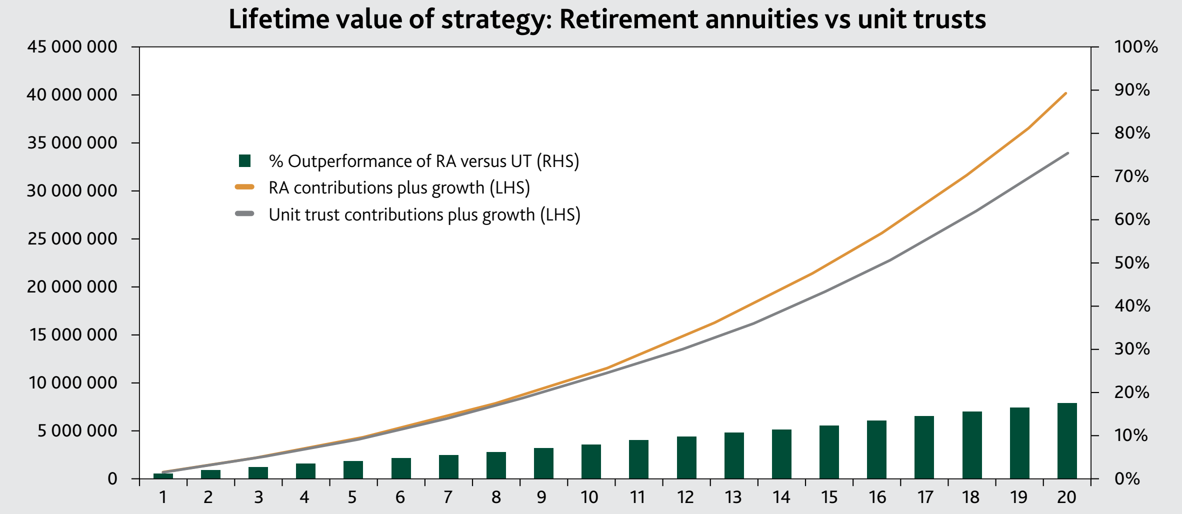
Let's assume that Peter contributes R1 000 000 per year towards his RA of which he qualifies for the full R350 000 contribution tax deduction. In previous years, Peter would also receive a tax deduction on the remaining R650 000 contribution. He is now looking at the consequences of continuing the full contribution of R1 000 000 to his RA versus contributing R350 000 to his RA and the remaining R650 000 to his unit trust account.

If Peter chooses to invest the remaining R650 000 into his RA he will not get a tax deduction on the contribution but will however accumulate tax-free growth while in the RA whereas all income generated from his unit trust account will attract income tax as well as dividends withholding tax. Any lump sum he receives from his RA will be taxed in terms of the retirement tax table and any income derived from a compulsory annuity will be taxed as income at his marginal rate of tax. We must however consider that other than the R500 000 tax-free amount that Peter is entitled to deduct from his taxable lump sum, he is also entitled to deduct his previously disallowed contribution of R650 000 per year from either his lump sum or any income derived from his compulsory annuity. Had he chosen to instead invest his R650 000 into his unit trust account then any withdrawal made would be taxed as a capital gain.

Assuming Peter contributed R650 000 per year to his unit trust account for 20 years without making any withdrawals and reinvesting all income, Peter would have accumulated R33 969 956 *(see graph)*. Using the maximum effective rate for Peter would mean he would have a CGT liability of R2 194 115 if he decided to do a full withdrawal, leaving him with an after tax amount of R31 775 841. In order to compare the scenario with that of an RA it would be more realistic to look at annual withdrawals from his unit trust account which will still be subject to capital gains tax but he will have a slight advantage of using his annual R40 000 CGT exemption.

Assuming Peter decided to contribute R650 000 per year to his RA for 20 years (we can assume for these purposes that he is entitled to retire after 20 years) without any allowed deductions, then Peter would have accumulated a fund value of R39 960 233 *(see graph)*.

Peter has different options when retiring from his RA. He can take up to one third of his fund value in cash and be subject to the retirement tax table (R500 000 tax-free) or he could purchase a compulsory annuity with the entire fund



Source: Nedgroup Investments

Assumptions used

Equity capital growth p.a: 9%	Dividend yield p.a: 3%	Fixed income return p.a: 6.5%
Allocation to equity: 60%	Allocation to fixed income: 40%	
Investment term: 20 years	Marginal rate of tax: 41%	

value. While various scenarios with various outcomes are possible, let's assume he decides to annuitise his entire fund value and purchases a living annuity. In terms of Section 10C of the Income Tax Act he is entitled to deduct the first R13 000 000 from any taxable income as the R650 000 per year that he has contributed for the past 20 years qualifies as a 'previously disallowed contribution'. This means that the remaining R26 960 233 will be taxed as income at his marginal rate of tax as he receives them on a monthly, quarterly or annual basis. He cannot access the entire benefit in cash and therefore cannot be taxed up front. Assuming he could be taxed upfront he would be left with R28 906 538 after tax. In reality however he will receive an annuity income at his selected intervals and will be subject to favourable tax rebates after turning 65 and then again after he turns 75. One should also consider that depending on the income he elects, he may fall into a lower tax bracket. Another important consideration is that while he is invested in a living annuity any returns earned within the fund will also be tax exempt similarly to the retirement annuity he invested in. This would not be the case had he decided on the unit trust account option.

So if we look at the over contribution (R650 000) purely from a tax perspective, there doesn't seem to be a massive advantage one way or the other. In fact there is an argument that the unit trust account comes out slightly better after tax depending on how the funds are accessed as illustrated in the example above.

This equation however would be different if we included the R350 000 per year contributed to a retirement fund that Peter is allowed as a contribution tax deduction from his taxable income. By contributing R350 000 towards his RA and getting a tax deduction on that amount Peter is effectively entitled to up to R143 500 per year back from SARS. If Peter decided to invest that R143 500 'rebate' into his existing unit trust account above, he would receive an extra R7 499 521. So while deciding to invest his over-contributions in either an RA or unit trusts might be a tricky decision for Peter from a tax perspective, investing his maximum tax deductible contribution of R350 000 to a retirement fund is a 'no brainer'. Peter does have the option to invest R30 000 from the R650 000 into a tax-free investment. This has the advantages of the unit trust example above with the added advantage that neither the income, dividend distribution nor any of the capital withdrawals is taxable.

From a tax perspective, a final consideration is that the entire fund value of a unit trust account is estate dutiable while the fund value of a retirement fund is exempt from estate duty (non-deductible contributions excluded).

Before you sign on the dotted line

While tax is a very important consideration when deciding where to invest your retirement fund over-contributions, there are many other factors to consider. Investing in a unit trust allows you freedom to choose your underlying funds while your choice of funds in a retirement fund is restricted by Regulation 28. One such restriction of Regulation 28 is that a member may not invest more than 25% of their market value into an offshore investment.

Another restriction with retirement funds is in terms of liquidity. An RA member for example can generally only access their fund value at age 55 and even then can only access up to one third of their fund value in cash, assuming the fund value is more than R247 500. The remainder of the fund value must be used to purchase a compulsory annuity. You are now able to stagger your retirement in that you don't have to retire from all of your retirement funds at the same time. You can however withdraw at any stage from a unit trust account. A further consideration in reducing contributions to a retirement fund is whether or not there are any fees or penalties involved. Generally unit trust companies don't levy fees for stopping or reducing contributions to an RA, but some product providers may.

Also, upon your death, consider how your unit trust account will be dealt with in terms of your will. You may instruct, in your will, how the proceeds of your unit trust account must be dealt with, however this is not the case with retirement funds. Section 37C of the Pensions Fund Act specifies that the trustee must apply their discretion as to who the factual dependants of the deceased member are and to distribute equitably.

Deciding how to invest any amount above what you are entitled to as a contribution tax deduction, while remaining tax efficient is not a straight forward decision. And, if you are in this fortunate predicament there are many factors to consider prior to making this decision.

Subscribe now

Opt to receive your investment statement digitally on any device. Call our Client Service Centre on **0860 123 263.**