45% TAX IS REAL:
Time to be tax efficient

DENVER KESWELL
SENIOR LEGAL ADVISOR

The 2017 budget introduced a marginal rate of tax of 45% - the highest marginal rate of tax for South Africans since the 1999/2000 tax year. Needless to say, this has received a lot of attention.

Although Treasury points out that they have not increased the inclusion rate for capital gains tax (CGT), the effect of increasing the marginal rate of tax still results in an increase in the effective rate of tax for CGT from a maximum of 16.4% to 18% for individuals and from 32.8% to 36% for trusts. Treasury has also increased the dividend withholding tax (DWT) rate from 15% to 20%.

Whether people become immediately aware of the effects or not, there is no doubt that this will have a real impact on South African's tax burdens. It is now more important than ever to explore ways to incorporate tax efficiency into one's broader financial planning, and there are some useful ways in which smart use of the financial products can assist in improving tax efficiency for investors.

1. Retirement Annuities (RAs)

Retirement annuities have been the subject of some (unfair) bad publicity due to the way some product providers structure their RA's. However, RA's are increasingly becoming more popular again. This is because RA's are structured to provide good tax saving opportunities for South Africans who make use of them.

Investors are entitled to deduct up to 27.5% per annum (capped at R350 000) of the higher of remuneration or taxable income from their contributions to an approved retirement fund. This means an RA member can claim up to 45% of their contributions to an RA made in that tax year. If the member contributes an amount of R120 000 in the tax year, and the entire contribution qualified for a tax deduction, the member would be able to claim up to R54 000 back from SARS.

Furthermore, should the member then choose to invest that R54 000, they would be generating returns on R174 000 of contributions. This is in comparison to returns on just R120 000 if the same member decided to invest in a product where the contributions did not qualify for a tax deduction. A pension or provident fund member can benefit similarly if they chose to increase their contribution to their fund, provided that the increased contribution qualifies for a tax deduction.

Twofold benefits

Apart from the tax deduction on contributions made to an RA, returns generated while invested in an RA are also not subject to tax. This means that not only can investors generate returns on the contributions 'subsidised by SARS' (should they decide to re-invest) but they can also generate returns on 'returns not taxed'.

What happens on retirement?

On retirement (from age 55 onwards) the member will receive up to R500 000 tax-free on any lump sum they receive. Income received from a compulsory annuity will be taxed as income but we do know that SARS provides favourable tax treatment to those individuals over the age of 65 in the form of additional tax rebates. The tax threshold for a 65 year old is currently R9 775 per month. Also with the introduction of Section 10C of the Income Tax Act, a compulsory annuitant can now use any contribution made to an RA (and pension fund) that did not qualify as a tax deduction to reduce their taxable income from the said annuity.

All deductible contributions made to an RA are also exempt from estate duty. Assuming our RA member made R5 000 000 deductible contributions over their lifetime, on death the deceased estate would have saved up to R1 000 000 (20%) that would have otherwise been payable to SARS had they not been in an estate duty exempt product.

All these benefits as added to the fact that any benefit paid to a beneficiary is not subject to executors fees, makes it easy to understand why RA's are becoming increasingly popular amongst South Africans.

2. Endowments

One of the interesting things noted from the Budget was that Treasury increased both the marginal rate of tax as well as DWT. This prevents taxpayers from re-structuring packages to reduce tax payable. Endowments however, are taxed in terms of what is referred to as 'four funds tax'.

When individuals invest in an endowment, their funds are placed into the individuals policyholders fund (IPF). The CGT inclusion rate in the IPF is 40% and the tax rate is 30%. This means that individuals invested in an IPF are currently subject to an effective rate of tax of 12% when they would be subject to a rate of up to 18% in their own names. Treasury has chosen not to increase the tax rates in the IPF, which makes endowments more attractive after the budget - and the higher a person's tax rate is above 30%, the more they stand to benefit from a tax perspective in an endowment.

Although they are taxed 'within the fund', investors are also not subject to a 'second form of CGT' when they withdraw from an endowment - provided they are the 'original beneficial owner' (i.e. not a second hand policy). Finally, endowments are also not subject to executors fees when paid out to nominated beneficiaries. This could be a significant benefit for endowment investors if used as a legacy product as opposed to a product that will in all likelihood be consumed over the lifetime of an investor.

3. Tax-free investments (TFIs)

Tax-free investments have surprised many people with their early success since the product's launch in March 2015. A large number of South Africans have taken up the opportunity to contribute up to R33 000 (increase from R30 000 in the 2017 budget) per annum.

While there are no tax deductions on contributions made to a TFI, once invested all returns from a TFI product will generate tax-free returns. There is no income tax, CGT or DWT on TFIs. Combining a TFI with an RA creates an opportunity to be even more tax efficient.

For example, an investor who contributes towards both an RA and a TFI could realise at age 55 that they need a source of 'income'. They would then have an opportunity to access regular tax-free withdrawals from their TFI - thereby allowing them to further preserve their RA, if possible to age 65, where any income derived from a compulsory annuity would benefit from favourable tax rates.

TFIs in the family

An individual South African can contribute a maximum of R33 000 per tax year to a TFI. If a parent would like to take out a TFI for their minor child as well as their spouse then the TFIs will be owned by the minor and spouse respectively. Any contribution made by the parent will be deemed to be a donation and will therefore be subject to donations tax. An individual South African can, however, donate up to R100 000 per tax year without incurring any donations tax. Donations between spouses are also exempt from donations tax. This means that a parent can therefore contribute R33 000 on behalf of their spouse as well as up to 3 children (R99 000) without incurring any donations tax.

4. Unit trusts

Unit trusts have proven to be quite popular over the years due to their efficient cost structures, governance and liquidity. Depending on your underlying investments, returns can be subject to income tax, CGT and/or DWT. Currently, all tax payers are entitled to an interest exemption of R23 800 per tax year for those under age 65 and R34 500 for those over age 65. Unit trusts allow investors to utilise this exemption by investing a portion of their unit trust holdings into interest bearing funds. In addition, unit trust natural investors are also allowed to use the annual CGT exclusion of R40 000 while alive and R300 000 on death. This allows unit trust investors to make withdrawals on an annual basis and, if the gain is less than R40 000, they will not be liable for any CGT.

5. Trusts

Trusts are succession planning vehicles that provide some protection from creditors. Trusts have often been used in the past for tax reasons. However, more often than not when Founders have done this, SARS has introduced legislation to close the tax-loopholes.

Many Founders have managed to peg their estate for estate duty purposes. In order to get assets into trusts founders would often 'loan' money to a trust without charging any interest or by charging a low rate of interest. However, to curb this abuse, Section 7C of the Income Tax Act was introduced. This section states that any interest not recovered by way of not charging interest or by charging a reduced rate of interest to be a donation and therefore would be taxed at a rate of 20%.

In spite of this, if the asset has substantially grown in value in the trust the founder has still managed to reduce his/her estate for estate duty purposes by the market value of the asset less any outstanding loan account. Taking into consideration Section 7C, the increase in the CGT effective rate of tax and the fact that the conduit principle is being looked into, brings into question the tax advantages of trusts in future years.

6. Living Annuities

A living annuity is essentially an income bought at retirement (and occasionally on the death of a retirement fund member) where the source of the funds is from a retirement fund only. Investors cannot use voluntary funds to purchase a living annuity. Similarly to retirement funds, living annuities are not taxed whilst invested. Income drawn from a living annuity is subject to income tax but, as mentioned, annuitants benefit from preferential tax treatment if they are over the age of 65, as well as now being able to use previously disallowed retirement fund contributions to reduce any tax payable from the annuity. Similarly to endowments with nominated beneficiaries and RAs, there are no executor's fees when a beneficiary is nominated on a living annuity.

7. Life Policies

On the death of an investor, the deceased estate often has many liabilities to settle. Even though the deceased estate may have more assets than liabilities, they may be faced with the situation where much of the assets are immovable and therefore have a shortfall of cash needed to pay for CGT, income tax, estate duty, executors fees, cash bequests, outstanding loan accounts, etc.

One way to avoid having the executor to enter into forced sales to settle liabilities, is for the investor to take out a life policy payable to the estate. Even though the policy is exempt from CGT when it pays out, it's important to remember that it becomes an asset in the estate on death, and therefore will have the effect of increasing estate duty and executors fees. One therefore needs to cater for this when establishing the policy amount required to settle liabilities.

Financial planning should be viewed as a 360 degree plan that incorporates not only tax considerations, but all the investors financial needs as well as appropriate products. However, given the current environment and the recent changes announced in the Budget Speech, using the financial tools available to increase tax efficiency can be a very valuable element of a broader financial plan.

It is therefore vital to have the conversations regarding the above when sitting with your financial advisors.

If you have any queries regarding this article, please feel free to contact Nedgroup Investments Legal Services.