Retirement funds and tax

Denver Keswell
Senior legal advisor

When trying to find an appropriate investment, one needs to look at various factors. You need to ask yourself a number of questions: Is your primary need to grow your funds and access them over the next few years, in which case you might want to consider unit trusts or a money market type account? Maybe you would like to invest for a long period of time but are concerned that an emergency might mean that you unexpectedly need to access some of your funds over the next few years. This might make tax-free investments or at least a combination of different types of investments attractive. There are many factors that you need to consider before choosing an appropriate vehicle. Factors such as term of investment, acceptable risk, age until retirement, investment product features, and costs make choosing an appropriate investment quite difficult. However, if tax is your primary consideration then it is hard to find an investment more attractive than a retirement fund.

Trying to understand the full tax regime around retirement funds can often prove quite difficult. The easiest way to understand the effects of tax on retirement funds is to break the investment up into three tax events namely, going into the fund, within the fund and coming out of the fund.

Going into the fund

This is the contribution stage of a retirement fund. One of the greatest advantages of contributing towards a pension fund or retirement annuity (provident fund as well from 1 March 2016) is that retirement fund members are entitled to deduct contributions made to their retirement funds up to a certain maximum from their taxable income *(see table on following pages)*. This in effect means that SARS 'subsidises' up to 41% of your contributions towards a retirement fund. Assuming that your marginal rate of tax is 41% it would mean that up to R410 of every R1000 earned will go to SARS. That leaves you with R590 to invest. Assuming that the entire contribution is tax deductible, contributing towards a retirement annuity would mean that you would be entitled to claim back the R410 due to SARS which in turn means you would be entitled to a return of R410. That's almost a 70% return that you are entitled to before your actual contribution to the retirement annuity starts earning a return. This is the primary reason why if you look at investments purely from a tax perspective, you will be hard pressed to find any other type of investment that compares to a retirement annuity.

Within the fund

Another tax advantage of a retirement fund, which becomes relevant as your investment grows, is that there is no tax on the interest or dividends earned by the investment as well as no capital gains tax on gains within the portfolio. This means that you can benefit from years of tax-free investment growth within a retirement fund, which will help towards increasing your investment returns.

Coming out of the fund

Certain tax benefits apply when you take out money from your retirement fund. You are entitled to R500 000 tax-free on any lump sum received at retirement as well as R25 000 tax-free when you withdraw from a retirement fund *(see table)*. Any annuity received will be taxed at your marginal rate of tax but generally one finds that their tax rate often drops at retirement with larger tax rebates. The other massive advantage of a retirement fund is that there is no estate duty payable on any approved retirement fund, saving a retirement fund member up to 20% of their investment value.

Tax is only one of the many factors to consider when seeking an appropriate investment. Many people however ignore the significant tax advantages purely because they seem difficult to understand. With the assistance of the diagram, we hope that you will find yourself in a better position to understand the tax advantages of a retirement fund as well as the consequences of some of your actions while you are a member of a retirement fund. □

Retirement funds and tax

<table>
<tr><th></th><th></th><th>Provident Fund</th><th>Pension Fund</th><th>Retirement Annuity</th></tr>
<tr><td rowspan="5">Contribution deductibility</td><td>Employer (current)</td><td colspan="2">10% of approved remuneration for pension, provident funds and medical aid schemes. Up to 20% with SARS approval.</td><td>Contribution made by employer deemed to be employee contribution.</td></tr>
<tr><td>Employer (proposed: 1 March 2016)</td><td colspan="3">Employer contributions to defined contribution funds will be deemed to be employee contributions. Employer contributions to be fully tax deductible and not limited.</td></tr>
<tr><td>Employer (current)</td><td>Not deductible</td><td>Greater of:
- R 1 750 or
- 7.5% of pensionable remuneration</td><td>Greater of:
- R1 750, or
- R3 500 – allowable pension fund contributions, or
- 15% of net non-retirement funding taxable income</td></tr>
<tr><td>Employer (proposed: 1 March 2016)</td><td colspan="3">Greater of: - 27.5% of taxable income or remuneration capped at R350 000 for all three types of retirement funds.</td></tr>
<tr><td>Arrear contributions</td><td>Not deductible</td><td>R1 800 per annum</td><td>R1 800 per annum</td></tr>
<tr><td rowspan="2">Non-deductible contribution</td><td>Current</td><td colspan="3">New Section 10C of the Income Tax Act now allows you to deduct any non-deductible contributions made to a pension fund or retirement annuity from your taxable income earned from a compulsory annuity.</td></tr>
<tr><td>Proposed (1 March 2016)</td><td colspan="3">Section to be amended to allow you to deduct any non-deductible contributions made to a pension fund, retirement annuity or provident from your taxable income earned from a compulsory annuity.</td></tr>
<tr><td>Within the fund</td><td>Returns</td><td colspan="3">All returns within the fund are exempt from tax.</td></tr>
<tr><td rowspan="5">Retirement</td><td>Benefit: lump sum vs. compulsory annuity</td><td>Max: full fund value may be commuted.
Min: n/a</td><td colspan="2">Max: up to 1/3rd can be taken in cash unless fund value is less than R75 000, then full fund value may be commuted.

Min: at least 2/3rds must be used to purchase a compulsory annuity.</td></tr>
<tr><td>Taxable lump sum</td><td colspan="3">Lump sum taken less:
• Contributions which did not previously qualify as a deduction;
• Previous taxed transfer of divorced awards to the retirement fund;
• Previous transfers that were taxed; and
• Pre 01/03/1998 amounts transferred from public sector funds.</td></tr>
<tr><td rowspan="2">Taxable portion</td><td>Taxable amount</td><td colspan="2">Rate of tax</td></tr>
<tr><td>First R500 000

R500 001 – R700 000

R700 001 – R1 050 000

R1 050 001 and above</td><td colspan="2">0% of taxable income

18% of taxable income exceeding R 500 000

R36 000 + 27% of taxable income exceeding R700 000

R130 500 + 36% of taxable income exceeding R1 050 000</td></tr>
<tr><td>Annuity portion</td><td colspan="3">Taxed as income at your marginal rate of tax.</td></tr>
<tr><td rowspan="6">Death</td><td>Benefit: lump sum vs. compulsory annuity</td><td colspan="3">Max: full fund value may be commuted.
Min: n/a</td></tr>
<tr><td>Taxable lump sum</td><td colspan="3">Same as for retirement in the name of the deceased member.</td></tr>
<tr><td>Taxable portion</td><td colspan="3">Same as for retirement in the name of the deceased member.</td></tr>
<tr><td>Annuity</td><td colspan="3">An any annuity taken by the beneficiary will be taxed as income in the name of the annuitant.</td></tr>
<tr><td>Estate Duty (current)</td><td colspan="3">No estate duty on any approved retirement fund.</td></tr>
<tr><td>Estate Duty (proposed: 1 March 2016)</td><td colspan="3">Only contributions that did not qualify for tax deduction will be dutiable.</td></tr>
</table>

Retirement funds and tax (continued)

		Provident Fund	Pension Fund	Retirement Annuity
Retrenchment	**Benefit: Lump sum**	Full fund value subject to fund rules.		n/a
	Taxable Lump sum	Same as for retirement provided withdrawal is as a result of retrenchment/redundancy in the following circumstances: • Termination due to employer ceasing trade or intending to do so; • Redundancy due to employer effecting a general deduction in personnel in a certain class; and • Members don't have more than 5% shares/members interest in the employer.		n/a
	Taxable portion	Same as for retirement		n/a
Withdrawal	**Benefit: Lump sum**	Full fund value subject to fund rules		No withdrawal prior to age 55, unless: • paid up value is less than R7 000 or • member has formally emigrated.
	Taxable Lump sum	Lump sum taken less: • Contributions which did not previously qualify as a deduction; • Previous taxed transfer of divorced awards to the retirement fund; • Previous transfers that were taxed; and • Pre 01/03/1998 amounts transferred from public sector funds.		
	Taxable portion	**Taxable amount**	**Rate of tax**	
		First R25 000	0% of taxable income	
		R25 001 - R660 000	18% of taxable income exceeding R25 000	
		R660 001 - R990 000	R114 300 + 27% of taxable income exceeding R660 000	
		R900 001 and above	R203 400 + 36% of taxable income exceeding R990 000	

Key: going into the fund · coming out of the fund · within the fund · current legislation · proposed legislation

How to calculate tax on a retirement fund lump sum at retirement

Step 1 Calculate the taxable lump sum for current tax year (after allowable deductions);

Step 2 Identify and add previous taxable amounts from withdrawal (as from 1 March 2009), retirement (as from 1 October 2007) and severance benefits (as from 1 March 2011);

Step 3 Add step 1 + step 2;

Step 4 Calculate the tax payable on the total amount calculated in Step 3 – using the Retirement Tax Table;

Step 5 Calculate the tax payable on the previous amounts received – thus the amounts calculated in Step 2 – using the Retirement Tax Table. This amount is referred to as the 'hypothetical Tax';

Step 6 Determine tax payable:

Tax calculated in step 4	R ________
Less hypothetical tax calculated in step 5	- R ________
= Tax payable	R ________