GRAY ISSUE
LONG TERM COMMENTARY

3 December 2003
Issue no. 28

An opportunity for retired people to reduce tax payable

The taxman has been described as the dark side of Robin Hood. He steals from the ‘uninformed’ and gives to the ‘informed’. Being aware of how capital growth and interest are taxed when it occurs inside a living annuity versus when it occurs in an investment in the retiree’s name creates an opportunity to reduce tax payable.

Retirees should as far as is practically possible have their exposure to share-based investments in their own name and their interest bearing assets in a living annuity.

Looking at assets held in the retiree’s own name, it is important to note that only 25% of the capital growth realized on these assets is taxable at his/her marginal rate. The first R10 000 of capital gain is excluded from capital gains tax. Dividends accruing in the retiree’s name are tax-free. Interest and net rentals are however treated as taxable income and taxed at his/her marginal tax rate. From this, it follows that the tax payable on capital growth in the retiree’s name is much lower than the tax payable on interest and net rentals accruing in his/her own name.

Inside a living annuity, capital growth, interest, net rentals and dividends are not taxed. The monthly pension paid by the living annuity is however taxed as taxable income. Therefore, all the growth in a living annuity - regardless of whether it occurred in the form of dividends, interest or capital growth - will eventually be withdrawn from the living annuity and taxed at the retiree’s marginal tax rate. Capital growth and dividends inside a living annuity are therefore effectively taxed at the retiree’s marginal tax rate.

From this one can see that capital growth outside the living annuity attracts a much lower tax rate (25 % of marginal rate versus full marginal rate in the case of the living annuity). This makes having exposure to shares in a living annuity less effective from a tax point of view.

The long-term impact of having exposure to shares in a living annuity can be very significant. In the table below, two scenarios are compared. In the first, the person has all his/her share exposure inside the living annuity while in scenario two the share exposure is outside the living annuity, in the unit trust.

The following assumptions were used in the calculations: 5% of the money in the living annuity is withdrawn and consumed annually; interest rates on bonds and cash is 10%; shares yield a 3% dividend yield and 12% capital growth; the first R10 000 of interest earned is excluded from tax; the first R10 000 capital gain is excluded from capital gains tax and a marginal tax rate of 40% applies.

From the table below it follows that the tax payable in scenario one is R41 000 while that in scenario two is R23 000, a potential saving of R18 000 per year!

	Scenario 1	**Scenario 2**
Value of shares in living annuity	R 750 000	0
Value of bonds & cash in living annuity	0	R 750 000
Value of shares in unit trust fund	0	R 750 000
Value of bonds & cash in unit trust	R 750 000	0
Taxable income from living annuity (5% withdrawal)	R 37 500	R 37 500
Taxable interest from unit trust funds	R 65 000	R 0
Taxable capital gain from unit trust funds	R 0	R20 000
Total taxable income	R 102 500	R 57 500
Tax payable at a marginal tax rate of 40%	R 41 000	R 23 000
Potential annual tax saving	**R 18 000**	

Commentary by Barend Ritter, Head of Individual Retirement Products