GRAY ISSUE

February: Don't miss out on your 2015/2016 tax breaks

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The end of the tax year is fast approaching – but there is still time to take advantage of some of the incentives the government has put in place to encourage savings. The introduction of the tax-free savings legislation last year has added an extra arrow to the quiver of tax-efficient options available to investors. Options are great, but having to choose often stops people from acting and can get in the way of our good intentions. If pressed to make a decision between a unit trust-based retirement annuity (RA) or a unit-trust based tax-free investment (TFI) product, which should you choose?

Begin with the end in mind

At this time of the year maximising tax breaks is a common, top-of-mind goal. However, it is important to look at your portfolio holistically, either on your own or with the help of a good, independent financial adviser, to ensure your decisions fit in with the long-term plan.

Let's talk tax

There has been much debate about the benefits of TFI products versus RAs. First, remember that both an RA account and a TFI savings product grow free of dividends tax, income tax on interest and capital gains tax. In our simple example[1], because you are compounding all gains tax free, your investment value at the end of 30 years would end up roughly 45% higher than in a discretionary investment.

The main difference between the two products is that an RA offers tax savings now, i.e. you pay less tax now because you make contributions with earnings on which you have not paid tax, but you will pay tax later, i.e. you defer paying tax. With TFI products, on the other hand, you use after-tax money to invest, but you pay no tax later; your withdrawals are completely tax free. So which offers the best deal tax-wise? Let's consider the detail:

Only 15% of non-retirement funding income is eligible for a tax deduction. This is set to change on 1 March 2016 to allow a tax deduction of up to the higher of 27.5% of taxable income or remuneration capped at R350 000 per year. This is a solid increase and will make the tax savings on an RA more relevant for higher income earners (albeit lower for the very high earners where the new annual rand cap is less than the previous 15% limit).

Apart from deferring tax in an RA, the tax saving comes from paying a lower average tax rate on the benefits withdrawn from the RA at and after retirement, versus the tax saved on contributions. The first R500 000 of any lump sum you withdraw from your RA is currently tax-free (you can withdraw up to one-third, but this includes any pre-retirement withdrawals), and the rest of the benefit must be transferred to an income-providing product, such as a living annuity or a guaranteed life annuity. When income tax is paid on this benefit, you are likely to be taxed at a lower rate than when you were making contributions, which is where the additional tax savings comes in. Because of this, a disciplined investor paying income tax at marginal rate of 36% could pay more than 50% less tax on their retirement savings over their lifetime. This obviously varies depending on each investor's personal circumstances, salary, age, how much and how long they have saved and any withdrawals made along the way. When comparing to a TFI product, the difference is that you have a future tax liability, whereas in a TFI your tax would already have been paid, but at a higher rate.

What's the catch?

While the tax benefits of the RA and TFI are clear, it's important to be aware of the restrictions before making a decision. RAs are governed by the retirement fund regulations, specifically Regulation 28 of the Pension Funds Act, which limits the exposure you can have to more risky asset classes, such as equities and offshore investments.

In TFI products, there are no restrictions on asset classes but you can only invest in investments that charge fixed fees, which limits your selection. We have recently launched a fixed-fee version of our flagship Balanced Fund to accommodate investors who would like to invest in our Tax-Free Investment Account. Another critical point, is that you can only invest R30 000 per year in TFI products. This is the maximum limit for all TFI accounts in your name, across product providers. If your goal is to save for retirement, the maximum annual contribution of R30 000 in a tax-free savings account may not be enough to sustain your lifestyle, and if you over-contribute SARS will hit you with a hefty 40% tax penalty.

Access to cash may be another deal breaker: your investments in an RA cannot be accessed before the age of 55. You can access your TFI investment at any time. However, withdrawing from a TFI account impacts negatively on your lifetime investment limit of R500 000 – you cannot replace money that you have withdrawn.

Other distinguishing features

Both the Allan Gray RA and TFI[2] are protected against the claims of creditors and do not form part of your insolvent estate. This feature is not applicable to all TFI products but it is applicable to the Allan Gray TFI, which is a life policy.

You may nominate beneficiaries for an RA, although the trustees determine the allocation between your dependants and nominees. You may nominate beneficiaries when the TFI is a life policy. RAs are exempt from estate duty, whereas TFIs forms part of your estate and attract duty, although there are no executor fees if beneficiaries have been nominated.

Which product wins?

From a retirement savings perspective, in most cases RAs offer the best tax deal. However you need to be able to live with the restrictions described above. For long-term discretionary investments, it probably makes sense to put your first R30 000 into a TFI product. Remember, however, that you will need to be disciplined and resist the temptation of withdrawing from your TFI account. You only get to enjoy the long-term compounding benefits if you don't dip your hands into the cookie jar along the way.

Contribution deadlines

If you are planning to make use of the tax concessions for this tax year by starting a new RA or TFI, or by making an additional contribution to an existing account, please note that we need to receive your instruction, supporting documents and payment, if applicable, by the 26 February for TFI accounts, and 29 February for RA accounts.

1. Assumptions:
    - The investor saves R2 500 per month for 16 years and 8 months, at which point they have saved the R500 000 lifetime cap and can no longer contribute to their TFI.
    - 13.3% total return, with the split between capital gains, interest and dividends based on our Balanced Fund's track record.
2. Provided certain requirements in the Long-Term Insurance Act have been met e.g. the policy must have been in force for at least three years.

Commentary by Jeanette Marais, director of distribution and client service, Allan Gray