Discovery

# The Retirement Annuity as an alternative to a Trust

# Introduction

- This presentation is meant to provoke and encourage discussion!
- While a RA obviously cannot hold a planner's house or business, it can do many other things that a trust cannot do, in many cases more effectively
- Debate should be under what circumstances is each vehicle more appropriate

# RA's-advantage 1-Full Estate Duty Shelter

**Background**

- Since 1 January 2009, all payouts from RA's on death are free of estate duty [Section 3 (2)(i) of the Estate Duty Act]

- In terms of the definition of "Retirement Annuity" in the Income Tax Act, on death, the full cash proceeds of the policy can be paid to dependants if they so wish:

  "that not more than one-third of the total value of the retirement interest may be commuted for a single payment and that the remainder must be taken in the form of an annuity (including a living annuity) **except where two-thirds of the total value does not exceed R50 000 or where the member is deceased**

- In terms of the Second Schedule to the Income Tax Act, any taxpayer contributions to a RA which did not "rank for deduction against the taxpayer's income in terms of section 11 (k) or (n)of the Act" will pay out tax free in addition to the R500 000 allowed. Section 11 (n) of the Act allows a deduction up to a maximum of 15% of non-retirement funding, taxable income. [The section has been paraphrased.]

# Cont

## Scenario

Client aged 84 has R3m to invest. He does not need the money, but wants to invest it for his family. He has an estate duty problem.

## Solution

The client invests the R3m in a single premium RA. With this simple investment, the client has achieved 5 benefits:

- The R3m has been removed from the client's estate, and will be free of estate duty when it pays out. This equates to a saving of R600 000, without taking growth of the investment into account! Also no CGT on death

# Cont

- The investment will be in the untaxed portfolio in the insurers hands

- When the client dies, his dependents can draw the full proceeds of the policy in cash if they so choose. This makes it a fully liquid investment for them.

- The policy proceeds will pay directly to the dependants on death and not be subject to executor's fees in the deceased estate. Assuming no growth, and the normal executor's fee at 3,99%, this equates to a saving of R119 700! The client will also therefore not have to worry about a will for these assets, as they are not part of the estate.

**Warning**

- This plan will not work if there are **family problems**-second marriages, kids and step moms etc, as **dependants get paid over nominated beneficiaries** when a RA pays out. [See later on Living Annuities though].

# Cont

- Finally, the R3m paid into the RA would have been well in excess of the allowable deductible amount-see above. It would be safe to assume that it would not have been tax deductible going into the RA. This would mean that it would come out tax free on top of the R500 000 allowed. If a small part of it was deductible, that bit would not come out tax free, but then the taxpayer could still use the R500 000 tax free allowance. [Assuming that has not been used before].

**Benefits**

- The client has been given an investment in an untaxed portfolio, which is fully liquid for the family, free of executor's fees and estate duty, and, in most cases, tax free when it pays out. No other investment product can match this.
- Important to note that unlike a trust, there is no loan account left behind in the estate on purchasing a RA

# RA advantage 2-liquid investment

## Background

- In terms of the definition of "Retirement Annuity Fund" in the Income Tax Act, the rules of the fund must provide-

  "that not more than one-third of the total value of the retirement interest may be commuted for a single payment and that the remainder must be taken in the form of an annuity (including a living annuity) **except where two-thirds of the total value does not exceed R50 000** or where the member is deceased; "[**NB-this will increase to R100 000 from 1 March 2015**]

- Note, that in practice, SARS aggregates each fund **per insurer**. For example, if X has two RA's with Discovery of R 50 000 each, then neither could be "cashed in" on retirement as they are in aggregate more than R75 000. However, if X has two RA's-one with Discovery and one with Insurance Company B, and they are worth R50 000 each on retirement, then both could be "cashed in".

# Cont

- In terms of the Second Schedule to the Income Tax Act, any taxpayer contributions to a RA which did not "rank for deduction against the taxpayer's income in terms of section 11 (k) or (n)of the Act" will pay out tax free in addition to the R500 000 allowed. Section 11 (n) of the Act allows a deduction up to a maximum of 15% of non-retirement funding, taxable income. [The section has been paraphrased.]

- On retirement, the table for retirement fund lump sum benefits will apply. This means that if R1050 000 is drawn as a cash lump sum, then R500 000 of the cash lump sum will be tax free, R500 001-R700 000 of the cash lump sum received will be taxed at 18%, and R700 001-R1050 000 will be taxed at 27%. Anything above R1050 000 will be taxed at a flat rate of 36%. Note that these concessionary amounts are only available **once over a taxpayer's lifetime**.

# Cont

**Scenario**

Client aged 53 has R100 000 to invest.

**Solution**

The client invests the R100 000 in two single premium RA's with two different insurance companies of R50 000 each. With this simple investment strategy, the client has achieved 4 benefits:

- The investment will be in the untaxed portfolio in the insurers hands
- Because the client is 53, the RA's will only have two years until maturity. The client therefore has obtained two short term investment policies.

# Cont

- Because both RA's with the different insurers will be worth less than R75 000 on maturity, they can both be "cashed in" in full at age 55 and the full fund value taken in cash.

- Finally, the R100 000 paid into the RA would probably be partly deductible [up to the 15% limit] with some part probably not being deductible. This would mean that for the part that was deductible, that bit would not come out automatically tax free, but then the taxpayer could still use the R500 000 tax free allowance. If part of the contribution [the original R100 000], was not deductible, as it was over the 15% limit, then that bit would come out tax free, on top of the R500 000 tax free allowance.

**Benefits**

The client has, in effect, been given an investment in a two year endowment policy in an untaxed portfolio, with a part of the contribution often being tax deductible! In most cases, the investment will also pay out tax free. **Money invested in a RA is not always "tied up forever"!**

# RA Benefit 3-Emmigration

**Background**

- In terms of the definition of “Retirement Annuity Fund” in the Income Tax Act, the rules of the fund must provide-

- “that not more than one-third of the total value of the retirement interest may be commuted for a single payment and that the remainder must be taken in the form of an annuity (including a living annuity) except where two-thirds of the total value does not exceed R50 000 or where the member is deceased;”

# Cont

- "that a member who discontinues his or her contributions prior to his or her retirement date shall be entitled to—
- ……..
- cc) the payment of a lump sum benefit contemplated in paragraph 2(1)(b)(ii) of the Second Schedule where that member's interest in the fund is less than an amount determined by the Minister by notice in the Gazette; or
- dd) **the payment of a lump sum benefit contemplated in paragraph 2(b)(ii) of the Second Schedule where that member emigrated from the Republic and that emigration is recognized by the South African Reserve Bank for purposes of exchange control**;"
- NB-must be a South African leaving the CMA to emigrate!

# Cont

- Note that this paragraph allows a member who emigrates officially through the Reserve Bank, to "cash in" their RA. This is **as long as the RA has not yet matured-i.e.not reached the client's retirement date**. Whether or not the client can take the money out of the country will depend on their personal foreign exchange control position and the applicable laws at the time.

- In terms of the tax position, the "cashing-in" of the RA will be taxed as a withdrawal. This means that the first R25 000 of the cash lump sum will be tax free, the balance up to R660 000 will be taxed at 18%, the balance up to R990 000 will be taxed at 27%. Anything above R990 000 will be taxed at a flat rate of 36%. Note that this concession is only available once.

- Section 11 (n) of the Income Tax Act allows a deduction of contributions to a RA up to a maximum of 15% of non-retirement funding, taxable income. [The section has been paraphrased.]

# Cont

- In terms of the Second Schedule to the Income Tax Act, any taxpayer contributions to a RA which did not "rank for deduction against the taxpayer's income in terms of section 11 (k) or (n)of the Act" will pay out tax free in addition to the R500 000 [or R25 000] allowed.

**Scenario**

- Client aged 40 is not a member of a pension or provident fund. He has made very little provisions for retirement, and is therefore not making use of the generous tax concessions for taxpayers contributing to retirement funds. His advisor wants to sell him a RA, but the client is reluctant to take one out because he is considering emigrating.

**Solution?**

# Cont

The client should still invest in a RA. He will achieve the following benefits:

- In terms of Section 11(n) of the act-see above-the client would be able to claim a tax deduction of the premium [up to 15% of his non-retirement funding, taxable income]
- The investment will be in the untaxed portfolio in the insurers hands
- If the client were to emigrate in the next few years, his RA would not have reached its maturity date, so he could cash it in in full and take the proceeds. Although there might be forex issues in taking the money out the country, [if he has used his R4m annual allowance], that would apply similarly to any other investment he had.

# Cont

- Most importantly, the client would even get a small tax benefit-his contribution to the RA would have been deductible at his marginal rate of 40%. When he “cashes in” his RA he would get R25 000 tax free, and the balance would only be taxed at 18% [assuming the RA has not grown to over R660 000 in the few years]. [**Note that normally a withdrawal from a retirement fund is not to be recommended as there will be tax penalties on retirement. That however is not applicable in the current scenario, as if the client is emigrating he will not be retiring from a fund in SA**]

**Benefits**

The client has not been prejudiced in any way by investing in a RA and then emigrating. **His cash is fully liquid on emigration, as long as it is done officially**

# Conclusion

**Conclusion**

- The fact that the client might emigrate is no longer a valid objection to taking out a RA-in fact , a RA is more liquid than many other structures on emigration!

- NB-this is as long as the RA was not taken out within a period of 5 years prior to date of emigration-if it was, then only “the actuarially calculated income portion would be allowed to be transferred abroad while the capital portion would have to be credited to the emigrant’s blocked account”-see Reserve Bank manual, para 6.2.5.15

# Number 4-The obvious advantage of a RA

## Background

- **Section 11 (n) of the Income Tax Act** allows a deduction of contributions to a RA up to a maximum of 15% of non-retirement funding, taxable income. [The section has been paraphrased.]

- **In terms of the tax tables on retirement**, any lump sums received from a pension, provident or RA fund will be taxed as follows:

- R0 – R500 000-Tax free
- R500 001 – R700 000-18% of amount above R500 000
- R700 001 – R1050 000-27% of amount above R700 000
- R1050 001 and above-36% of amount above R1050 000

# Cont

**Note the following:**

- This concessionary table is only available **once**, and is aggregated across all retirement funds. That means that once R1050 000 has been taken from a pension fund, for example, there would be no concessionary rates left for any lump sum from a RA.

- Secondly, taking a lump sum of up to R1050 000 from a retirement fund makes a lot of sense, as the taxpayer is only paying an average rate of 15% on the full R1050 000. [Taking the 3 scales into account and averaging them.] However, taking more than R1050 000 makes very little sense, as the taxpayer is then paying tax at a flat rate of 36%.

# Cont

**Scenario**

- Client aged 40 runs his own business and is not a member of a pension or provident fund. He has made very little provisions for retirement, and is therefore not making use of the generous tax concessions for taxpayers contributing to retirement funds. His advisor wants to sell him a RA, but the client is reluctant to take one out because he has other investments.

**Solution**

- By not investing at least some of his money in a RA, the client is passing up the following benefits:

# Cont

- In terms of Section 11(n) of the act-see above-the client would be able to claim a tax deduction of the premium [up to 15% of his taxable income, as it would all be non-retirement funding, seeing as he is not a member of a pension/provident fund ]
- The investment will be in the untaxed portfolio in the insurers hands
- When the client retires, he will be able to draw a lump sum of up to R1050 000 at the very favorable tax rate of only 15%-see above
- Finally, the RA will generally [assuming no intent to defraud creditors] be protected on insolvency, and is a nice “nest egg” for the self employed

# Cont

## Benefits

- The client has an investment where the contributions were tax deductible at his marginal rate of 40%, there was no tax within the portfolio, and when he retires, he is able to draw up to R1050 000 at a tax rate of only 15%! In addition, the investment is protected on insolvency! What other investment has these benefits?

## Conclusion

- All self employed business people should be allocating at least **part** of their investment contributions to a RA-by failing to do so they are simply not utilizing major tax benefits allowed in the Income Tax Act. **NB-contributions to a trust are not deductible!** There are no tax free amounts when a trust matures an investment!

# Advantage No 5-General Tax Benefits of a RA

- **Straight Unit Trust investment**
  - After tax money invested
  - Interest taxable above rebate [not to be updated anymore]
  - DWT at 15%
  - CGT on sales/switches up to 13.3%
  - On death-CGT and estate duty and exec fees

- **RA Investment**
  - Contributions deductible within limits [capped in 2015]
  - Interest earned tax free
  - No DWT
  - No CGT on switches/sales
  - On death no estate duty [3 (2)(i) of the Estate Duty Act] or CGT or exec fees
  - PLUS protected on insolvency!

# Summary so far…

- Contributions to a trust are not tax deductible AND transfers to a trust create a loan account
- While trust holds the investment it is not tax free
- When the trust liquidates the investment and pays it to beneficiaries there will be tax [either income or CGT] somewhere. With a RA there are major tax concessions when the investment is matured
- On death, RA pays out to dependants, so does facilitate transfer to the next generation
- Much harder for creditors to claim against a RA than against a trust..

# A member of a RA can switch into a living annuity which means…

- When a member of a RA turns 55, he/she can mature the RA and purchase a living annuity. This has the following extra advantages:

  - The living annuity is still free of estate duty
  - The living annuity allows the annuitant to draw a monthly income, of between 2.5%-17.5% of the fund
  - The living annuity allows the annuitant to nominate beneficiaries, which avoids the restriction of Section 37C of the Pension Funds Act
  - The living annuity is not subject to Regulation 28 and prescribed investments

# What about Divorce?

- On divorce, the ex-spouse cannot claim against the capital in the living annuity, because "pension interest" is defined in the Divorce Act as a party who is-

"A) a member of a pension fund (excluding a RA fund)

B) a member of a retirement annuity fund…"

Section 7 (7) (a) of the Divorce Act reads:

- "in the determination of the patrimonial benefits to which the parties to any divorce action may be entitled, the pension interest of a party shall, subject to paragraphs (b) and ( c), be deemed to be part of his assets."

# Cont

Section 8 of the Divorce Act reads:

- "Notwithstanding the provisions of any other law or of the rules of any pension fund-
- a) the court granting a decree of divorce in respect of a member of such a fund, may make an order that-
- (i ) any part of the pension interest of that member which, by virtue of subsection (7 ), is due or assigned to the other party to the divorce action concerned, shall be paid by that fund to that other party when any pension benefits accrue in respect of that member…"

- **Note-a living annuity is not a pension interest as defined, so it falls outside the Divorce Act. That means that only the monthly income can be attached**…
- So while a trust is automatically attacked on divorce, **a RA can "convert" into a living annuity and avoid this problem very often**!

# What about the tax changes coming in 2015?

- The Taxation Laws Amendment Act was gazetted on 12 December 2013. From **1 March 2015**, Section 11k will allow a tax deduction for any amount contributed to any pension fund, provident fund or retirement annuity fund to a limit of **the lesser of-**
- R350 000 or
- 27.5% of the person's remuneration or taxable income.

- Most people will be better off. But for those who are restricted by the Rand limit, Paragraph 10C of the Income Tax Act reads as follows:
- "There shall be exempt from normal tax in respect of the aggregate of compulsory annuities payable to a person an amount equal to so much of the person's own contributions to any pension fund, provident fund and retirement annuity fund that did not rank for a deduction against the person's income in terms of section 11 (k) or (n)…"
- Came into operation on 1 March 2014

# RA's and non-deductible contributions-TLAB 2012, Explanatory Memorandum

- "To the extent a retirement fund member elects to receive a portion of his or her retirement fund interest in the form of a lump sum upon retirement (or a pre-retirement withdrawal), that lump sum is subject to tax as per the retirement lump sum tax table (or the retirement lump sum withdrawal tax table). **In calculating the tax due on the lump sum, the former member is afforded an exemption to the extent the member has made non-deductible contributions to retirement funds**. This exemption applies in respect of retirement and pre-retirement withdrawals.

- The South African Revenue Service (SARS) keeps record of non-deductible contributions made by individuals to retirement funds (e.g. a contribution to a pension fund by a member to the extent that exceeds the 7.5% contribution limit). When an individual applies for a tax directive, SARS reduces taxable lump sums to the extent of all prior non-deductible contributions made by that individual. This relief is applied across retirement funds on a 'first-come, first-serve' basis. "

# Cont

- **“However, if retirement fund interest is applied to provide/acquire annuities, the annuity payments are fully subject to normal income tax. No relief is currently available in respect of non-deductible retirement contributions against annuities received even if the individual’s non-deductible contributions exceed all lump sums**.

- **Reasons for change**
- **The exemption for retirement and pre-retirement lump sums in respect of non-deductible contributions to retirement funds prevents potential double taxation. In other words, after-tax contributions should not be taxed a second time upon withdrawal. No policy reason exists for this relief not to apply in the case of receipts and accruals by way of compulsory annuities.**

- **III. Proposal**
- **In view of the above, non-deductible contributions will be exempt from income tax in respect of retirement interests, regardless of whether these interests are withdrawn as part of a lump sum or by way of compulsory annuity**. “

# Comment

- The major concern around the capping of deductions in 2015 has therefore been removed
- If clients make contributions above the capping, then, if they exceed the lump sum they can be used against their monthly annuity
- Note-the annuity will still be taxable, the deduction will be on assessment
- Example-X has a lump sum of R1 000 000 when he retires. He has not used the R500 000 tax free amount before. He has **contributions that were not deductible of R700 000**. From the R1 000 000, first utilize the R500 000 tax free. That leaves **R500 000**. **This amount is also tax free, using the R700 000** non-deductible contributions. **That leaves R200 000 of unused non-deductible contributions** which can be used against his living annuity every year.

# Costs

- Client makes an investment into a RA of R10m. Assuming no broker commission, average costs would be 1.8% per annum

- With a trust, the costs would be:
  - Professional trustee fee, based on activity/% of assets
  - Set up costs
  - Accounting fees and tax returns
  - Banking fees for separate account
  - Ongoing fees for resolutions, meetings etc if professional trustee
  - Money still has to be invested, so there would still be an asset manager's fee!

# General

- Will the client ever run the trust properly? According to Prof. VD Westhuizen, 90% of trusts in SA could be invalid. With a RA, no admin is required
- Does the client want to complicate his life with a trust and the admin required? With a RA, things are kept very simple
- With a trust, the assets still need to be managed. Who will do that? If invest via an asset manager will have to pay more fees. With a RA, assets managed by the fund manager
- On insolvency, if a member does not take a lump sum, and has not moved money into the RA with the intention of defrauding creditors, the assets cannot be attached. How many trusts have stood up to an attack by creditors? [FNB V Britz]

# Conclusion

- Trust does have advantages as well. If client has a R100m estate might not want to tie it all up in a RA. Remember, with a RA the money can’t be accessed until member is 55 [generally speaking]

- Horses for courses. For some clients a trust still might be better. Idea was to make you think and consider a RA as an alternative!