Tax changes mean more to retire on

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By Bruce Cameron

Illustration: Colin Daniel

You need to prioritise retirement planning in your medium to long-term investment and savings plans following tax changes aimed at encouraging retirement savings, Bruce Cameron, editor of Personal Finance and author of the book Retire Right, told recent meetings of the acsis/Personal Finance Financial Planning Club. He says tax-incentivised savings should be considered despite ongoing problems with high costs, opaque and poorly structured products, and uncertainty about government policy.

Cameron says that tax changes announced this year and those scheduled to be implemented from next year could make a significant difference to your standard of living in retirement, whether you are saving for retirement or are in retirement.

The biggest single change was the announcement made by Finance Minister Pravin Gordhan in his Budget speech this year that the new withholding dividends tax would not be applied to tax-incentivised savings products in the savings build-up period or to residual capital in a tax-incentivised retirement savings fund being used to provide a compulsory-purchase pension.

This means that retirement funds of all types are currently not subject to income tax (40 percent, at the top marginal rate), capital gains tax (at a top effective rate of 13.3 percent), or dividends withholding tax (15 percent) on investment returns in the build-up stage or to the residual capital being used to provide a compulsory-purchase pension.

The tax exemptions mean that tax-incentivised retirement savings products will now provide you with a far superior pension than if you used similar non-incentivised products.

The dividends tax exemption also, in effect, improves the position of all tax-incentivised retirement assets, whether pre- or post-retirement, as previously the 10-percent secondary tax on companies (STC) was deducted from any dividend payment before payment was made.

The dividends withholding tax replaces STC.

Research undertaken by Cadiz Asset Management on behalf of Personal Finance shows that your income in retirement could be more than 20 percent higher, depending on your contributions and earning levels, than you would receive if you saved outside the tax-incentivised environment (see table “Vanilla vs tax-incentivised investment”, link at the end of this article).

The Cadiz research also shows that the more you save, the greater the impact will be on your pension because of tax-free compounding investment growth.

Cameron says, however, that you have to take care in selecting the vehicle you use for your tax-incentivised retirement savings, because costs and poor product structure could wipe out any tax advantage you receive. He says you need to take account of product structure, governance, costs and any need for guarantees, including the costs and the nature of the guarantees.

He says the first choice you have to make in deciding on a tax-incentivised retirement savings vehicle is whether to use an occupational retirement fund and/or an industry product such as a retirement annuity (RA) or preservation fund.

Cameron says that, as of next year, the best option for members of stand-alone occupational funds will be to top up their retirement savings using their fund rather than an expensive financial services product.

The reasons are:

* **Costs.** Larger stand-alone funds are able to negotiate much lower administration and asset management costs than individuals using RA products.

* **Governance.** There is a higher standard of governance in occupational funds than in industry funds because members can elect trustees. The trustees of industry funds are appointed by the product providers.

* **Contribution levels.** Currently you are limited to contributing 7.5 percent of your pensionable income (basic pay excluding allowances) to an occupational retirement fund. This means that you are forced to use an industry RA product to top up your retirement savings (see “Financial sector retirement products” for choices).

From next year, retirement fund members:

– Below the age of 45 will be able to claim total maximum contributions to all funds (for example, an occupational and an RA fund) from all sources (member and employer) of up to 22.5 percent, on the higher of employment or taxable income, as a deduction, with a R250 000 annual limit.

– Aged 45 and older will be able to claim total maximum contributions to all funds from all sources of up to 27.5 percent, on the higher of employment or taxable income, as a deduction, with a R300 000 annual limit.

In both cases, employer contributions will be added to your taxable income as a fringe benefit.

Cameron says that while there are still governance, product structure and cost problems with retirement savings products, with scandals still occurring on a regular basis, there is now much tighter regulation, and government is upping its game in pressurising the industry to treat you far better than it currently does.

FINANCIAL SECTOR RETIREMENT PRODUCTS

The financial sector’s main retirement savings products are retirement annuity funds and preservation funds. The main features of these products are:

Retirement annuity funds (RAs)

* Contributions are tax deductible (a maximum of 15 percent of your taxable income less your pensionable income).

* No taxes on investment returns in the build-up stage.

* No withdrawals permitted before age 55 and then only as a retirement benefit.

* At retirement, two-thirds must be used to buy a pension.

* Any lump sums are subject to lump-sum tax. Your pension is taxed at your marginal rate but there are no taxes on the investment growth of the residue, which is invested for ongoing pension payments.

Preservation funds (provident and pension)

* Allow for tax-free transfer from an occupational fund to preserve the benefits for retirement, with the same tax advantages as received in the former fund.

* No further contributions permitted.

* One withdrawal of any amount is permitted on transfer. The withdrawal is subject to lump-sum taxation.

* Benefits may only be withdrawn from age 55.

* The same withdrawal/pension rules apply at retirement as for occupational funds.

RAs and preservation funds come in various product packages. These are:

Life assurance products

The main features are:

* High costs. Research has shown that these products can have extraordinarily high costs, reducing your ability to retire financially secure.

* Contractual: you sign a contract to pay contributions to an RA. If you do not maintain the payments you will be subject to confiscatory penalties, which are limited to 15 percent of accumulated savings on retirement products sold from January 2009 and 35 percent on older products. Life companies have introduced non-contractual products, but the costs are higher.

* Commissions: advisers are paid 50 percent of commission upfront, 50 percent on-going. Commissions are based on the premium and the length of the contract.

* May have guarantees, which come at additional cost.

* Smooth/stable bonus options, which smooth out investment returns of good and bad years.

Linked-investment service provider (Lisp) products

The main features are:

* High costs: Research undertaken by National Treasury indicates these products could have cost structures similar to life assurance products. There are likely to be multiple cost layers, including double charging with both annual asset management and performance fees.

* Provide for wide investment choice and the freedom to move between investments.

* Contributions are versatile, with no penalties for reducing or halting contributions.

* Commissions paid as-and-when, as a negotiated percentage of your premiums.

* Capital guarantees may be available through costly, very opaque, index-linked structured products.

Unit trusts (provided by one management company)

The main features are:

* Lowest-cost RAs: Personal Finance research conducted in 2008 found that unit trust RAs offered by a unit trust management company had the lowest costs of all forms of RAs. However, be careful, because some unit trust management companies offer unit trust RAs on a Lisp platform.

* Your choice of underlying investments is limited to funds of the management company.

* Contributions are versatile, with no penalties for reducing or halting contributions.

* Commissions paid as-and-when, as a negotiated percentage of your premiums.

TYPES OF OCCUPATIONAL FUND

Occupational retirement funds come in two main forms: defined benefit funds, where your pension is defined as a percentage of your final pay cheque and the number of years' membership of the fund; and defined contribution funds, where contributions made by you and your employer are fixed but the lump-sum payment and/or pension you receive at retirement is dependent on investment returns.

Occupational retirement funds can be stand-alone funds or can fall into a category known as umbrella funds, which include a number of participating employers. All occupational funds are divided into provident and pension funds.

Provident funds

These funds, which are due to be phased out, have the following features:

* No tax deductibility on member contributions.

* Tax deduction by your employer for employer contributions (to a maximum of 20 percent of pensionable income).

* No taxes on investment returns in the build-up phase.

* Withdrawals before and at retirement: member contributions are tax-free but employer contributions and investment growth are subject to lump-sum tax tables.

* Currently it is not compulsory to buy a pension.

Pension funds

The main features are:

* Member contributions are tax deductible (to a maximum of 7.5 percent of pensionable income).

* Employer contributions are tax deductible (to a maximum of 20 percent) by your employer.

* No taxes on investment returns in the build-up.

* Full withdrawals allowed on fund exit before retirement, subject to lump-sum tax tables.

* At retirement, two-thirds must be used to buy a pension. Any lump sums are subject to lump-sum tax. Your pension is taxed at your marginal rate, but there are no taxes on investment growth of the residue, which is invested for ongoing pension payments.

Umbrella funds

Umbrella funds, which can be either provident or pension funds, allow a number of employers to group together and share a retirement fund structure. They come in two main guises: those structured by an industry sector body or trade union, and those provided by the financial services industry, where diverse employers sign up employees for membership. The employees of each participating employer are ring-fenced within the umbrella fund, but they share service providers such as asset managers, administrators and group risk assurance providers.

FLEXIBLE FUND INVESTS ACROSS ASSETS

The Cadiz Managed Flexible Fund, chosen by Personal Finance to demonstrate the effects of the new tax regime on tax-incentivised retirement funds, conforms to the prudential investment requirements of regulation 28 of the Pension Funds Act that applies to all retirement savings products.

The fund was the best-performing prudential asset allocation fund over three years for the period ending December 31, 2011, with an annual average return of 15.04 percent.

The fund also won the 2011 Personal Finance/Plexus/Profile Data Raging Bull certificate for the best risk-adjusted fund over five years in the unit trust sector: domestic – asset allocation, prudential variable equity.

The current asset allocation is: domestic equity 58.6 percent, international equity 9.2 percent, cash 18.3 percent, fixed income 9.2 percent, and property 4.7 percent. The asset allocation varies according to views of fund manager, Francois van Wyk, also the chief investment officer at Cadiz.

WISE PHILOSOPHY

“So I have been truly blessed by the magical combination of my Scottish thrift genes; my generous compensation; my propensity to save whatever remains each year; the mathematical miracle of tax-free compounding; the knowledge that in investing, costs matter enormously; and enough common sense to focus on a balanced asset allocation.” – John C Bogle, founder of United States-based passive manager Vanguard and author of Enough – True Measures of Money, Business and Life

Table: Vanilla vs tax-incentivised investment