

Investing for Tomorrow

INVESTOR EDUCATION – PLAIN + SIMPLE

Dear Investor

As the March 2006-Feb 2007 tax year comes to an end there has been a lot of coverage in the media explaining the mechanics of tax deductions on Retirement Annuity (RA) contributions. Bruce Cameron, in the Saturday Star edition of last weekend, also gave this topic much coverage (on page 2).

I have to say though, if I were not in the financial services industry, I would not have found the large majority of articles on the topic at all easy to understand.

I have attempted to dramatically simplify the concept of a tax deduction, and specifically in the context of one's retirement annuity contributions over the past tax year.

Importantly it is also necessary to emphasise that it is not advantageous to contribute to a retirement annuity beyond the tax deductible limit. Rather invest the money in a discretionary fashion where there is also no tax advantage but at least the money is accessible whenever you need it. One cannot utilise the money invested in an RA before the age of 55 (and no later than age 70) so why have one's money tied up if there was no tax advantage in the first place? Money invested in a retirement annuity is specifically intended for one's retirement.

For members of a company pension or provident fund who do not earn significant taxable income beyond their salaries (eg. in the form of bonuses, commission income, rental income etc.) the tax deductible limit for a retirement annuity contribution is very small, because the tax deduction has already been utilised by one's pension or provident fund contributions.

To repeat the familiar formula: For a retirement annuity contribution the maximum tax deductible contribution is the greater of:

a.) Only R3,500 a year (a mere R292 a month) if you are a member of a provident fund and earn little in additional taxable income other than your employment-related salary.

b.) Only R1,750 a year (a mere R146 a month) if you are a member of a pension fund and earn little in additional taxable income other than your employment-related salary

c.) 15% of taxable income excluding your employment-related salary. For self employed people this would include the full taxable income one earns in a year, and for those earning taxable income beyond their employment-related salary this would include one's bonus, commission, rental income etc. (to which one's pension or provident fund contribution was not applied).

In this case non-salary related taxable income that one earns in a year could be sizable. The maximum tax deductible contribution is then R15,000 per R100,000 of taxable income. You could of course contribute less, and most people do because of cash flow constraints.

So what does a tax deduction actually mean in simple speak?

Example:

Let us calculate the tax deduction on a retirement annuity contribution per R100,000 of taxable income (the tax deduction would then be four times this amount for someone earning R400,000 in taxable income etc).

- The contribution for the year is then a maximum of R15,000
- Assume the investor's marginal tax rate is 35%
- The investor effectively gets a discount of 35% on the contribution because SARS will reduce his/her tax by 35% of the contribution at the time that SARS assesses his/her tax following the end of the tax year
- Put another way, although R15,000 has actually been contributed to the RA, the investor effectively only pays 65%, or R9,750 of the contribution.
- A year later, even if the R15,000 has not grown a cent, the investor's growth on the contribution is still 54% (R15,000 - R9,750) / R9,750. Yes, because the investor effectively only contributed R9,750 and the current value is R15,000
- And the final irony is that the higher your tax rate, the greater your tax deduction. Yes, a 40% marginal tax payer gets a 40% discount on the annual RA contribution, meaning he/she effectively only pays 60% of the actual amount contributed. SARS is still scratching its head over this one, because higher tax payers (wealthier people generally) have a greater tax incentive to save for retirement than lower tax payers.

The RA contribution must be paid by the end of the current tax year to enjoy the deduction for the tax-year March 2006-Feb 2007. RA contributions can be made via debit order or via ad hoc contributions.

As the tax year draws to a close, for the self employed and those who have earned taxable income over-and-above one's salary, it is now necessary to estimate the amount of taxable income earned over the past tax year in order to contribute up to 15% of that amount to a retirement annuity, and in so doing to enjoy a tax deduction.