SAINDEXINVESTOR

www.indexinvestor.co.za

Fourth Quarter 2014

Tax-free savings bonanza

By Daniel R Wessels

In recent years Treasury announced their intentions to reform the savings culture of South Africans, which by all measures are far too low for the pressing needs of a developing economy, by implementing far-reaching retirement reforms and introducing a new, tax-free savings vehicle from 1 March 2015. Some changes to retirement legislation, however, have been put on hold until further negotiations have cleared uncertainties and concerns, especially brought forward by industry and trade unions.

Nonetheless, the introduction of the new, tax-free savings vehicle is going ahead as planned and it is worthwhile exploring how the new vehicle can be utilised in one's financial plan, especially minimising one's tax liabilities.

But first, some background on the features and type of products that will qualify as tax-free savings accounts. Section 12T of the Revised Taxation Laws Amendment Bill provides the legal and regulatory framework. Treasury indicated that three overriding principles will apply in approving appropriate investment products, namely simplicity, transparency and suitability.

The types of products that will qualify for the tax-free savings accounts include bank deposits, investment endowments (only pure investment policies), collective investments (unit trusts), ETFs, and RSA Retail Bonds. Certain unit trusts, however, that charge outperformance fees besides fixed management fees will be excluded. Also, individual stock broking accounts (e.g. trading of individual shares) will not qualify for these tax exemptions.

- Only applicable to natural persons, legal entities, including trusts, excluded.
- Maximum contribution per year = R30,000 per person, or R2,500 per month.

- Lifetime contribution limit = R500,000 per person. Thus, the minimum period in which the overall limit can be reached is 16 years and 8 months (200 months).

- Excess contribution amounts (any amount exceeding R30,000 per year or the lifetime limit of R500,000) will be taxed at 40%.

- All growth in the portfolio - interest, dividends, and capital gains - will be exempt from any tax implications.

- A person will be allowed to invest in any investment asset class; i.e. equities, properties, bonds and fixed interest. Certain types of investments, however, will not be permitted, probably those less regulated, high-risk investments or hedge fund structures. Also, direct foreign investments will in all likelihood not form part of the tax-free savings accounts since those investments do not fall under the jurisdiction and control of local authorities.

- Generally, no liquidity constraints will apply. Yet, investment endowments will be allowed and restrictions may then apply. In those instances, however, exit and penalty fees will be limited.

- Withdrawals made from the account during the year, say R50,000 cannot be replaced by a new investment of R50,000; the overall limit of R30,000 per year remains in place.

- A person may have multiple tax-free savings accounts, but the overall yearly and lifetime limits will apply.

- Transfers between tax-free savings accounts will be allowed, but not transfers between existing discretionary investments and tax-free savings accounts.

- Tax-free savings accounts will be a pure investment account only, no transactional facilities may be linked to such accounts; i.e. debit or credit card payments, third-party payments, stop-orders and debit orders, access via ATMs, etcetera, will not be allowed.

Next, let me quantify the practical considerations and put some numbers behind the obvious tax benefits of the tax-free savings account. For example, let us consider the potential benefits of the tax-free savings account relatively to a normal, discretionary investment.

For both types of investment I used the same assumptions, namely the contribution amount (maximum R2,500 per month), investment period, and portfolio composition (65% equities and 35% interest-bearing). The dividend yield amounts to 3% of the equity portion of the portfolio, while an interest rate of 7% per annum is allocated to the interest-bearing portion of the portfolio. In the discretionary portfolio the full interest earned is taxable (at the marginal tax rate), dividend tax of 15% applies, and at the end of the investment period, capital gains tax (proceeds less dividends less interest less contributions) will be levied.

The table below highlights the difference in values attained by the two investments. Clearly, depending on one's marginal tax rate, the after-tax return of the discretionary portfolio always will be less than the proceeds of the tax-free savings account.

For example, at a pre-tax, annualised portfolio return of 12%, a person investing R2,500 per month over 200 months will accumulate R1,594,794 over the full period. The proceeds and part-withdrawals are exempt from any tax implications. The discretionary investment, at a marginal tax rate of 30%, will yield an after-tax amount of R1,419,450, or, the final value of the tax-free savings investment will be 12% higher than the discretionary investment.

Depending on one's marginal rate of tax, the tax erosion of investment value can be substantial. With an ordinary investment, and a person paying the maximum marginal rate of tax (40%), up to 15% of the final value that would have accumulated in the tax-free savings account will be forsaken.

The table below illustrates the tax erosion effects at different marginal rates of tax over a 200-month period:

Marginal tax rate	18%	25%	30%	35%	38%	40%
After-tax value in discretionary investment as percentage of final value in a tax-free savings account	93%	91%	89%	87%	87%	86%

Thus, the benefits of the tax-free savings account are real, especially if the investment is kept for the longer term in so far one is maximising the tax benefits from the investment and the compounding effect thereof is given sufficient time to work its magic.

To illustrate this principle, consider the differences in outcome between tax-free savings and discretionary investment for a person in the 40% marginal income tax bracket, who after certain time intervals redeem the tax-free savings investment.

Period of withdrawal	Margin of outperformance of tax-free savings account relative to discretionary investment
36 months	3%
60 months	4%
84 months	6%
120 months	9%

It implies that careful consideration should be given to “early” withdrawals for perhaps less-than-necessary purposes, especially because withdrawn amounts cannot be replaced by new investments without breaching perhaps the yearly and lifetime limits.

From a tax point of view, the working of the tax-free savings account is the reverse of contributions towards a retirement fund (retirement annuity, pension fund). The contributions to the tax-free savings account are made with after-tax monies, whereas contributions to the retirement fund are tax-deductible (tax savings = contributions x the marginal rate of tax).

Withdrawals/drawdowns from the tax-free account remain tax-free, but are fully taxable as an annuity from the retirement fund. Benefits from the retirement fund are only available at retirement/resignation whereas one may withdraw at any stage from the tax-free savings account. In both instances, all growth within the portfolio are exempt from any taxes (interest, dividends, and capital gains).

Features	Tax-free savings account	Retirement annuity
Contributions	Not tax-deductible	Tax-deductible
Growth	Tax-free	Tax-free
Withdrawals	Tax-free	Taxable

Which option is the better? That is if not both options can be utilised to minimise one's tax liabilities – remember, contributions to the tax-free savings account are limited to R2,500 per month (R30,000 per year), or otherwise the excess contributions are taxed at 40%. This "maximum" limit may be hopelessly inadequate providing for retirement income needs.

For both types of investment consider a contribution of R2,500 per month and a contribution period of 16 years and eight months (200 months). At the end of the savings period, a systematic drawdown of 5% of the capital value is made. The withdrawals from the tax-free savings account will be non-taxable, but such withdrawals from the retirement fund (annuity) will be fully taxable. On the other hand, contributions towards the retirement fund are tax-deductible, while the contributions to the tax-free savings account are not.

All else being equal, a person contributing towards a retirement plan and paying a marginal tax rate of 40% will be saving R12,000 (40% x R30,000) per year in income tax relatively to the person that contributes only towards the tax-free savings account. Thus, for comparative purposes, this tax benefit is credited to the retirement fund investor as an additional contribution amount. Alternatively, the tax-free savings account investor will have R1,000 per month less available than the retirement fund investor.

Tax-free savings vehicle = R2,500 per month x 200 months

Expected value @ 6% real growth (in today's terms)		R 860,037.35
Drawdown per year	5%	R 43,001.87
Taxable		R 0.00
After-tax proceeds		R 43,001.87

Retirement fund contribution = R3,500 per month x 200 months

Marginal rate of tax = 40%

Expected value @ 6% real growth (in today's terms)		R 1,204,052.30
One-third cash		R 401,350.77
Lump sum tax		R 0.00
Net lump sum		R 401,350.77
Drawdown from lump sum per year	5%	R 20,067.54
Taxable portion	25%	R 5,016.88
After-tax proceeds per year (one-third)		R 18,060.78
Two-thirds compulsory annuity		R 802,701.53
Drawdown per year	5%	R 40,135.08
Taxable	100%	R 40,135.08
After-tax proceeds per year (two-thirds)		R 24,081.05
Total proceeds per year		R 42,141.83

Under these assumptions, the tax-free savings vehicle will marginally yield better results than the retirement fund, but at lower marginal tax rates (30% and lower), the retirement fund option will yield a slightly better outcome.

Another factor that might be worth considering is that retirement assets are exempt from estate duties, while the tax-free savings account will probably form part of one's estate.

But perhaps it is better to weigh up the non-quantitative aspects of the two savings vehicles, namely protection and liquidity. Retirement fund assets are protected against the claims of creditors; i.e. such assets do not form part of insolvent estates or cannot be attached by creditors, while no creditor protection exists for the tax-free savings account. Another aspect is the availability of assets. Retirement fund assets are only accessible upon retirement/resignation (from the age of 55 for retirement annuities). No liquidity constraints typically will apply to the tax-free savings account. But if the primary purpose of savings is for retirement needs, it is perhaps not a bad idea that one cannot access one's savings prior to retirement. It is a matter of protecting your financial well-being against one's own irrational behaviour at times.

Thus, I would contextualise the tax-free savings account as an investment vehicle earmarked predominantly for medium- to long-term financial needs, such as retirement savings and providing tax-free retirement income. All in all, the proposed tax-free savings account is a welcome relief for over-burdened tax payers and should be popular among investors. In a sense it is a just reward for the prudent savers among us to receive some real tax concessions whereas in the past only limited tax benefits accrued to them.

Sources:

Publications by Momentum, Nedgroup Investments, and Treasury