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Retirement planning for financial independence: exploring different investment vehicles from a tax benefit perspective

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University of the Witwatersrand

Faculty of Commerce, Law and Management

School of Accountancy

RETIREMENT PLANNING FOR FINANCIAL INDEPENDENCE: EXPLORING DIFFERENT INVESTMENT VEHICLES FROM A TAX BENEFIT PERSPECTIVE

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A research report submitted to the Faculty of Commerce, Law and Management.

University of the Witwatersrand, Johannesburg, in partial fulfilment of the requirements for the degree of Master of Commerce (Specialising in Taxation)

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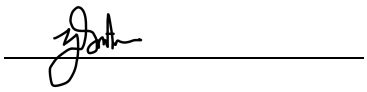
Abstract

Planning for retirement is an important step in the lives of South Africans, whether they are employed or self-employed. The Labour Relations Act 66 of 1995, of South Africa, does not specifically prescribe the age of retirement, however the normal age of retirement for employed individuals is generally between the ages of 55 and 65 years, depending on the industry and the rules of the retirement funds involved (Western Cape Government, 2018). This study evaluates the different investment options available to the ordinary South African in planning towards his or her retirement. It focuses specifically on three investment vehicles, namely, Real Estate Investment Trusts (REITs), retirement annuity funds and offshore endowment policies. The study examined the characteristics of these investment vehicles, the tax benefits available, the risks involved and how to use those returns to ensure a financially independent and sustainable life during retirement.

Key words: Real Estate Investment Trusts (REITs), Retirement Annuity Funds, South Africa, tax planning, retirement planning, financial independence, risks, offshore, foreign currency, exchange rates, tax incentives, offshore endowment policies, South African endowment policies

Declaration

I declare that this research report is my own unaided work. It is submitted for the degree of Master of Commerce in the University of the Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination in any other university.



Zizile Mthembu

(03 January 2023)

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Figure 1: List of Abbreviations

Abbreviation	**Meaning**
The Act	Income Tax Act 58 of 1962
CGT	Capital gains tax
SARS	South African Revenue Service
REIT	Real-Estate investment trust
RAF	Retirement Annuity Fund
PF	Pension Fund

Chapter 1: Introduction

Background

The life expectancy at birth of South African females dropped from 68.4 to 64.6 and for South African males, it dropped from 62.4 to 59.3 in 2021 from the year 2020, as a result of the COVID-19 pandemic (Stats SA, 2021). None the less, it is still important to plan for retirement and these statistics should not be used to discourage individuals from adequately planning for their retirement. According to John Anderson (2020), an executive of investments at Alexander Forbes, only 8% of people can retire comfortably (BusinessTech, 2020). It is therefore important that individuals start making informed investments and spending decisions, as poor decisions can lead to decreasing the potential retirement capital available.

When considering the investments and annuities purchased before and at the start of retirement, the investor needs to consider the investment risk and investors need to manage the level of risk to which their investments are exposed by consulting with financial advisors and other financial experts. The risks involved in the REIT market, for example, include exposure to interest rate changes as this may have an effect on their capacity to buy more property (Ntuli & Akinsomi, 2017:383).

Some risks need to be taken when deciding on an investment portfolio. If too conservative, the return upon retirement and available funds during retirement could be too low to provide adequate financial independence to maintain a desired lifestyle in retirement, pay for medical expenses, tax and other expenses that may arise (Cameron & Wouter, 2019).

Taxation is an important part of retirement planning and the provisions in the Income Tax Act should influence the retirement investment vehicles taxpayers choose in order to optimize their retirement savings. There are many investment options to which South Africans have access, both locally and internationally, as such, it is imperative that taxpayers make informed investment decisions and take advantage of all the tax benefits that are available while securing enough savings for their desired post-retirement lifestyle. These investment decisions should be taken at the start of employment and re-assessed regularly to ensure that the investments are sufficient, taking into account inflation. The taxpayer, after his or her regular reviews of his or her portfolio, can then increase his or her capital contributions specifically in those investments that earn compound interest and ensure that he or she continues to capitalize on his or her potential future tax deductions (Hirsch, 2005:24).

Headline inflation (which is the '*increase in the general price level of an economy*' (SARB, n.d.) in 2020 was the lowest it had been since 2005 at an average of 3.3 per cent, however, food and electricity prices are forecast to rise (National Treasury, 2021a:34). This further adds to the importance of saving towards retirement and other unexpected events, such as a pandemic as experienced since 2020, which has led to a decrease in household income as a result of job loss or reduction of salaries (National Treasury, 2021a:33). Over the past decade, there has been an increase in the tax incentives for retirement savings as government aims to encourage individuals to save for retirement in an effort to decrease the reliance on government funding (National Treasury, 2004:4). The tax incentives available for retirement saving vehicles include tax deductible contributions, no tax on interest, capital gains and no dividend withholding tax (BusinessTech, 2020).

The various types of taxation that must still be considered when planning for retirement is normal tax on annuity monthly income, tax on lump sum payments from retirement funds, as well as capital gains tax on non-retirement specific investments. These taxes are examined in this report to provide an overview of the tax that can be expected in order to address the research problem.

Scope and Limitations

The following falls outside the scope of this report and is not examined:

Estate duty taxes, double tax agreements, REITs JSE listing requirements.

Research Question

The main research question to be addressed by this report is: Does a combination of retirement specific and non-retirement specific investment vehicles lead to an optimal investment portfolio for retirement from a tax perspective, based on the chosen combination of investments?

This research examines various investment vehicles from a tax perspective in order to determine if the chosen vehicles are an optimal investment portfolio for retirement planning purposes for the South African employee when compared to a portfolio that consists of only a pension and retirement annuity fund. The specific investment vehicles examined are REITs, Retirement Annuity funds and Endowment Policies. It also considers the tax liabilities after

retirement, such as tax on annuity income, capital gains tax as well as taking into account the various tax benefits available that can aid in reducing the tax liability.

The following sub-questions are addressed in order to answer the main research question.

1.1.1. What is a REIT and is it a good investment from a tax and risk perspective? This is addressed by first defining a REIT and by looking at various studies on the investment risks in relation to REITs from a South African perspective. The tax implications are also identified and examined to address this question.

1.1.2. What are the returns investors can expect from endowment policies and how are these taxed in South Africa? This question is addressed by first defining endowment policies, briefly examining an offshore endowment policy with a South African insurer and finally, looking into the tax consequences of endowment policies.

1.1.3. What are the tax benefits of Retirement Annuity funds and are they required in order to maximise retirement savings? This is dealt with by doing an analysis of retirement annuity funds in terms of their withdrawal requirements and their tax implications.

1.1.4. Does a combination of retirement specific investments and non-retirement specific investments lead to an optimal investment portfolio? This question is answered by determining what the tax implications are of a portfolio that consists of only a Pension Fund and Retirement annuity fund and whether or not the tax benefits outweigh the benefits from using the Retirement Annuity fund with a REIT and an endowment policy.

1.1.5. What are the various types of annuities that can be purchased on retirement using the two thirds of the total value of the retirement annuity fund/s chosen? The annuities available are defined and explained in terms of the Income Tax Act of South Africa and other literature available. The tax implications are looked at and it is determined whether there are ways in which the tax liability can be reduced.

Research Methodology

The research method adopted is qualitative and interpretive in nature. An extensive literature review and analysis is undertaken of the South African Income Tax Act 58 of 1962 as well as the following sources:

Case law

Electronic resources - internet

Statutes

Journal articles.

Chapter Outline

The chapter outline for this research report is as follows:

1. Chapter 1: Introduction

This chapter introduces the research problem and sub-problems which are addressed throughout this report. It defines retirement and tax planning as well as provides an overview of the importance of planning for retirement for South Africans.

2. Chapter 2: Real Estate Investment Trusts (REITs) in South Africa and their tax implications

The purpose of this chapter is to address sub-question 1.1.1, which deals with the definition of a REIT and to determine if it is a good investment from a tax and risk perspective in order to address the research problem identified. The tax consequences and returns expected from this type of investment are discussed and the investment risks are addressed briefly to provide a broader picture of REITs and why they should form part of the investment portfolio of the South African employee who is planning for retirement.

3. Chapter 3: Endowment Policies and their tax implications

This chapter defines endowment policies and identifies the difference between South African insurer offshore polices versus non-South African insurer offshore policies. The aim of this chapter is also to identify the distributions, their classifications and tax consequences of endowment policies. Special attention must be given to the Exchange Regulations Control in South Africa when transacting internationally and this chapter deals briefly with the Single

Discretionary Allowance as well as the Foreign Investment Allowance available to residents in order to facilitate the transfer of funds outside of the Republic of South Africa.

4. Chapter 4: South African Retirement Annuity Funds and their tax implications

A Retirement annuity fund as defined in s 1 of the Income Tax Act 58 of 1962 is any fund, excluding pension, provident or benefit fund which is approved by the Commissioner and where no more than one-third of the total fund value may be taken as a lump-sum payment. Retirement funds offer several tax benefits in an effort to encourage South Africans to save for retirement and reduce the burden on the Government. These tax benefits, which come with certain limitations, are evaluated, and discussed in detail in this chapter.

5. Chapter 5: An evaluation of the investment portfolio: REIT, Retirement Annuity fund and an Endowment policy

The chapter briefly discusses the economic state of markets in the country and globally, based on the Monetary Policy Committee report. The Committee's report considers the effects of the Covid-19 pandemic on the financial markets which has an effect on household savings, investment risks and overall expected growth and returns. This makes the Committee's report relevant when dealing with retirement planning.

6. Chapter 6: Life after retirement: how to secure monthly income

This chapter examines living and life annuities, discretionary trusts and endowment policies as vehicles that can be used after withdrawal from the various retirement funds and investments which provide fixed monthly income throughout retirement.

7. Chapter 7: Conclusion

This chapter evaluates the chosen investment portfolio and does a comparison with a portfolio that consists of only a retirement annuity and a pension fund. The research findings are discussed, and it proposes areas of further research.

Chapter 2: Real Estate Investment Trusts (REITs) in South Africa and their tax consequences

Introduction

Investment occurs when money is spent on assets with the goal of earning income or capital appreciation (Sarkar & Sahu, 2018:1). The traits of an investment are, namely, time and risk (Sarkar & Sahu, 2018:1). Investment risk, in simple terms, is the risk that the actual return from an investment will be less than expected and includes market, inflation and interest risk (Ontario Securities Commission, n.d.). When investing for retirement, there are various factors that must be considered, one of these factors that influence investment decisions and the appetite for risk is the age of the investor. An investor who is younger and does not expect to withdraw from his or her investments for a number of years will be able to take greater risks as they have more time to recover from market downturns whereas an investor who is older and is closer to retirement requires a more stable investment which carries less risk (Sarkar & Sahu, 2018:9).

A Real Estate Investment Trust (hereafter referred to as a REIT) is defined in s 1 of the Income Tax Act 58 of 1962 (hereafter referred to as the Act) as a company that is a resident of South Africa, whose shares are listed on an exchange as shares in a REIT as defined in the listing requirements of the exchange, for example, the Johannesburg Stock Exchange (JSE). South African REITs enable the investor to invest in properties by buying shares in listed real estate companies on the JSE without the need for a huge lump-sum of capital (Barnard 2021). This chapter briefly looks at the investment risks from a South African investor's perspective that specifically affect REITs, but the main focus is on the tax implications of this type of investment.

There are three different types of REITs that investors may choose to invest in, namely, Equity, Mortgage and Hybrid REITs. Equity REITs generate income through renting out properties, while Mortgage REITs invest in residential and commercial mortgages. Hybrid REITs are simply a combination of both Equity and Mortgage REITs (Maurer, 2009: 4).

Investing in REITs allows investors to diversify their investment portfolio (Ntuli &Akinsomi, 2017:365) and possibly improve the performance of their portfolios. REITs are required to

distribute at least 75% of their taxable earnings to their investors as one of the requirements to retain their REIT status (Ntuli &Akinsomi, 2017:366) which is beneficial to the investor.

Tax Implications

It is important to firstly understand a general overview of tax and the legislation contained in the Act regarding normal tax, dividend tax and Capital Gains Tax to help in understanding how the different investments are taxed. A natural person is liable for tax on their taxable income which is calculated by taking their gross income, less exemptions and deductions, plus any taxable capital gains (Stiglingh et al., 2011:1-4 as cited in Kokott, 2011:23). The three investments being examined in this report will lead to an increase in gross income, possible deductions, and capital gains, therefore it is important to look at the definition of these terms throughout the report to determine why these amounts would be included in the taxable income of the investor/natural person.

The first step in order to determine taxable income is determining what is gross income. Gross income is defined in s 1 of the Act as meaning the following:

> in relation to any year or period of assessment, means
>
> i. In the case of any resident the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or
> ii. In the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within the Republic
>
> During such year or period of assessment, excluding receipts or accruals of a capital nature
>
> Source: Section 1 of the Income Tax Act 58 of 1962

The definition of a resident is also found in s 1 of the Act and states that the natural person is classified as a resident of South Africa for tax purposes if he or she is ordinarily resident, or if he or she was physically present in South Africa according to the physical presence test which is prescribed in the Act. The physical presence test in s 1 of the Act states that a person is considered to be a resident if that person was physically present in South Africa for more than 91 days in total during the year in question and for more than 91 days in each of the previous five years as well as being present for more than 915 days in total during the previous five years. The burden of proof in terms of the physical presence test lies with the taxpayer in question in accordance with s 102 of the Tax Administration Act 28 of 2011 if the taxpayer aims to prove that he or she was not a resident. The term ‘ordinary resident’ is not defined in the Act and therefore case law is consulted. Schreiner JA stated that ‘ordinary residence would

be the country to which (a man) would naturally and as a matter of course return from his wanderings' (*Cohen v CIR*, 1946 AD 174 (13 SATC 362)). If a person was ordinarily resident during a period in the year in question, then this person cannot be regarded as a resident due to the physical presence test during that same year even if he or she stops being ordinarily resident during that year (Coetzee et al., 2020:35). The investor in this report is a South African resident for tax purposes and as such, the amounts included in his or her gross income are inclusive of world-wide income.

A further look into the definition of gross income and the terms included in the definition would be beneficial in order to provide an understanding into why the amounts investors receive may be included in their gross income. Since the amounts received in this report are assumed to be in cash only, the term 'in cash or otherwise' is not explored further as it is self-explanatory in this case. However, it is useful to look into the term 'received by or accrued to'. One of the principles that arose from the *Geldenhuys v CIR* case was that an amount that is received by a person will only be included in his or her gross income if it was received for his or her own benefit and on his or her own behalf. The term 'accrued to' means that the person has been entitled to that amount (*Lategan v CIR,*1926 CPD 203, 2 SATC 16). A person is taxed on the earlier of receipt or accrual (Coetzee et al., 2020:51).

Lastly, the term 'in favour of' means that if an amount is received by another person, on behalf of the investor in question, then that amount will be included in the gross income of the investor and not the person that received the amount on his or her behalf (Coetzee et al*.,* 2020:49). If interest, as an example, has accrued to the investor but has not been paid to the investor, the amount of interest will still be included in his or her gross income. This is contained in s 7(1) of the Act which states the following:

> Income shall be deemed to have accrued to a person notwithstanding that such income has been invested, accumulated or otherwise capitalised by him or that such income has not been actually paid over to him but remains due and payable to him or has been credited in account or reinvested or accumulated or capitalised or otherwise dealt with in his name or on his behalf, and a complete statement of all such income shall be included by any person in the returns rendered by him under this Act.
>
> Source: Section 7(1) of the Income Tax Act 58 of 1962

It is worth noting that the year of assessment for a natural person is from 1 March to 28/29 February of the following year (Coetzee et al., 2020:51). The exclusion of receipts and accruals of a capital nature is dealt with under the Capital Gains Tax section in this Chapter.

The REITs tax legislation aims to tax the investor in the same way the investor would have been taxed if he or she had made a direct investment into the property market (Ungerer, 2013). The next section examines the tax implications for an investor in a REIT which includes dividend tax, Capital Gains Tax, Value-Added Tax and transfer duty.

- Dividend Tax

The earnings that have been distributed by the REIT are taxed in the hands of the investor. These distributions generally consist of dividends and interest. A person may purchase shares or linked units in a REIT. A linked unit is a combination of equity shares and debentures which is typically issued by companies listed on the JSE. The holders of linked units receive interest on the debentures and dividends on the shares. (SARS, 2020:48)

A dividend is defined in s 64D of the Act as any amount that is:

a) 'paid by a company that is resident; or
b) paid by a foreign company-
    i. if the share in respect of which that foreign dividend is paid is a listed share; and
    ii. to the extent that that foreign dividend does not consist of a distribution if an asset in specie'

Source: Section 64D of the Income Tax Act 58 of 1962

Dividend tax is imposed on the shareholders (also referred to as the beneficial owners) who receive the dividends and not the company paying the dividend, however the company paying the dividend must withhold the tax and pay it over to SARS on behalf of the shareholder. There are instances where the dividend will be exempt from dividend tax which depends on the status of the recipient of the dividend, for example, where the dividend is paid to a natural person, deceased or insolvent estate in terms of a s 12T(1) tax free investment, or where the dividend is paid to a retirement fund according to s 64F of the Act, provided that the dividend does not consist of dividend in specie. A dividend in specie is a dividend that is paid in a form other than cash (SARS, n.d.b.: 3). A dividend in specie is exempt from dividend tax or is subject to a reduced rate of tax according to s 64FA if the beneficial owner submits a declaration to the company paying the dividend, in a form prescribed by the Commissioner, by the payment date of the dividend which declares that if the dividend had not constituted of a dividend in specie, it would have qualified for the s 64F exemption or a reduced rate of tax (section 64FA(2)).

In terms of the Act, under s 10(*k*)(i) a dividend is exempt from gross income, however, according to s 10(*k*)(i)(*aa*), a dividend that is distributed by a company that is a REIT, is excluded from this exemption. As a result of this exclusion, dividends that investors receive

are included in the investors' gross income under paragraph (k) and will be taxed at their marginal tax rate, but these dividends are exempt from dividend withholding tax (currently 20 per cent as per s64E(1)(*i*) of the Act) when paid to South African taxpayers (Growthpoint 2021:6). There are, however, situations where the dividend is exempt from normal tax under s 10(*k*)(i), such as when the dividend constitutes a share buy-back by the REIT (SARS, 2020:15). Section 25BB(6)(*a*) of the Act, deems any interest received by or accrued to a holder of a linked unit in a REIT on the debenture part, to be a dividend, from the year of assessment starting on or after 1 April 2013.

If the investor is a South African trust and the trust has not vested the income in its beneficiaries, the trust will be liable for income tax in respect of the dividend at a rate of 40 per cent [45 per cent from the 2018 tax year] but the dividend will be exempt from dividends withholding tax (Edward Nathan Sonnenberg, 2013).

- Capital Gains Tax: Disposal of shares

The Income Tax Act defines what is meant by the term 'disposal' in para (11) of the Eighth Schedule. A disposal includes, 'a sale, donation, expropriation, decrease in value of a person's interest, loss or destruction and the vesting of an interest in an asset of a trust in a beneficiary' (para (11) of the Eighth Schedule). A capital gain or loss is calculated in accordance with the provisions in the Eighth Schedule by taking the proceeds received or accrued and deducting the base cost. The capital gain is included in the taxable income of a taxpayer in accordance with s 26A of the Act while a capital loss is set off against any capital gain in the current year or carried forward to the following year to be set off against future capital gains.

Paragraph 5 of the Eighth Schedule allows for an annual exclusion for natural persons and special trusts of R 40 000 to be deducted from the capital gain or loss calculated during a year of assessment which increases to R 300 000 if that person dies during a year of assessment (para 5(2) of the Eighth Schedule). The resulting net capital gain is then included in the taxable income by multiplying it by the inclusion rate of 40 per cent for natural persons or a special trust (para 10(1)(*a*) of the Eighth Schedule). This calculation can be illustrated as follows;

Determining a taxable capital gain/assessed loss	**R**
Sum of capital gains and capital losses during the year of assessment	XXX
Less: Annual exclusion	(XXX)
=Aggregate capital gain or aggregate capital loss	XXX
Less / add: Assessed capital loss brought forward from previous year of assessment	(XXX)/XXX
=Net capital gain or assessed capital loss	XXX
Multiply a net capital gain by the inclusion rate (40% for an individual)	XX
=Taxable capital gain to be included in taxable income	**XXXX**

Figure 2 : Determining a taxable capital gain/assessed loss (Source: SARS, 2021:5)

There are other exclusions in part VII and part VIII of the Eighth Schedule which allows for the exclusion of any capital gain or loss from the disposals of specified assets and these include (SARS, 2021:6):

- Personal-use assets (for example, motor vehicles but excludes shares and participatory interests in collective investment schemes)
- Lump sum payments from approved retirement funds such as Pension and Retirement Annuity funds.
- Proceeds from an endowment policy or life insurance policy (but not if it is a second-hand policy).
- Compensation for personal injury or illness.
- A tax-free investment under section 12T.

Where shares are held as a capital asset, any gain as a result of a disposal will be capital in nature and therefore subject to capital gains tax (CGT) and is not subject to income tax. Capital losses from the disposal of a capital asset are set off against capital gains and not income. It is therefore important to distinguish between an amount that is revenue and one that is capital in nature. When making the distinction between capital and revenue, there are factors that must be taken into account as there is no definition that exists. The intention of the taxpayer is an important factor that must be taken into account.

In *Elandsheuwel Farming (Edms) Bpk v SBI* the intention of the taxpayer was considered a decisive factor in determining if the amount was revenue or capital in nature. If the intention of the taxpayer is to enter into a profit-making scheme, then this would mean that any proceeds from the disposal would be revenue in nature whereas if the taxpayer's intention was to use the asset to produce income, then the proceeds on disposal would be capital in nature. (*Elandsheuwel Farming (Edms) Bpk v SBI*, 1978 cited in Makhaya and Barnard, 2017:177) The intention of the taxpayer may change from his or her initial intention at purchase to hold an asset as a capital asset into a scheme of profit-making in which case the initial intention is no longer conclusive (*CIR v Richmond Estates (Pty) Ltd* 1956 (1) SA 602 (A)). The decision of the taxpayer to realise the asset or to realise the asset in the most advantageous way (*CIR v Stott* 1928 AD 252, 3 SATC 253) does not automatically imply a change of intention. The taxpayer must be said to have 'crossed the Rubicon' (*Natal Estates Ltd v CIR*, 1975 (4) SA 177 (AD)) by his or her change in intention from merely selling an asset to its best advantage to selling it in a scheme of profit-making.

The intention of the taxpayer is subjective and must be proven using the evidence available, nonetheless, there are objective factors that the courts also consider such as the manner of acquisition, disposal, and the period for which the asset is held (Coetzee *et al,* 2020:62). Section 9C(2) of the Act deems an amount received or accrued on the disposal of an equity share to be capital in nature if that equity share had been held for at least three years at the time of disposal. In order to apply s 9C, a share must be classified as an equity share and therefore it is important to determine what classifies as an equity share.

According to s 9C(1) of the Act, an equity share includes a 'participatory interest in a portfolio of a collective investment scheme in securities'. A share in a REIT may be classified as an equity share if it meets the definition in s 9C(1) and as a result, the treatment of a disposal of an equity share in a REIT would be in accordance with s 9C(2). It is important to note, however, that if the share, which was held for less than three years is disposed of, the amount received or accrued is not automatically deemed as revenue in nature and the circumstances surrounding the sale must be tested against the guidelines provided through case law (SARS, 2020:19).

- Value-Added Tax

Another tax that must be considered is Value-Added Tax (hereafter referred to as VAT) which is an indirect tax. The Value-Added Tax Act 89 of 1991 (hereafter referred to as the VAT Act)

is the legislation that is referred to, to determine the VAT implications of a transaction of a REIT shareholder. According to s 7(1)(*a*), (*b*) and (*c*) of the VAT Act, VAT is levied at the standard rate (currently 15 per cent) on the supply of goods or services by a vendor in the furtherance of the VAT enterprise, on the importation of goods into South Africa and on the supply of any imported services, unless if that supply has been exempted or is zero-rated. VAT is a consumption tax that is levied on goods and services in various countries, including South Africa (Coetzee et al*.,* 2020:19). In order for a transaction to have VAT consequences, the requirements set out in the above definition must be met, therefore it is beneficial to understand these requirements so that it can be determined if the transactions that take place when dealing with the proposed investment portfolio attract VAT. The requirements and their meanings can be explained as follows:

Firstly, there should be a supply which is defined in s 1 of the VAT Act as including a rental agreement, the performance of a sale or any other form of supply regardless of where the supply is affected and whether voluntary or enforced by law. There may be transactions that do not meet the definition of the term 'supply' that may be regarded as a deemed supply under s 8 of the VAT Act. Secondly, a good is defined as any corporeal movable thing, any real right in fixed property but excludes things like money while a service is widely defined as anything done or to be done and includes the granting of any right or facility but excludes money or revenue stamp (Section 1 of the VAT Act). Thirdly, the term vendor is understood to be a person who is required to be registered under the VAT Act and includes a company, partnership, and a trust fund (Coetzee et al., 2020:34). Section 23(1) of the VAT Act provides for the requirements of compulsory registration of a person as a vendor, but these will not be addressed by this report. Lastly, the requirement for the above to be carried out 'in the furtherance of his or her enterprise, where enterprise is widely describes as follows:

> Any enterprise or activity which is carried on continuously or regularly by any person in the Republic or partly in the Republic and in the course or furtherance of which goods or services are supplied to any person for a consideration, whether or not for profit.
>
> Source: Section 1 of the Value-Added Tax Act 89 of 1991

The type of service that a REIT provides to its shareholders is classified as a financial service as defined under s 2(1)(*d*) of the VAT Act as it involves the 'issue, allotment or transfer of ownership of an equity security or a participatory security'. A participatory security is a participatory interest which as defined in s 1 of the Collective Investment Scheme Act 45 of 2002, is any interest or share which can be purchased by an investor in a portfolio. Section

12(*a*) of the VAT Act exempts the supply of financial services from VAT and as a result, the issue of a share in a REIT is exempted from VAT, this also includes the subsequent disposal of the share by the holder. Nevertheless, the fees relating to this financial service are usually not exempt from VAT, for example, the fees for providing advice on the services are levied VAT at the standard rate (Coetzee et al*.,* 2020:64). The payment of a dividend by a REIT fall outside the scope of the VAT Act (SARS, 2020:64).

- Transfer duty

In South Africa, transfer duty is levied according to s 2(1) of the Transfer Duty Act 40 of 1949, on the value of property that has been acquired by a person. Property is defined in s 1(1) of the Transfer Duty Act as any land and fixtures in South Africa and specifically includes a share or interest in a residential property company. Therefore, it is important to look into the definition of a residential property company in order to ascertain whether the shares purchased in a REIT will be subject to transfer duty. A residential property is defined in s 1(1) of the Transfer Duty Act as follows:

> means any company, other than a REIT as defined in section 1 of the Income Tax Act, 1962 (Act 58 of 1962), that holds property that constitutes-
>
> (a) residential property; or
>
> (b) a contingent right contemplated in paragraph (f) of the definition of 'property',
>
> and where the fair value of that property or contingent right comprises more than 50 per cent of the aggregate fair market value of all the assets, as defined in paragraph 1 of the Eighth Schedule to the Income Tax Act, 1962, (other than financial instruments as defined in section 1 of that Act or any coin made mainly from gold or platinum), held by that company on the date of acquisition of an interest in that company;
>
> Source: Section 1(1) of the Transfer Duty Act 40 of 1949

It is clear in the definition above that a REIT is specifically excluded from the definition of a residential property company. This means that the acquisition of a share in a REIT by an investor is not subject to transfer duty.

REITs and retirement

When you are considering whether to include REITs in your investment portfolio for retirement purposes, it is beneficial to identify the advantages and disadvantages of this type of investment. Some of the advantages that exist when investing in REITs include diversification,

helping in hedging against inflation (Nair, 2012) as well as greater liquidity as the shares are listed on the JSE (Strauss, 2018:10). REITs as an investment, has the added advantage of low transaction costs, stable income in the form of dividends as well as being regarded as a generally safe and stable investment due to its diversification (Mazurczak, 2011:118). REITs can be a reliable source of income for retirees and people living on fixed incomes and can assist in paying medical expenses as well as other living expenses (Anson, Fabozzi & Jones, 2010:300). This type of investment also has the benefit of an increase in the underlying asset and share price during periods of inflation (Fevurly, 2014:249). An advantage from a tax perspective is that a transaction to acquire the shares in a REIT, as mentioned earlier in this chapter, falls outside the scope of the VAT Act and it is not subject to transfer duty.

Some of the disadvantages that exists when investing in REITs, is the exposure to both the real estate and stock market as a result of the shares being listed on a stock market, such as the JSE (Anson, Fabozzi & Jones, 2010:301). Another disadvantage is the taxation of the dividends in the hands of the investor because of s10(*k*)(i)(*aa*) of the Act which states that dividends received from REITs do not qualify for the s10(*k*)(i) exemption. It is worth noting though that if an investor has a REIT as part of his or her retirement annuity or pension fund, the investor will only pay tax on the dividends when he or she receives the pension payments from the fund (Barnard 2021). The other disadvantage include, interest-rate risk which can have a negative impact on the growth of the REIT as it is more expensive for the REIT to purchase additional property (Fevurly, 2014:250).

If the investor chooses to include SA REITs in his or her investment portfolio, then he or she can choose whether to invest in SA REITs that are sector-specific or diversified. Sector-specific REITs focus on properties in either retail, office, residential or industrial sectors. According to research conducted by Akinsomi (2020:9), sector-specific REITs performed better than diversified REITs during the period of April 2013 to September 2020. Therefore, the investor should consider including sector-specific REITs in his or her investment portfolio instead of the diversified SA REITs.

Conclusion

The purpose of this chapter was to provide details regarding the tax treatment, risks, and types of returns an investor can expect when investing in a REIT. It can be concluded that including a REIT in the investor's portfolio is beneficial to diversify the portfolio and to benefit from the

classification of the disposal of shares as capital in nature, if the investor decides to dispose of shares after at least three years.

Although the taxation of dividends received from REITs results in the investor paying more tax as a result of choosing this type of investment, if the investor falls within the lower or middle-income tax bracket, the taxation of the dividends as part of his or her income should not be detrimental.

It is advisable to re-invest the dividends received before retirement in a fund and either use the accumulated dividends to pay off and close any outstanding debts closer towards retirement or leave the investment as an emergency fund for during retirement.

Chapter 3: Endowment Policies and their tax implications

Introduction

An endowment policy is basically a life insurance policy that has a savings component where the investor is able to save regularly by paying a fixed premium. At the maturity date, provided the investor (the term investor and policyholder will be used interchangeably) has not died, the investor can withdraw a lump sum or make regular withdrawals from the policy to add to his or her retirement funds, pay off debts or buy/pay off a home at the start or early stages of retirement. If the investor dies before the maturity date, then his or her nominated beneficiaries will be able to receive the funds from the policy (Verifi, 2019).

According to Allan Gray (n.d.), an endowment policy is most beneficial in terms of tax savings if the investor's marginal income tax rate is greater than 30 per cent and the policy is also useful for estate planning purposes. The endowment policy can also be offshore where the investor has the choice between using a South African or foreign insurer. This chapter briefly discusses the differences in terms of the tax treatment of offshore endowments through a South African insurer compared to a foreign insurer.

It is worth noting that if an investor chooses to invest in an offshore endowment policy, then the investor will have to make use of his or her offshore investment allowances. South African's have a Single Discretionary Allowance of R 1 million per year which can be sent overseas and used for either travel or investment purposes without the need to get a tax clearance certificate (Fick & van Zyl, 2018). In terms of section B.2(B) of the Authorised Dealer Manual, which must be read together with the Exchange Regulations Control, there are various requirements that the South African resident person must comply with in order to be able to use his or her foreign investment allowance to invest funds offshore over and above the R1 million Single Discretionary Allowance. The South African can invest up to R 10 million per year using his or her Foreign Investment Allowance and must obtain a tax clearance certificate, be 18 years or older and enter into transactions permitted by the South African Reserve Bank, whose requirements are not discussed in this report (CDH, 2019:5).

An overview of Endowment policies

There are four parties to the endowment policy, which are the policyholder, the insurer, the life insured and the beneficiary. The insurer agrees to make payments when the policy matures or when the life insured dies on the condition that there are no other lives insured on the policy. If the event that occurs first, is the policy maturing then the insurer will pay out to the policyholder and not the beneficiary unless the life insured dies before maturity (the policyholder can be the life insured). If there is no beneficiary that has been nominated and the policyholder, which is also the only life insured, dies, then the policy pays out the funds to the policyholder's estate which will then administer the policy proceeds in terms of the policyholder's last will and testament (Momentum, 2019:3).

The endowment policy has certain restrictions imposed on it by legislation such as the regulations of the Long-Term Insurance Act 52 of 1998. Some of the restrictions include the 'restriction period' which is the minimum investment term for endowments of five years from date of inception. One of the conditions in place during the restriction period is that the policyholder can only access funds in the policy through one withdrawal and one loan. This withdrawal or loan is a restricted amount which is calculated by taking all the premiums paid plus 5 per cent per year. This withdrawal cannot be repaid and if at a later stage funds are paid into the policy after a withdrawal has taken place, in excess of the restricted amount, then the restriction period may be extended (Momentum, 2019:5). Another restriction that exists is a restriction on the premium increases. The premium increase is restricted to not more than 20 per cent of the total value of the previous two 12-month premium periods immediately before the premium increase. If this restriction is exceeded, then the restriction period will commence again from the day the additional premium is paid into the policy (Momentum, 2019:6).

In terms of offshore endowment policies, more administration work is required as the investor needs to deal with either his or her bank and/or an authorised dealer to provide services relating to arranging foreign currency, helping with the tax clearance certificate and the use of the foreign currency allowance. Nevertheless, there are several advantages of choosing an offshore endowment policy that the South African investor should consider. The advantages of an offshore investment may outweigh the additional administrative burden that is required for most investors. Offshore investment gains the investor access to economies and currency cycles that are different from South Africa which helps to reduce investment risk. South Africa also experiences greater volatility as it is an emerging market and foreign investors are quick to

disinvest whenever the state of the economy or country appears unstable. The effect of the weakening rand, which is expected to continue to depreciate in the long-run mainly due to the higher-than-average inflation rate when compared with the country's trading partners and high levels of imports, can be countered by offshore investments. Another advantage is the ability to hedge against political risk, which although this can occur globally, it is unlikely that a majority of the world will experience significant political instability during the same period hence a reduction of this risk through diversification is attainable (Momentum, 2020:3).

The investor can invest in a rand-dominated international fund or directly into a foreign currency dominated fund. The rand-dominated international fund does not require the investor's foreign currency allowance, rather it uses the asset manager's offshore allowance capacity to invest in foreign funds. This option allows the investor to reduce the administrative burden required specifically if the investor plans to invest more than R1 million abroad (Momentum, 2020:5). On the other hand, if the investor is considering emigrating to another country, he or she can invest directly into the foreign currency dominated fund in the currency of the desired emigration country and when the investor emigrates, he or she is not required to go through the foreign currency exchange process as the offshore investment will be paid out in the foreign currency (Momentum, 2020:19).

Tax Implications

Endowment policies offer attractive tax benefits for investors which are explored in further detail in this chapter.

- Income Tax

When the policyholder receives a payment from the endowment policy, the proceeds are not subject to income tax in the hands of the policyholder. The proceeds are deemed to be a capital amount and may be subject to capital gains tax, which is explored in the following section. Nevertheless, the funds are subject to income tax during the investment term in the hands of the insurer. According to s 29A of the Act, insurance companies are liable for income tax consistent with a five-fund approach where these long-term insurers are required to allocate their assets to the five distinct funds. The following figure is a summary of the income tax applicable to long-term insurers. The category that the endowment policy that is addressed in this report falls into is the first category 'Individual Policyholder Fund.'

Individual Policyholder Fund- investment policies	
Policyholder	Individuals Trusts (with individual beneficiaries)
Income Tax	30 %
Risk Policy Fund- risk policies	
Policyholder	All risk policies as defined
Income Tax	28 %
Company Policyholder Fund	
Policyholder	Company or CC
Income Tax	28%
Untaxed Policyholder Fund	
Policyholder	Tax exempt entities and all retirement funds
Income Tax	0 %
Corporate Fund (insurance company's funds)	
Income Tax	28 %

Figure 3: Section 29A Five-Fund approach (Adapted from Momentum, 2019:1)

Therefore, the proceeds in the endowment policy during the investment term for individuals and trusts is subject to income tax of 30 per cent which the insurer administers and pays on behalf of the investor on items such as interest and rental income (earned from property investments that are part of the assets within the fund).

If the investor has an offshore endowment policy with a South African insurer, then the same tax treatment as prescribed by the five-fund approach would apply. If the offshore endowment policy is with a foreign insurer, then the investor is responsible for making the declarations to SARS regarding the foreign dividends and foreign interest received as well as any capital gains earned. The investor would also need to convert the foreign currency used in the tax statement received from his or her foreign insurer for reporting purposes (Joffe, 2020).

- Capital Gains Tax

An endowment policy is included in the definition of an asset (SARS, 2021) and as such, capital gains tax is a consideration that must be considered when determining the tax implications of investing in an endowment policy.

The proceeds from the endowment policy when paid to the investor is a capital amount and may be subject to CGT. Paragraph 55 of the Eighth Schedule however states the following with regards to capital gains or losses from long-term assurance;

> A person must disregard any capital gain or capital loss determined in respect of a disposal that resulted in the receipt by or accrual to that person of an amount-
>
> a) in respect of a policy, where that person-
> (i) is the original beneficial owner or one of the original beneficial owners of the policy
> (ii) is the spouse, nominee, dependant as contemplated in the Pension Funds Act or deceased estate of the original beneficial owner of the relevant policy and no amount was paid or is payable or will become payable, whether directly or indirectly, in respect of any cession of that policy from the beneficial owner of that policy to that spouse, nominee or dependant;
>
> Source: Paragraph 55(1)(a) of the Eighth Schedule of the Income Tax Act 58 of 1962

This exclusion results in the investor paying no CGT when the pay-out is received from the endowment policy, but if the policyholder who receives the pay-out is not the original beneficial owner, then the exclusion may not apply.

An endowment policy however is not exempt from CGT in its entirety as CGT is paid by insurers on behalf of the policyholder during the investment term if there is a disposal or deemed disposal of the underlying assets within the policy. Most of the assets held under a policyholder fund typically include shares, bonds, derivatives and immovable property; as such any disposal or deemed proposal may attract CGT. The CGT that insurers pay during the investment term is at an effective rate of 12 per cent (para 10(1)(*b)*(i) of Eighth Schedule) which is lower than the effective rate of 18 per cent for individuals (para 10(1)(*a)* of Eighth Schedule).

- Dividend Tax

Where a dividend, other than a distribution of an asset in specie, is paid to a long-term insurer s 64I of the Act prescribes the tax treatment as follows:

a) Firstly, the insurer must be deemed to be a regulated intermediary which means that according to s 64G(2)(*c)* of the Act, the company paying the dividend is not liable to withhold dividend tax.
b) Secondly, the dividend must be deemed to be paid to a natural person that is a resident if it was allocated to an individual policyholder fund.

The dividend that is received by the insurer will be accumulated in the fund and will not be paid to the policyholders (SARS, 2010:141). The dividend is subject to withholding tax

according to s 64H(1) at the rate of 20 per cent as prescribed in s 64E(1)(*a*)(i) and must be withheld by the insurer and paid over to SARS.

Where a dividend that comprises a distribution of an asset in specie, is paid to a long-term insurer s 64EA(*b)* of the Act prescribes that the company paying the dividend is liable for dividend tax, but the long-term insurer may be exempt from dividend tax in this instance as it is a company as defined in s 1(1) of the Act and under s 64F(1)(*a*) where a company is the beneficial owner of a dividend, it is exempt from dividends tax. If the insurer according to s 64FA(1)(*a*), submits a declaration form and written undertaking in a form prescribed by the Commissioner to the company paying the dividend that comprises a distribution of an asset in specie stating that it is exempt from dividend tax then the company should not withhold the dividend tax. This applies irrespective of which policyholder fund the insurer allocates this dividend to (SARS, 2010:142) and s 64H(1)(*a)* states that dividend tax must be withheld by a regulated intermediary unless it consists of a distribution of an asset in specie and as such, the insurer will not withhold dividend tax in this instance.

- Value-Added Tax

As discussed in Chapter 2, financial services are exempt from VAT. The supply of long-term insurance under the Long-Term Insurance Act, such as an endowment policy, is classified as a financial service and as such is exempt from VAT (SARS, n.d.a.:5).

- Estate Duty

Estate duty is excluded from this report; however, it is helpful to note that the endowment policy with a nominated beneficiary is favourable and should be considered when deciding on an appropriate investment for retirement as death is an inevitable event.

After examining the different tax implications of an endowment policy, it is clear that choosing to invest in such a policy is beneficial from a tax perspective.

Endowment Policies and retirement

When the investor is considering whether he/she should include an endowment policy in his/her investment portfolio for retirement purposes, it is beneficial to identify the advantages and disadvantages of this type of investment. An endowment policy offers the following advantages:

a) Tax efficient: as mentioned in the previous section, the insurer administers and pays the tax due on behalf of the investor which reduces the administrative burden in addition to paying tax at a rate of 30 per cent (this is most beneficial to investors with a marginal tax rate of above 30 per cent) and 12 per cent CGT which is lower than the effective CGT rate for individuals. (Sanlam, 2019)
b) Saving on executor fees: as with an endowment policy the investor can nominate a beneficiary who will receive a pay-out if the investor were to pass away before maturity of the fund. The beneficiary will not be liable to pay executor fees which would be a saving of about 3.5 per cent. (Sanlam, 2019)
c) Insolvency protection: s 64 of the Long-Term Insurance Act provides for the protection of long-term insurance policies such as an endowment policy from the policyholder's insolvent estate if the policy has been in force for at least three years and is payable to the life insured or spouse of the life insured. This protection applies even after the death of the policyholder if the funds are paid to that person's spouse, child or parent. (Sanlam, 2019)
d) A flexible policy upon maturity: once the endowment policy has matured, the investor will have unlimited access to the funds in the policy and can decide whether to make regular withdrawals to add to his or her retirement income or can make a lump sum withdrawal (Sanlam, 2019).
e) Offshore investments allow for global diversification and access to stronger economies which can potentially decrease investment risk (Standard Bank, n.d.b.)

There are a few disadvantages that exists with endowment policies such as the restriction period of five years where only one withdrawal and loan can be taken out, though this does encourage more disciplined saving which is a benefit in the long run. Another disadvantage is the fact that if the investor increases the premiums by more than 20 per cent of the total value of the previous two 12-month premium periods immediately before the premium increase then the restriction period may be extended. As noted in this chapter, investors with a marginal tax rate of less than 30 per cent will not benefit from the income tax rate of 30 per cent levied on insurers. In terms of offshore endowments, it is worth noting that although investing in a developed economy is an advantage in terms of offering a stronger economy, there is a risk although a small risk, that a developed economy may grow at a slower rate than an emerging one (Standard Bank, n.d.b).

Conclusion

The purpose of this chapter was to gain an understanding of what an endowment policy is and to examine the tax benefits, advantages and disadvantages of such an investment for an investor. It can be concluded that an endowment policy offers a number of advantages and has very few disadvantages and it also has sufficient tax benefits to warrant having it form part of the investment portfolio. The burden of tax administration is borne by the insurer which means that the investor can rest assured knowing that adequately qualified and experienced professionals are administering the fund and handling the tax implications.

The Long-Term Insurance Act 52 of 1998 also offers protective measures such as a restriction period, insolvency protection and prescribes the conduct of long-term insurers when dealing with the funds they manage through the various policies that they offer clients.

Chapter 4: South African Retirement Annuity funds and their tax implications

Introduction

A Retirement Annuity fund is defined in s 1 of the Income Tax Act as any fund except a pension, provident or benefit fund, where no more than one-third of the total value of the fund may be withdrawn as a lump sum and it prescribes that the remainder of the fund must be taken in the form of an annuity. This restriction does not apply if the two-thirds of the total value is less than R165 000 or if the member is deceased. The fund also prescribes the time from which a member can access the funds which is when the member has reached normal retirement age. Section 1 of the Act defines the term 'normal retirement age' for a Retirement Annuity, Pension Preservation or Provident Preservation fund as the date when the member attains the age of 55 or the date when the member is unable to carry out his or her profession as a result of sickness, accident, injury, or incapacity through ailment of mind or body.

If a member of a Retirement Annuity fund stops contributing into the fund, he or she may only withdraw benefits from the fund if the person has emigrated from the Republic in accordance with the exchange control provisions of the South African Reserve Bank (SARB) or upon the expiry of his or her work/visitor's visa provided he or she is not regarded a resident for an uninterrupted period of at least three years and if the total value of the benefit does not exceed R 15 000 [previously R 7 000] (PPS, 2021:2).

The fund management of Retirement Annuity funds are regulated by Regulation 28 in line with the provisions in the Pension Fund Act. Regulation 28 limits the kind of assets and the level of which the retirement funds may invest in certain kinds of assets in order to protect the retirement savings from being negatively affected by poorly diversified investment portfolio (Sanlam, 2018:1). The more vital Regulation 28 asset class limits are as follows:

i. Equity 75%
ii. Listed Property 25%
iii. Offshore Assets 30%
iv. Hedge funds 10%

The retirement fund plan must stay within these limits in order to be complaint with the regulation. This serves as a benefit for members to ensure that their retirement savings are

sufficient during retirement as the funds exposure to risky assets is controlled and managed by Regulation 28.

Tax Implications

Retirement Annuity funds are popular as they offer a wide range of tax benefits. Government has an interest in ensuring that their retirement policy meets their set objectives which includes encouraging individuals to save sufficiently for retirement in order to decrease the burden on the Government and its resources. Tax legislation helps in this objective by prescribing provisions that allow for retirement funds to allow for tax deductions and through having favourable tax rates for lump sums withdrawn from retirement funds.

- Tax deductions on contributions

According to s 11F of the Act, a natural person is allowed a deduction from income if that person contributed to any retirement fund such as a Pension or Retirement Annuity fund during the year subject to the limitations stated in s 11F(2)(*a)* to *(c)*. The deduction must not exceed the lower of;

i. R 350 000, or
ii. 27,5 per cent of the higher of;
    a. Remuneration or
    b. Taxable income (before s6quat, (1C) and 18A Donations, taxable capital gain)
iii. Or the taxable income (before s6quat, (1C) and 18A Donations, taxable capital gain)

In addition to the above, according to s 11F(3), any amount that was not allowed as a deduction in the previous years as a result of the application of the limitation, should be taken into account as a deemed contribution in the current year of assessment. Contributions made by an employer on behalf of an employee must be deemed to be contributed by that employee (s 11F(4)(*a*) & (*b)*) and the amount paid must be deemed to be equal to the cash equivalent of the value of the taxable benefit.

- Fringe benefits

A fringe benefit basically means benefits that an employer provides to his or her employee other than the cash salary paid to the employee. Paragraph (*i)* of the gross income definition in

the Act specifically includes in gross income, the cash equivalent of taxable fringe benefits, the value of which is determined in terms of the Seventh Schedule to the Act. If the contributions made are for a retired employee or the dependants or nominees of a deceased employee, then no value is given to the taxable fringe benefit (Coetzee et al., 2020:186).

The value of the taxable fringe benefit must be determined in accordance with the 'fund member category' and the type of the retirement benefits to which the employee member is entitled. The term 'fund member category' is defined in para 12D of the Seventh Schedule to the Act as follows;

> 'fund member category' in relation to members of a Pension, Provident or Retirement Annuity fund means any group of members in respect of whom, in terms of the rules of the fund-
>
> a) the employers of those members and those members must respectively make a contribution to that fund in an amount in respect of retirement funding income at the same fixed rate and
> b) the determination of the value of the benefits of the members referred to in paragraph *(a)* and the determination of the entitlement of those members to those benefits are made according to the same method.
>
> Source: Paragraph 12D of the Seventh Schedule to the Income Tax Act 58 of 1962

The retirement benefits are classified into five different components and include a defined benefit component, a defined contribution component, a risk benefit and an underpin component. This report focuses on the 'defined contribution component' as this is the component used for illustrative purposes in Chapter 5. Paragraph 12D of the Seventh Schedule to the Act defines a defined contribution component as meaning;

> A benefit or part of a benefit receivable from a Pension, Provident or Retirement Annuity fund-
>
> a) where the interest of each member in the fund in respect of that benefit has a value equal to the value of-
> i. the contributions paid by the member and by the employer in terms of the rules of the fund that determine the rates of both their contributions at a fixed rate;
> ii. less such expenses as the board of that fund determines;
> iii. plus any amount credited to the members individual account…
>
> Source: Paragraph12D of the Seventh Schedule to the Income Tax Act 58 of 1962

This definition can be summarized as meaning that the member receives all his or her contributions plus any capital growth and less any costs (Coetzee et al., 2020:222).

Paragraph 12D(2) of the Seventh Schedule to the Act states that the cash equivalent of the value of the taxable fringe benefit for a defined contribution component is equal to the value of the contribution by the employer. The value determined must be included in the taxable income of the employee and the employee will be liable for tax on this fringe benefit.

- Tax on lump sum benefits

A lump sum benefit is defined in paragraph 1 of the Second Schedule to the Act as follows;

> a) Any amount determined in respect of the commutation of an annuity or portion of an annuity
> i. Payable by; or
> ii. Provided in consequence of membership or past membership of,
>
> a pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund.
>
> b) Any fixed or ascertainable amount (other than an annuity) …
>
> whether in one amount or in instalments, but does not include any amount deemed to be income accrued to a person in terms of section 7(11)

Source: Paragraph 1 of the Second Schedule to the Income Tax Act 58 of 1962

All lump sums received by a person from a retirement fund are taxed on a cumulative basis which means that when a person retires, all the lump sums paid out until the current retirement lump sum will be added together and the tax will be calculated on the total value. The tax already paid on previous lump sums will be deducted from the tax owed on the total value of all the lump sums received.

The following tax rates are applicable to retirement lump sum benefits received;

2022 tax year (1 March 2021 – 28 February 2022)

Taxable income from lump sum benefits	Rates of tax
1 – 500 000	0% of taxable income
500 001 – 700 000	18% of taxable income above 500 000
700 001 – 1 050 000	36 000 + 27% of taxable income above 700 000
1 050 001 and above	130 500 + 36% of taxable income above 1 050 000

Source: Paragraph 9(*b*)(i) of Schedule 1 of the Rates and Monetary Amounts and Amendment of Revenue Laws Act, 2018.

- Tax on annuity income

As mentioned above, only one-third of the total value of the retirement fund can be taken as a lump sum. The remaining two-thirds must be taken as an annuity and will attract tax at the taxpayer's marginal tax rate if the income from the annuity exceeds the below thresholds for the 2022 year of assessment (SARS, 2022);

i. Person below the age of 65 – R87 300 per annum

ii. Person aged 65 and above but not yet 75 – R135 150 per annum

iii. Person aged 75 and above – R151 100 per annum

- Capital Gains Tax

In terms of CGT para 54 of the Eighth Schedule states that a person must disregard any capital gain or capital loss determined in respect of a disposal that resulted in that person receiving;

i. A lump sum benefit as defined
ii. A lump sum benefit paid from a fund outside the Republic which has similar benefits to a retirement fund

The tax implications of Retirement Annuity funds are beneficial and investors should take advantage of the favourable tax rates and tax deductions that investing in a Retirement Annuity fund offers.

Retirement Annuity funds and retirement

This section discusses the advantages and disadvantages that an investor can consider when deciding whether or not to include a Retirement Annuity fund in their portfolio.

The advantages that are available with Retirement Annuity funds include;

a) Tax savings; as mentioned in the previous section, the contributions investors make towards their retirement funds are deductible from their taxable income up to the limit as per s 11F as well as benefitting from deferred tax as the returns are not taxable while in the Retirement Annuity fund. The lump sum benefit received is also tax free up to the first R 500 000.
b) Protected from creditors; Section 37A (1) of the Pension Fund Act 24 of 1956 states that;

> no benefit provided for in the rules of a registered fund (including an annuity purchased … by the said fund from an insurer for a member) ... shall ... be liable to be attached or subjected to any form of execution under a judgment or order of a court.
>
> Source: Section 37A (1) of the Pension Act 24 of 1956

c) Provision of monthly income; as a result of the provision in the Income Tax Act that states that two-thirds of the Retirement Annuity benefit must be taken in the form of an annuity, investors may have access to a consistent monthly income during retirement.
d) Flexible contributions; an investor can increase, stop or even temporarily pause his or her contributions as needed without the investment value being significantly impacted (Standard Bank, n.d.a).
e) Benefits are paid directly to dependents upon death; Section 37C of the Pension Fund Act provides for the payment of retirement benefits to the investors dependents without the benefits forming part of the deceased estate.

There are a few disadvantages that exists such as the provision that states that the benefits can only be withdrawn once the member reaches the age of 55 unless if the member is permanently disabled or emigrates from the Republic. Another disadvantage is the limitations provided by Regulation 28 in terms of the amount of offshore investment that a fund can have which decreases diversification potential of the fund.

Reducing the investor's taxation expense is vital to increase the available funds that can be used for investment purposes and a reduction in tax on the income generated from the chosen investment will also benefit the investor as the return will not be greatly reduced by taxation. Retirement funds in general offer tax deductions to the investor while he or she invests in a retirement fund and offers favourable tax rates once the funds are withdrawn upon retirement age. It is beneficial to consider the reasons for choosing to invest in a retirement fund especially if the investor is not an employee of a company that provides for compulsory contributions to Pension funds. One of the reasons, as mentioned in this Chapter, for investors to include a Retirement Annuity fund in their investment portfolio, is to benefit from the tax deductions available on the contributions made by the investor or his or her employer. A simple way to illustrate the benefit of the tax deduction available is by way of an example using the 2022 tax rates;

	Investor with RAF	**Investor without RAF**
Income	600 000	600 000
Tax deduction	(81 000)	(0)
Taxable income	519 000	600 000
Tax payable	(129 279)	(158 439)
Net available income	389 721	441 561

The investor with an investment in a Retirement Annuity fund reduces his or her tax burden by R29 160 (158 439 -129 279) and although he or she has less net available income as a result of the R 81 000 total contribution to the retirement fund, the tax saving can be used to contribute further towards retirement by increasing his or her savings. Therefore, the investor with a retirement fund has greater savings compared to the investor without one and will allow for greater investment returns on retirement.

Conclusion

Government encourages South Africans to save towards their retirement and this is evident by the favourable tax policies and the current legislation that governs retirement funds. It is vital that every South African seriously considers all the tax benefits that Retirement Annuity funds have to offer and include this in his or her investment portfolio. The limitations that fund managers have in terms of the level of investment permitted by Regulation 28 in risky asset classes may limit the possible returns that the funds may generate, however, mitigating the risks involved with these asset classes to put the investor in a better position in retirement is worth the slightly lower returns. Another deterrent might be the fact that investors may only access the funds once they either reach the retirement age of 55, are permanently disabled or emigrate from the Republic. Nevertheless, this serves as a means to prevent South Africans who are not disciplined when it comes to their finances, from accessing and using up their retirement savings before they retire.

Chapter 5: An evaluation of the investment portfolio from a tax perspective

Introduction

It is important to determine the tax implications of the proposed investment portfolio in comparison to an investment portfolio that only consists of a Pension and Retirement Annuity fund. This chapter provides a high-level analysis of the net tax payable for two different investors using two fictional scenarios. The effects of the Covid-19 pandemic on the economy is also examined briefly as this has a direct impact on household savings, expenses and livelihood and further emphasises the importance of choosing adequate retirement plans in order to secure a financially stable life, taking into account the probability of events such as the pandemic, having a profound impact on the economy, livelihood and lives.

Another consideration in the evaluation of the investment portfolio would be to look at some simple questions that investors can ask themselves when deciding on which investment vehicles to consider as part of their portfolio which were formulated by Nedbank. These simple questions can be addressed before considering the various tax implications of the investment vehicles and are as follows:

1. Do you need to supplement your existing retirement savings?
2. What's your income tax bracket?
3. How important is it to you to have access to your savings?
4. Do you want to invest in more high-risk, high-growth assets?

Source: Nedbank Private Wealth, (n.d.:1)

One of the main reasons for including non-retirement specific investment vehicles, specifically for investors who already belong to an employer Pension fund, is to provide additional income in other words, supplement their current Pension fund retirement savings which already answers the first question. The second question is especially important when considering whether to include an investment, such as an Endowment policy, which as discussed in Chapter 3, is most beneficial from a tax perspective for the wealthier investor with a marginal tax rate of above 30 per cent. If the answer to the third question is that it is important to have access to the savings then non-retirement specific vehicles do provide more flexibility and, in that case, should be included in the portfolio, nevertheless, savings that allow for easy access to funds increase the risk of depletion of savings within the early years of retirement. Lastly, the risk appetite of the investor must be considered and weighed against the desired income during

retirement to achieve a balance between acceptable level of risk, desired income, and the age of the investor.

This chapter provides an overview of pension funds, a brief analysis on the Covid-19 pandemic's impact on the economy and lastly, it provides a tax evaluation of the chosen investment portfolio and compares that to a portfolio that consists only of a Pension and Retirement annuity fund.

An overview of Pension Funds

To effectively evaluate the proposed investment portfolio against a portfolio that consists only of a Pension and Retirement Annuity fund, it will be an oversight if an overview of a Pension fund is not addressed by this report. Though the Pension fund and some of its characteristics has been mentioned throughout the report, this section provides more information on the characteristics already mentioned and addresses some additional characteristics. A Pension fund as defined in s 1 of the Act provides that employees should, as part of the condition of their employment, belong to the fund and should contribute according to a predetermined scale. In the same way as a Retirement Annuity fund, not more than one-third may be taken as a lump sum on retirement unless the total value of the remaining two-thirds does not exceed R165 000. Pension funds are also governed by the Pension Fund Act 24 of 1956 and must be established by law.

In general, employers will offer a Pension fund that is either a 'defined benefit fund' or a 'defined contribution fund'. A 'defined benefit fund' is where the fund guarantees the benefits, and the benefits are not dependent on the returns generated by the investment. The benefits are determined based on the employees' years of service and the average of the last two years' salary before retirement (GEPF, 2017:1). A 'defined contribution fund' was already discussed in Chapter 4. There are several advantages and disadvantages that can be identified in either fund type. A 'defined benefit fund' takes away the investment risk from the employer while a 'defined contribution fund' passes on the investment risk to the employee as the benefits are dependent on the performance of the fund, however this can also be an advantage as if the underlying assets perform well, then the benefits received will increase (Fundamental Investments, n.d.)

The 'defined benefit fund' offers a more secure income during retirement as a result of its pre-determined benefits and as a result, is more beneficial to the employee, however, the employer

in this scenario undertakes the investment risk which has led to a decrease of such funds being offered by employers. A survey conducted by PWC in which 114 Fortune 500 global multinationals were included, found that only six per cent of these companies sought to continue with 'defined benefit' funds. A decision to change from 'defined benefit' to a 'defined contribution' by nine in 10 of these surveyed multinational companies was supported by the increasing deficits on the balance sheets of these companies as a result of the financial strain and volatile impact of 'defined benefit' funds (PWC, n.d.).

As a Pension fund is linked to employment, generally whenever an employee resigns from the employer's company, the employee has to choose between withdrawing from the fund and receiving a lump sum or transferring the pension benefit to a Pension Preservation or Retirement Annuity fund or a combination of both these choices. Where the employer decides to withdraw his or her pension benefit before retirement, then there will be tax implications at the rates shown below. The tax implications aim to discourage South Africans from making early withdrawals from their retirement savings before retirement.

2022 tax year (1 March 2021 – 28 February 2022)

Taxable income (R)	Rate of tax (R)
1 – 25 000	0%
25 001 – 660 000	18% of taxable income above 25 000
660 001 – 990 000	114 300 + 27% of taxable income above 660 000
990 001 and above	203 400 + 36% of taxable income above 990 000

Figure 4: Tax rates on retirement fund lump sum withdrawal benefit (Source: SARS, Retirement Lump Sum Benefits, 2022)

The exempt tax amount is only the first R25 000 of the pre-retirement withdrawal compared to the exempt first R500 000 if the lump sum is received on retirement. Whereas, if the pension benefit is transferred to a Preservation or Retirement Annuity fund then this would be a tax-free transaction (10X Investments, n.d.).

The tax implications of a Pension fund are the same as the implications discussed in Chapter 4, for example, s 11F of the Act which provides for the deduction on contributions made to a retirement fund is applicable to Pension funds as well as the inclusion of the cash equivalent value of the fringe benefit where an employer contributes on behalf of the employee to the fund. The tax rates on retirement lump sum benefits are applicable to lump sums received from Pension funds on retirement and para 54 of the Eighth Schedule which provides for the exemption from CGT of a lump sum received from a retirement fund would apply to a Pension fund. It is evident that the tax implications of retirement funds are applicable throughout the different types of funds and there are only minor differences in their characteristics like, for example, when an employee resigns from a company, he or she would not need to withdraw or transfer funds from his or her retirement fund if the fund was a Retirement Annuity fund as this fund is not directly linked to employment.

Another difference comes in the form of the contributions where the contributions can be changed, increased, or decreased towards a Retirement Annuity whereas, in general, the contributions towards a Pension fund are based on a fixed percentage. Lastly, the rules around Retirement Annuity funds do not allow early withdrawal benefits from the fund except under conditions discussed in Chapter 4 while the Pension fund allows for withdrawal upon resignation (BusinessTech, 2019). Retirement Annuity funds offer greater flexibility in terms of employment, contributions and allows the investor to choose the underlying assets he or she would like to invest in, bearing in mind his or her risk appetite. In cases where the investor is employed by a company that has a membership in a specified Pension fund as a condition of employment, it would be prudent to still include a Retirement Annuity of his or her choosing in the investment portfolio.

Covid-19's impact on retirement savings in South Africa

During the year 2020, the world was hit by a pandemic that had overarching impacts on the economy, global markets, livelihoods, and lives. This section briefly evaluates the effect of the pandemic on the South African economy as this has a direct impact on household savings, investment risks and overall expected growth and returns. An example of the impact of this pandemic on the market can be seen in the REIT market which did not go unaffected by this Covid-19 pandemic and the lockdowns that followed. As a result of the financial strain that many businesses faced following the lockdowns that forced non-essential businesses to shut down for months, the businesses that were tenants of the REITs were in need of financial relief.

Many REITs provided their tenants with rent relief in the form of discounts and deferrals during the toughest months of the pandemic and lockdown in 2020. According to the SAREIT Association, an estimated R 3 billion worth of rental relief was provided by SA REITs. This relief measure was provided on top of the already strained earnings that these REIT companies were subject to during the pandemic. The pandemic had a negative impact on the overall growth of REIT companies as seen in Figure 5 below (SAREIT Association, 2021:3). Figure 5 provides a view of the growth of REIT companies that form part of the SAREIT Association.

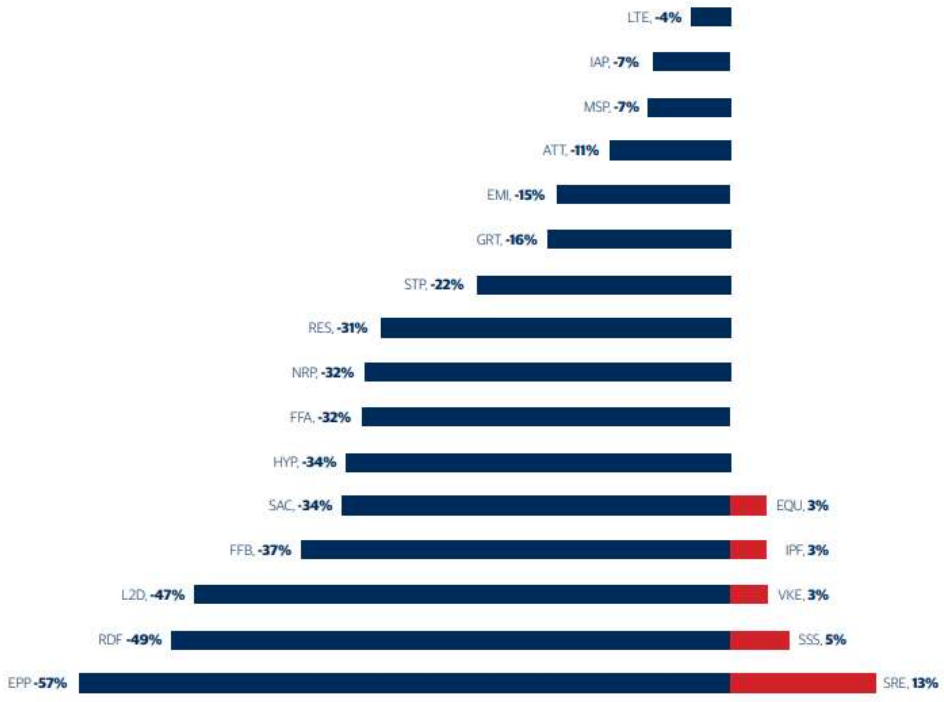


Figure 5 : 2020 Distributable income growth for SAPY constituents (Source: SA REIT Research, Company data, 2021:7)

Unfortunately, the risk of pandemics and other such events occurring cannot be fully mitigated, however it can be expected that over the time of the investment, the overall investor's portfolio should be able to recover, especially if the investor has diversified. Overall real estate as part of an investment portfolio is believed by researchers to improve the performance of the portfolio and offers an alternative to direct asset investment (Ntuli & Akinsomi, 2017:365).

The Covid-19 pandemic had a detrimental effect on economies around the globe and is estimated to have led to a 7.2 per cent contraction in Gross Domestic Product growth in 2020 (National Treasury, 2021a:1). One of the main factors that affect South Africans, and their

investment returns is inflation. Inflation decreases the purchasing power of money as items such as transport costs, electricity and food prices increase which may result in households having less money to put towards their retirement savings. Rising inflation also affects investments and may decrease the purchasing power of the investor's returns in the future therefore it is important to choose an investment portfolio that has underlying assets that account for the effect of inflation over the investment period.

The Monetary Committee report that was released in September 2020 reported that the forecasted headline consumer price inflation averages 3.3 per cent which is lower than the 2021 and 2022 forecasts of 4 per cent and 4.4 per cent respectively (Kganyago, 2020:4). The Monetary Committee had noted that the slow recovery and economic contraction will keep inflation rates below the midpoint of the target in 2020 despite the higher-than-expected inflation rates in July 2020. The Monetary Committee released another report in September 2021 which reported a slightly higher headline consumer inflation for 2021 of 4.4 per cent. An issue of concern is the unstable oil prices and estimated rising petrol price inflation at 16.1 per cent (previously 15.3 per cent) as well as a weaker currency (Kganyago, 2021:4-5) which further increases the household expenditure and threatens to lead to a decline in household savings.

Another impact on household expenditure is the constant increase in the costs of electricity as a result of the electricity shortages experienced in South Africa since 2018 (Khobai et al., 2017:6). The unstable electricity supply also has an adverse effect on the industrial sector which is the main economic contributor to South Africa's Gross Domestic Product (Ateba et al., 2019:1325). The pandemic led to about 1.7 million fewer jobs when compared with 2019, loss of income and the loss of about 50 000 South African lives (National Treasury, 2021a:7). On a positive note, the Monetary Committee reported that the domestic economy has grown by 4.2 per cent in the first quarter and by 4.7 per cent in the second quarter in 2021 (Kganyago, 2021:2). Despite the negative economic impact of the pandemic, the agriculture sector performed well with a 13.1 per cent increase in production in 2020 while other industries such as the construction and transport industry were hit hard by the pandemic (Stats SA, 2021). These statistics provide further evidence for the importance of a diversified investment portfolio.

The Covid-19 pandemic and the subsequent lockdowns experienced globally have had an impact on the retirement savings industry. The impacts have included a decrease in the value

of the underlying assets in the retirement fund as a result of a downturn in the financial markets during this period, a decrease in member contributions due to job losses or salary reductions and an increase in cyber-attack risk as a result of remote working during the pandemic (OECD, 2020). The effect of the pandemic on the economy was exacerbated by the already strained economy as a result of years of low levels of growth which was furthered pushed down in 2019 by the return of load-shedding while the country continues to experience rising rates of unemployment which was as high as 32.5 per cent in the fourth quarter of 2020 (World Bank, 2021).

In terms of retirement funds, Finance Minister, Enoch Godongwana, made an announcement at the 2020 Medium-Term Budget Policy Statement in Parliament regarding proposed retirement fund reform to allow South Africans access to their retirement savings in order to allow them to deal with the financial distress that many South Africans find themselves in after the loss of jobs, decrease in income and loss of lives following the devastating effects of the Covid-19 pandemic. If these proposals were to be implemented, the current laws and policy around retirement funds would have to be amended. The amended laws would likely allow for limited withdrawals with a mandatory preservation to ensure that retirement savings are not entirely used up before retirement. (National Treasury, 2021b;1-2) These considerations currently cover Pension and Provident funds, but a similar course of action is being considered for Retirement Annuities (National Treasury, 2021b;2).

According to the 2021 Schroders Global Investor Study (GIS), about 69 per cent of South Africans indicated their desire to increase their retirement savings as a result of this pandemic (Nkosi, 2021) which serves to have a positive impact on the lives and livelihoods of South Africans in future. The pandemic might have had a detrimental effect; however, it has helped investors learn the importance of a balanced investment portfolio, the need for increased savings and overall better management of their budgets. This is not the first pandemic or event to have such an effect on the markets and might not be the last, therefore, it is important for investors to give their investments time to recover and to re-evaluate their investment choices to decrease the chances of another event of this magnitude wiping out their retirement savings.

Tax evaluation of the investment portfolio

With the purpose of evaluating the proposed investment portfolio from a tax perspective, a simulated calculation using a fictional scenario has been done. This calculation determines the

net tax payable by an investor, investor A, who has used the proposed investment portfolio for retirement planning purposes and compares the net tax payable to investor B, who has only used retirement-specific investments specifically a Retirement Annuity Fund and Pension Fund only. The two scenarios examined are firstly, the net tax payable before retirement, secondly, the net tax payable after retirement.

- Investor A

Investor A is 64 years of age and invested in an endowment policy, a REIT and a Retirement Annuity Fund when he was 35 years of age. The tax liability for scenario one is being determined for the 2021 tax year which runs from 1 March 2020 till 28 February 2021.The second scenario for investor A will assume that the tax rates applicable on retirement, at the age of 65 years, is the 2022 tax year tax rates.

i. Scenario one: 2021 tax year: Tax payable during years of employment

	Total (R)
Salary for the year	600 000
Medical Aid monthly contributions-employee only, main member	3 822
Endowment policy initial lump sum payment	10 000
Endowment policy monthly contributions	500
REIT- 5000 shares @ 486 cents per share	24 300
REIT dividend- 5000 shares @32.33 cents per share	1 617
Retirement Annuity monthly contributions- 13.5 per cent of salary	6 750

	Calculation/Reason	**Total (R)**
Salary	50000 x 12 months	600 000
Dividends-L2D REIT 5000 shares	5000 x 32.33cents	1 617
Gross Income		*601 617*
Less:Exemptions		
Local dividends	s10(*k*)(i)(aa)excludes dividends from REITs	0
Less: Deductions		
Retirement fund contributions		-81 000
Actual RAF contributions	6750 x12 months	
s11F Limited to lesser of; *R350 000 or,* *27.5% x the higher of* *Remuneration R600 000=165 000* *Taxable Income R601 617=165 445* *Therefore limit is R165 000, allow the contributions in full*		
Taxable Income		**520 617**
Normal Tax on taxable income	(36% x (520617-445100) + 105429)	**132 615**
Less:Rebates		
Primary rebate		-14 958
Medical fund tax credit	319 x 12 months	-3 828
Normal tax		*113 829*
Net normal tax payable		**113 829**

The net normal tax payable for investor A is R113 829 during employment.

- Investor B

Investor B is 64 years of age and invested in Pension and a Retirement Annuity Fund when he was 35 years of age. The tax liability for scenario one is being determined for the 2021 tax year which runs from 1 March 2020 till 28 February 2021. The second scenario for investor B will

assume that the tax rates applicable on retirement, at the age of 65 years, is the 2022 tax year tax rates.

i. Scenario one: 2021 tax year: Tax payable during years of employment

	Total (R)
Salary for the year	600 000
Medical Aid monthly contributions-employee only, main member	3 822
Pension Fund-employer monthly contributions	4 500
Retirement Annuity monthly contributions- 13.5 per cent of salary	6 750

	Calculation/Reason	**Total (R)**
Salary	50000 x 12 months	600 000
Fringe benefit: Pension fund defined contribution		57 000
Gross Income		*657 000*
Less: Exemptions		
Less: Deductions		
Retirement fund contributions		- 138 000
Actual RAF contributions	6750 x 12 months	
Actual PF contributions	(9% x 50000) x12	
s11F Limited to lesser of; *R350 000 or,* *27.5% x the higher of* *Remuneration R657 000=180 675* *Taxable Income R657 000=180 675* *Therefore limit is R180 675, allow the contributions in full*		
Taxable Income		519 000
Normal Tax on taxable income	(36% x (5–9000 - 445100) + 105429)	132 033
Less: Rebates		
Primary rebate		-14 958
Medical fund tax credit	319 x 12 months	- 3 828

Normal tax		113 247
Net normal tax payable		**113 247**

The net normal tax payable for investor B is R113 247during employment.

When looking at scenario one, the tax payable by investor A is only R582 higher than investor B. Scenario two will look at the tax payable by the two investors on retirement, assuming both investors are 65 years of age and retired 31 July 2021 (falls within the 2022 tax year).

- Investor A
    ii. Scenrio two: 2022 tax year rates: Tax payable on retirement

	Total (R)
Salary until retirement- 50 000x 5 months	250 000
Annuity income after retirement- 36391x7 months	254 737
Medical Aid monthly contributions-employee only, main member	3 822
Endowment policy lump sum withdrawal	100 000
Endowment policy monthly contributions (for 5 months)	500
REIT- 5000 shares @ 486 cents per share	24 300
REIT dividend- 5000 shares @32.33 cents per share	1 617
Retirement Annuity monthly contributions (for 5 months)	6 750
Retirement Annuity lump sum	2 180 000

	Calculation/Reason	**Total (R)**
Salary	50000 x 5 months	250 000
Dividends-L2D REIT 5000 shares	5000 x 32.33cents	1 617
*Assume same dividend paid in 2022		
Annuity- RAF	36391 x 7 months	254 737
Lump sum received-RAF		0
Endowment lump sum	capital in nature-Para 55 (1)(a) Eighth Schedule exempts from capital gain	0
Gross Income		*506 354*
Less: Exemptions		

Local dividends	s 10(k)(i)(aa)excludes dividends from REITs	0
Less: Deductions		
Retirement fund contributions		
Actual RAF contributions	6750 x 5 months	- 33 750
s11F Limited to lesser of; *R350 000 or,* *27.5% x the higher of* *Remuneration R504 737=138 803* *Taxable Income R506 354=139 247* *Therefore limit is R139 247, allow the contributions in full*		
Taxable Income		**472 604**
Add: taxable income on lump sum		*2 180 000*
Total taxable income		**2 652 604**
Normal Tax on taxable income*	(36% x (472604 - 467500) + 110739)	**112 576**
Less: Rebates		
Primary rebate		-15 714
Secondary rebate		-8 613
Medical fund tax credit	332 x 12 months	- 3 984
Normal tax		84 265
Tax on retirement fund lump sum		
tax on R2180 000	(36% x (2180000 - 1050000) + 130500	537 300
Net normal tax payable		**621 565**

*Normal Tax on taxable income is the tax calculated on the taxable income before adding the lump sum benefit received. The lump sum retirement benefit is taxed at a different rate, using a specific tax rate table which is applicable to retirement/death and severance benefits.

The net normal tax payable for investor A is R621 565 after retirement.

- Investor B

	Total (R)
Salary until retirement- 50 000 x 5 months	250 000
Annuity income after retirement- 36391 x 7 months and 10050 x 7 months	325 087
Medical Aid monthly contributions-employee only, main member	3 822
Retirement Annuity monthly contributions (for 5 months)	6 750
Pension lump sum	100 000
Pension Fund-employer monthly contributions	4 500

	Calculation/Reason	**Total (R)**
Salary	50000 x 5 months	250 000
Annuity- RAF	36391 x 7 months	254 737
Annuity-PF	10050 x 7 months	70 350
Fringe benefit: Pension fund defined contribution	(9% x 50000) x 5	22 500
Lump sum received-RAF		0
Lump sum received-PF		0
Gross Income		*597 587*
Less: Exemptions		
Less: Deductions		
Retirement fund contributions		
Actual contributions	6750 x 5 months	-33 750
Actual contributions	(9% x 50000) x 5	-22 500
s11F Limited to lesser of; *R350 000 or,* *27.5% x the higher of* *Remuneration R272 500=74 938* *Taxable Income R597 587=164 336* *Therefore limit is R164 336, allow the contributions in full*		
Taxable Income		**541 337**
Add: taxable income on lump sum	2180000 + 100000	2 280 000
Total taxable income		**2 821 337**
Normal Tax on taxable income	(36% x (541337 - 467500) + 110739)	**137 320**
Less: Rebates		
Primary rebate		- 15 714
Secondary rebate		- 8 613
Medical fund tax credit	332 x 12 months	- 3 984
Normal tax		109 009
Tax on retirement fund lump sum		

tax on R2280 000	(36% x (2280000 - 1050000) + 130500	573 300
Net normal tax payable		**682 309**

The net normal tax payable for investor B is R682 309 after retirement.

When looking at scenario two, investor A has a net normal tax payable that is less than investor B by R60 744. Investor A has a lower tax payable on retirement because he benefits from the treatment of withdrawals from endowment policies which are not taxed in the hands of the investor. Although this investor receives less monthly income from the REIT dividend compared to investor B's pension annuity it does not significantly affect the investor's available cash and he is able to withdraw regular amounts from his endowment policy when needed.

Conclusion

What this chapter has established is that the tax treatment of an investment portfolio that includes an Endowment policy, Retirement Annuity Fund and a REIT may lead to higher net tax payable in the short-term or during the years of employment mainly as a result of the dividends received from REITs which are not exempt from tax according to s 10(*k*)(i)(*aa*) of the Act. However, the amount of dividends received from an investment in a REIT is not high enough to have a significant negative effect on the tax payable by this investor. By the time the investors reach retirement and receive their pay-outs from their different investments, the tax payable by the investor that only invested in a Retirement Annuity and Pension fund is higher than the tax payable by the other investor. The tax treatment of the lump sum from the Endowment policy compared to the tax treatment of a lump sum from a Pension fund is what leads to the significant difference in the tax payable at retirement. Therefore, it can be concluded that based on the difference in tax treatment, the investor with the combination of retirement specific and non-retirement specific investment, benefits from a lower tax payable on retirement when these funds are accessed.

Chapter 6: Life after retirement: how to secure monthly income

Introduction

This report has discussed three different investment vehicles that an investor can use when planning towards his or her retirement. It is important to choose the right investment vehicle, taking into account the specific needs, risk appetite and age of the investor, however, it is also crucial to secure a monthly income that is consistent and reliable for retirement. Once the investor has chosen his or her investment vehicles to accumulate capital, the investor must also decide on the right vehicles to use to generate or provide him or her with the accumulated capital as monthly payments. As prescribed by the Income Tax Act, the two-thirds of the Retirement Annuity fund value must be taken in the form of an annuity. This chapter discusses the different options available to the investor which he or she can use to secure monthly post-retirement income with a specific focus on living and life annuities, discretionary trusts and endowment policies. It is important to ensure that the retirement savings are adequate and secure to allow the investor to be able to afford basic essentials without having to actively work during retirement to supplement his or her monthly income.

This chapter provides a brief overview of post-retirement income options that are available to investors.

An overview of post-retirement income options

- Living versus Life annuities

A Living annuity provides post-retirement income to the investor while investing the initial lump sum investment into underlying assets with the aim of increasing the returns for the retired investor and allows the investor to choose an annual income of between 2.5 per cent and 17.5 per cent of the value of the annuity (Coronation, n.d.). Living annuities offer flexible income, an inheritance for beneficiaries upon death, potential for investment growth and the option to choose the underlying assets invested in however, this also means that investors face the risk of outliving their savings and a fluctuation in capital with the performance of the underlying assets (Old Mutual, 2019).

On the other hand, Life annuities provide post-retirement income throughout the life of the investor that may increase annually, however these increases may not always keep up with inflation, so it is up to the investor to choose a life annuity that will keep up with inflation (Wentzel, 2020). It is also worth noting that Life annuities generally donnot provide for the remaining capital to be paid to the investor's beneficiaries upon death (Wentzel, 2020). Whether the investor chooses a Living or Life annuity, the monthly income is taxed in the hands of the investor according to their marginal tax rate which will most likely be lower than his or her marginal tax rate before retirement due to their reduced sources of income.

The tax rates applicable to individuals will be applicable to the income the investors receive from the chosen annuity as follows:

2022 tax year (1 March 2021 – 28 February 2022)

Taxable income (R)	Rates of tax (R)
1 – 216 200	18% of taxable income
216 201 – 337 800	38 916 + 26% of taxable income above 216 200
337 801 – 467 500	70 532 + 31% of taxable income above 337 800
467 501 – 613 600	110 739 + 36% of taxable income above 467 500
613 601 – 782 200	163 335 + 39% of taxable income above 613 600
782 201 – 1 656 600	229 089 + 41% of taxable income above 782 200
1 656 601 and above	587 593 + 45% of taxable income above 1 656 600

Figure 6 : Individuals Tax table (Source: SARS, Rates of Tax for Individuals, 2022)

Section 10C provides for the exemption of the non-deductible portion of the compulsory annuities. When the investor receives his or her lump sum payment from the Retirement

Annuity fund, any unclaimed section 11F contributions from prior years of assessment can be used to reduce the tax liability on the lump sum received, and any remaining unclaimed contribution can be used to reduce the tax liability on the annuity income received from the remaining two-thirds of the retirement funds (Coetzee et al., 2020:341).

- Section 10A of the Act-Purchased annuities

The investor may decide to use the lump sum received from the Retirement Annuity fund to purchase an annuity from an insurer and then receive the lump sum as a monthly payment. This type of annuity is referred to as a 'purchased annuity'. The lump sum that has been received will be subject to tax as discussed in Chapter 4, as well as the monthly income that is earned from the purchased annuity. Therefore, s 10A of the Act provides for the exemption of the capital portion which was already subject to tax. (Coetzee *et al,* 2020:339-340)

The capital portion of the purchased annuity is calculated by way of a formula prescribed in s 10A(3) of the Act as follows:

$$Y = \frac{A}{B} \text{ x } C$$

Where:

Y: Capital portion to be calculated

A: Lump sum paid to the insurer

B: Sum of the returns expected during the duration of the annuity contract

C: The total annuity amount received during the year

In order to calculate the sum of all the returns expected it must be determined if the annuity is purchased for a fixed term or for the rest of the investor's life. If the annuity is for a fixed term, then 'B' is calculated by multiplying the yearly return by the fixed term whereas if the annuity is for the rest of the investor's life, then the life expectancy must be used instead of the fixed term. The life expectancy is determined using the life expectancy tables (which can be found in the Government Notice R1942 dated 23 September 1977) and is based on the age of the investor on commencement of the annuity contract (Coetzee et al., 2020:341).

- Discretionary trust versus Endowment policies

A trust is classified as a legal entity in the Income Tax Act and is created to hold assets for the benefit of another person/s or entities (BDO, n.d.:3). A trust can be formed during the life of the founder, known as Living (Inter Vivos) Trust or after the death of the founder, known as a Testamentary (Mortis Causa) Trust (Wong, 2021). The trust can either be a discretionary or a vested trust. The focus of this report is the discretionary trust. A discretionary trust provides for the appointed trustees to determine how and when to allocate income or capital of the trusts to the beneficiaries (BDO, n.d.:9). The founder of the trust can be a beneficiary and a trustee as long as he or she is not the only trustee. The discretionary trust can allocate monthly income to the investor during retirement and can also take ownership of the investor's assets such as his or her house and other investments which provides for the protection of those assets from creditors in most instances. Unfortunately, trusts pay income tax at a fixed rate of 45 per cent which is the highest individual tax rate and capital gains tax at 36 per cent. Any income or capital gains that have not been distributed or vested in the beneficiaries, will be taxed in the hands of the trust (Wong, 2021).

Endowment policies have been discussed in detail in Chapter 3. In terms of post-retirement income, an investor can choose to arrange for regular withdrawals from his or her chosen endowment policy to provide the required income during retirement while benefiting from the tax benefits available. The income tax rate applicable to endowment policies is 30 per cent which is lower than the 45 per cent applicable to the discretionary trust and as such, leaving the retirement savings in an endowment policy throughout the retired investor's lifetime would be the more optimal from a tax perspective.

Tax implications

The definition of gross income in the Act, which was discussed in Chapter 2, specifically includes amounts received by way of annuity in the definition and as such, these amounts will be subject to tax in the hands of the investor. There are a number of tax benefits enjoyed by South Africans after the age of 65 years. These are discussed briefly in this section to provide an overview of the tax relief that is available post-retirement age. Firstly, the interest exemption in s 10(1)(*i)* which states that any interest received by a natural person will be exempt from tax up to a specific amount, provides for a higher interest exemption of R 34 500 when the taxpayer is 65 years of age or older whereas those below 65 years of age only receive an exemption of R 23 800. The Income Tax Act also provides for a higher tax threshold above which a person

who is at least 65 years would start paying tax compared to a person who is below the age of 65 years as shown in the below table:

Age	Tax Year			
	2022	**2021**	**2020**	**2019**
Under 65	R87 300	R83 100	R79 000	R78 150
65 and older	R135 150	R128 650	R122 300	R121 000
75 and older	R151 100	R143 850	R136 750	R135 300

Figure 7 : Tax thresholds (Source: SARS, Rates of Tax for Individuals, 2022)

Secondly, s 6B of the Act which provides for the deduction from the normal tax payable of an additional medical tax credit, allows for a greater deduction for taxpayers who are at least 65 years by allowing for all qualifying medical expenses to be included in the calculation of the s 6B tax credit. Qualifying medical expenses are expenses paid by the taxpayer which have not been reimbursed by his or her medical aid but are subject to restrictions as set out in the Act such as amounts paid to registered medical practitioners, chiropractors, nursing homes or pharmacists who have provided prescribed medicines (section 6B (1) of the Act). This tax credit is calculated as follows;

Age and Disability Status	**Formula used to calculate additional Medical Expenses Tax Credit**
Under 65, No Disability	25% of: Total contributions paid to the medical scheme *Less:* (4 x Medical Scheme Fees Credit) *Plus:* (Qualifying medical expenses paid less 7.5% of taxable income)
Under 65, Disability	33.3% of: Total contributions paid to the medical scheme *Less:* (3 x Medical Scheme Fees Credit) *Plus:* (Qualifying medical expenses paid)
65 or Over, With or Without Disability	33.3% of: Total contributions paid to the medical scheme

	Less: (3 x Medical Scheme Fees Credit) *Plus:* (Qualifying medical expenses paid)

Figure 8: Calculating the additional medical tax credit, s 6B(1) of the Act (Source: TaxTim, Medical Expenses & Tax, 2022)

Thirdly, the tax rebates under s 6(1) of the Act provide for a natural person to deduct an amount, in accordance with his or her age category, from the normal tax payable excluding tax payable on retirement lump sum or severance benefits when determining the tax payable to SARS. This tax rebate increases from the age of 65 years as shown below:

Tax Rebate	**Tax Year**			
	2022	**2021**	**2020**	**2019**
Primary	R15 714	R14 958	R14 220	R14 067
Secondary (65 and older)	R8 613	R8 199	R7 794	R7 713
Tertiary (75 and older)	R2 871	R2 736	R2 601	R2 574

Figure 9 : Tax rebates, s 6 of the Act (Source: SARS, Rates of Tax for Individuals, 2022)

The rebate is cumulative, in other words, a taxpayer that is 65 years of age and older may deduct a normal tax rebate of R24 327 (R15 714 + R8613) which serves as another tax relief that is available to retired investors. The rebate cannot result in a net tax credit position and is limited to an amount of zero, in other words if normal tax less rebate is equal to a negative amount, then the result is limited to zero.

Conclusion

It is evident that although retirement may come with reduced sources of income, the Income Tax Act has provided a number of tax benefits to assist those 65 years of age and older to alleviate the financial burden they may face as they have to rely heavily on their accumulated retirement savings. Investors have the responsibility to not only choose the best investment vehicles in which to accumulate capital but to also ensure that their accumulated capital is paid out to them on a regular basis in such a way as to preserve the funds for their lifetime. There is a greater likelihood of increased medical expenses with age therefore, the retired investor must

ensure that they are able to continue to pay for medical aid and must ensure to keep all the required documents for out-of-pocket medical expenses in order to qualify for the s 6B additional medical tax credit for qualifying medical expenses.

After briefly evaluating the post-retirement income vehicles available, it would be beneficial for the retired investor to use a combination of an endowment policy and a life annuity. This would allow the retired investor to continue to benefit from the tax efficiencies available to endowment policies including the relief from the tax administration burden as well as benefit from a guaranteed income that the life annuity provides. It would also be beneficial for the retired investor to arrange for his or her annuity to provide him or her with the minimum required monthly amount to maintain his or her desired retirement lifestyle in order to keep his or her tax liability as low as possible.

Chapter 7: Conclusion

Introduction

This chapter provides a summary of the findings of this research report and provides a conclusion on the research question as well as potential areas for further research.

Summary of findings and conclusion

The main research question that was addressed by this report is whether a combination of retirement specific and non-retirement specific investment vehicles leads to an optimal investment portfolio for retirement from a tax perspective. The three investment vehicles chosen were REITs, Retirement Annuity funds and Endowment policies.

Each of the three investment vehicles have characteristics that either add to the benefits for investors or are a disadvantage. In terms of REITs, investing in one allows for the receipt of dividends during employment which can be used to decrease debt steadily over the years of investment before retirement or these dividends can be put into another investment such as a Tax-free investment where these funds can accumulate returns while benefiting from the exemption provided under the s 12T provision of the Act. Upon subsequent disposal of the investor's shares in a REIT, should the need arise for cash, if the investor has held the shares for at least three years then he or she will benefit from being taxed in accordance to CGT and not income tax in line with s 9C(2) of the Act's classification of equity shares as capital in nature. This is another tax benefit of including a REIT in an investment portfolio, although in the short-term it leads to higher tax payable as a result of the dividends received, the benefits outweigh this tax on dividends.

An endowment policy is another vehicle that has been proven to be beneficial to the wealthier investor with a marginal tax rate greater than 30 per cent. As a result of the fixed rate of tax at 30 per cent and the effective CGT rate of 12 per cent which is lower than the effective CGT rate for individuals of 18 per cent (para 10(1) of the Eighth Schedule), investors can benefit from these lower tax rates which in turn, increases their potential savings. Another advantage of an Endowment policy is the 'tax free' nature of the withdrawals as the funds have already been taxed in the hands of the insurer and para 55(1)(*a*) of the Eighth Schedule provides for the exclusion of any capital gain or loss realised by a person on the receipt of an amount with regards to long-term assurance policies provided that the recipient is one of the original

beneficial owners or the spouse/dependent of one. This provision results in the investor paying no tax on the lump sum received on retirement which results in a significant tax saving.

It is already generally well-known that retirement specific funds have tax benefits to encourage South Africans to save for their retirement and as such reduce the burden on government. Therefore, it would be an oversight on the part of the investor if he or she excludes retirement funds from his or her investment portfolio. Retirement Annuity Funds which were discussed in this report, provide for tax deductions of the investor's contributions, subject to certain limits under s 11F of the Act during the investment period and in addition to these deductions, on retirement, the lump sum benefit is tax-free up to the first R 500 000 (para 9(*b*)(i) of Schedule 1 of the Rates and Monetary Amounts and Amendment of Revenue Laws Act, 2018) received or accrued to the investor. As mentioned in Chapter 4, the limitation in terms of the percentage of the fund that can be invested in certain risky assets according to Regulation 28, may result in lower returns, but the funds are not taxed until withdrawal thus allowing the capital to grow at a faster rate than if it were being taxed throughout the investment period which is the case when it comes to an endowment policy.

When doing a comparison from a tax perspective of an investment with the proposed investment vehicles with a portfolio that consists of only a retirement annuity and a pension fund, it can be concluded that the proposed investment portfolio has benefits that outweigh the retirement specific fund's portfolio. These benefits include additional income before retirement in the form of dividends from the REIT, lower tax rates for the endowment policy and tax deductions and restriction of access to funds offered by retirement annuity funds.

Pension funds are tied to the investors' employment and can only be joined through an employer and therefore if the investor is self-employed then a pension fund is not a viable option. In addition, if the employer resigns from his or her employment, the funds in the pension fund must either be transferred to a preservation fund, a retirement annuity fund or the new company's pension fund to avoid taxation on the withdrawal benefit, such transfer could impose fees on the investor which would decrease the value of retirement funds transferred by the costs incurred on transfer which varies according to the chosen fund (Old Mutual, n.d.). The ability to access a withdrawal benefit upon resignation also poses a threat to the investor's financial independence during retirement due to the possibility of the investor using the lump sum received in an irresponsible and short-sighted manner, whereas, since a retirement annuity fund is not tied to employment, if the investor resigns from a company before retirement, the

fund is not affected and nothing needs to be done by the investor which allows for the retirement funds to continue to grow within the fund.

Both the retirement annuity fund and an endowment policy provide for insolvency protection which is especially beneficial to investors who may be going through financial difficulties which may be further aggravated by events, such as the recent Covid-19 pandemic. This helps in ensuring that once investors reach retirement age, they are able to afford their lifestyles. It would be worth noting, however, that there are certain restrictions on this insolvency protection and a potential investor should seek the appropriate legal and financial advice should the need arise. Investors should review their chosen investment portfolio with their financial advisors on a regular basis to ensure that the investment basket is the most optimal option for the investor, given any new circumstances whether personal or economic, but investors must be wary of making any rash decisions regarding their investments during any economic downfalls and should rather allow their investments time to recover in line with the advice given by their financial advisors.

The main research problem was addressed by this report, and it can be concluded that based on the analysis of the tax treatment in this report, that a combination of retirement specific and non-retirement specific investment vehicles does in fact, lead to an optimal investment portfolio from a tax perspective.

Potential areas for further research

This report analyzed two non-retirement specific investment vehicles and limited the study to exclude estate planning which forms an important part of tax planning. Further research can be done to determine if the inclusion of estate planning in the analysis would have any impact on the chosen investment portfolio. It would also be beneficial to analyze the tax implications of an investment portfolio that includes both a retirement annuity and pension fund together with any other non-retirement specific investment vehicle.

Concluding remarks

The three investment vehicles chosen were evaluated from a tax perspective and it is important for investors to consult with financial advisors and other financial experts to assist them in choosing the right investment vehicles, considering their specific circumstances and financial

goals. This report does not serve as financial advice, but merely provides information that can be used to gain a better understanding of retirement and tax planning for retirement.

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