



Using a retirement annuity as an estate planning tool

Additional contributions to an RA provide opportunities for astute financial planning.

This idea was first published in January 2008 and was amended again in August 2009. This third amendment takes into account the recent amendments to the tables applicable to retirement fund lump sum benefits.

While the focus with retirement annuities is usually on income tax, what about estate planning?

Two of the essential elements of estate planning are:

- o reducing the planner's exposure to taxes (estate duty, donations tax, Capital Gains Tax);
- o ensuring that the planner and/or his surviving family members have sufficient income to maintain their standard of living.

How does a retirement annuity (RA) measure up?

Reducing exposure to taxes

Contributions

Contributions are tax deductible within the following limits:

The greater of R1 750; or
R3 500 – allowable pension fund contributions; or
Fifteen percent (15%) of non-retirement funding taxable income.

Note: This is expected to change following the announcements in the 2011 Budget Speech.

Excess contributions can be:

- o rolled over to subsequent tax years; and
- o thereafter be used to increase the tax-free portion of any lump sums at retirement; and
- o if still not fully utilised, be deducted from income after retirement as if they were current contributions.

Build-up

Since the abolition of retirement fund tax the build-up in retirement annuities is totally tax free.

Consider the following implication – A well-constructed investment portfolio will have exposure to the following asset classes: Cash (fixed interest & long-term bonds), Equity, and Property, with an element of offshore exposure for further risk diversification. When looking at an investor's exposure across these classes the opportunity arises to hold the asset classes with a higher tax exposure, usually cash and property, in the retirement annuity in order to earn a tax-free investment on these assets.

Retirement date

The old rule that the member had to retire from a retirement annuity at age 69 has fallen away.

This has a two-fold benefit for persons over the age of 69:

- they may now join a retirement annuity fund to reduce the tax on the monthly taxable income; and/or
- reduce the dutiable value of their estate from an estate duty perspective.

At Retirement (and Death)

At retirement, the member will have the option of electing up to a third as a cash lump sum. Lump sums taken at retirement will be subject to the following tax concessions:

TAXABLE PORTION OF THE LUMP SUM	RATES OF TAX
R0 to R315 000	0%
R315 000 to R630 000	18% of the amount over R315 000
R630 001 to R945 000	R56 700 plus 27% on the amount over R630 000
R945 001 and above	R141 750 plus 36% on the amount over R945 000

It is important to note that the benefit to be taxed includes all taxable benefits accrued to the member, including withdrawal benefits taken in earlier tax years as well as retrenchment benefits received or accrued after 1 March 2011.

NOTE: Upon death, the full benefit may be taken in the form of a lump sum. Where the beneficiary/-ies elect to take any benefit in the form of a lump sum the lump sum will be deemed to have accrued to the deceased member on the day before his death and will be taxed in accordance with the above table in the deceased's hands. The beneficiary will bear the tax liability, if any.

Assuming that all contributions qualified for a deduction at a 40% marginal rate, the table below indicates the tax saving.

LUMP SUM	EFFECTIVE TAX RATE	TAX ADVANTAGE
R1 000 000	16.1%	23.9%
R1 500 000	22.7%	17.3%
R8 000 000	33.5%	6.5%

*any disallowed contributions could lower the overall effective tax rate even further

Annuity Income

Retirement annuities will provide a protected income source for the member and/or his dependents at death or retirement. Annuity income from the retirement annuity is taxed at the recipient's marginal rate of tax.

The incidence of tax on the annuity can be lessened by:

- selecting an income percentage rate from as low as 2.5%;
- deducting the remaining excess contributions from the income after retirement;
- spreading the annuity income across a number of nominated beneficiaries upon the death of the planner, which may reduce the overall tax burden.

Estate Duty

Contributing to a RA will allow the contribution to be taken out of an estate without attracting donations tax, but with the added benefit of an income tax deduction.

Upon the death of a member, any benefit (including lump sums) payable in consequence of membership of a retirement fund will be excluded from the deceased's estate for estate duty purposes. Therefore, in addition to the

income tax advantage, the contribution to the retirement annuity will reduce the dutiable value of the planner's estate by 20% (being the current estate duty rate) on the contribution. Any growth on the contribution also takes place outside of the planner's estate.

CGT

The combination of estate duty and CGT (Capital Gains Tax) payable at death poses an enormous threat to the value of a client's estate. Retirement annuities are not subject to CGT (or estate duty).

Living Annuities

For planners with the correct profile, investing in a single contribution retirement annuity and then electing a living annuity can be likened to being a beneficiary of a Trust.

The amount applied to buy the annuity does not form part of the member's estate for estate duty purposes. A Living Annuity has the following additional benefits:

- A Living Annuity is protected against creditors in the case of insolvency or divorce. With divorce, it's important to note that this does not apply during the build-up phase.
- A beneficiary/beneficiaries can be nominated to receive an income upon the death of the investor.
- The investor can select the underlying assets in which the annuity is to be invested.
- No Capital Gains Tax, Income Tax or Retirement Fund Tax is payable on the assets backing the Living Annuities.
- The percentage and frequency of payouts can also be selected. This means that the investor can regulate income flows annually on the anniversary of the contract. The income percentage on all new contracts concluded after 1 March 2007 may not be less than two and a half percent (2,5%) simple interest rate of return calculation and may not exceed seventeen and a half percent (17,5%) simple interest rate of return calculation - subject to the condition that the annuity will be for the life of the annuitant.

A retirement annuity provides a planner with the opportunity to make additional provision for their retirement, together with the potential for saving income tax, estate duty and CGT, as well as ensuring that the member and/ or his dependents are provided with a protected income source at death or retirement.

Case Study

Mr Smith is 80 years old and has an estate duty 'problem'. Part of his estate consists of a share portfolio of R5 million (the base cost of which was R4 million).

Compare the position where he retains the shares in his own estate with what the position would be if he sold the shares and transferred the proceeds to a retirement annuity with the same underlying portfolio.

Assume he never leaves the fund and his beneficiaries elect to take the full benefit as a lump sum. Ignore growth for the sake of the example.

Retained in own estate until death		Transfers to an RA	
Gross dutiable value of shares	R5 000 000	CGT on disposal of shares	R100 000*
Less : CGT on disposal of shares	(R 100 000*)	Tax on the Lump sum	R 0**
Dutiable value	R4 900 000	Estate Duty	R 0
Estate duty @ 20%	R 980 000		
Total cost: R980 000 + R100 000		Total cost: R100 000	
		Total saving R980 000	

<p>*CGT calculation R5 000 000 – R4 000 000 = R1 000 000 Effective rate 10% CGT R100 000 Ignores annual exclusion of R20 000 and R200 000 in year of death.</p>	<p>** R4 900 000 to be treated as a disallowed contribution and will as a result be tax-free.</p>
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The example also assumes that a surviving spouse is not the beneficiary.