Why retirement contributions don't reduce your taxable capital gains

You may be aware that every tax year you can make a pre-tax contribution to your retirement fund of up to 27.5% of the higher of taxable income or remuneration, capped at R350 000 per year. But you may not be aware that the tax deduction you are entitled to from contributing to your retirement fund can include taxable capital gains. The logical next question to ask is whether your retirement contributions can reduce that taxable capital gain.

Unfortunately, the answer is no. The retirement savings deduction is applied to reduce your income amount before the taxable capital gain is added. In other words, your taxable capital gain is still fully taxable.

The confusing part is that the South African Revenue Service (SARS) uses the words 'taxable income' in two instances: One for determining the maximum amount you can deduct for tax purposes for retirement fund contributions, and the other to determine your final tax liability.

Taxable income is used to determine the maximum amount you can deduct for tax purposes for retirement fund contributions

Your retirement deduction calculation tells you how much of a deduction you will get from SARS based on the amount you save for retirement. It has no bearing on the sum of your taxable capital gain. This is where the first use of 'taxable income' comes into play. To work out your maximum annual retirement fund deduction, you need to determine the following amounts:

- **Your remuneration** – how much did you earn from your employer (including any commissions and bonuses)?
- **Your taxable income** – the sum of the taxable income you earn from your employer, other income (such as rental, annuity income and the taxable portion of your interest income) and any taxable capital gain you have made for the tax year. The taxable income amount here is effectively your 'income' amount (see **Graphic 1**), plus your taxable capital gains for the year.

Next, you choose the higher of the two figures and multiply it by 27.5% to get your retirement savings tax deduction.

Taxable income is used to calculate your tax liability

Once you have calculated your retirement deduction, you can use it to work out your tax liability for the tax year. The retirement fund deduction is first applied to reduce your income amount and then you add the taxable portion of capital gains. If you look at the complete tax calculation shown in the graphic, you can see this bit in block 3.

What is the benefit of including capital gains?

You can look at it this way: Your maximum retirement deduction would be limited to 27.5% of your annual salary plus any other taxable income you may have earned outside of your employment, such as rental income. Allowing you to include your capital gain in the calculation enables you to benefit from a greater deductible amount. If you can't use the full tax deduction in one year it can roll-over to the following tax year, or it can be used when you take a lump sum from your retirement fund or when you receive an annuity income.

Whether you can use the full tax deduction in the current year or whether it rolls over depends on the proportion of your other taxable income to the amount of your taxable capital gains. There is always a benefit in contributing more to your retirement fund, even if you don't benefit from the entire deduction in the same tax year as the year you make the contribution.

As the end of the 2017/2018 tax season approaches on 31 October, we encourage you to take advantage of these deductions and file your tax return. If you can afford to increase the amount you save for your retirement, you can benefit from an increased tax deduction when you file your return for the 2018/2019 tax year. If you are able to contribute in excess of the maximum tax-deductible amount for this tax year, you will receive the tax benefit next year or at some point in the future.

Graphic 1: Calculating your taxable income

1		2		3		
GROSS INCOME LESS EXEMPT INCOME	–	RETIREMENT FUND CONTRIBUTIONS	+	YOUR TAXABLE CAPITAL GAIN FOR THE TAX YEAR IS ADDED HERE	=	TAXABLE INCOME
INCOME		DEDUCTIONS		TAXABLE CAPITAL GAINS		

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