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Retirement annuities still offer exciting tax benefits

For taxpayers in South Africa, a retirement annuity is still the most exciting tax-saving vehicle available. Contributions to retirement annuities are excluded from taxable income and as such are tax-free. By lowering your taxable income, a contribution to a retirement annuity may also result in your taxable income falling into a lower tax bracket resulting in even more of a tax saving. At retirement, a portion of the retirement annuity (currently R120 000) can be withdrawn tax-free.

If you are not contributing to a pension fund, you can contribute 15% of taxable income to a retirement annuity tax-free. If you receive taxable income that is not taken into account when calculating your pension contribution (such as overtime, bonuses, etc.), 15% of this income can be contributed to a retirement annuity tax-free.

In what follows, it is demonstrated that the total tax saving at retirement can potentially result in a halving of the tax rate charged on your income at the time when the contribution to the retirement annuity was made. It is also demonstrated that this benefit, unlike the current R120 000 tax-free portion at retirement, is not eroded by inflation.

At retirement, a portion of the contributions to your retirement annuity plus the growth on it will be withdrawn in part as a cash lump sum (the maximum being one third of the market value of the retirement annuity) with the balance being transferred tax-free to a living annuity (or similar pension-providing product).

A portion of the cash lump sum withdrawn is tax-free. For those who have held a retirement annuity for less than 26 years, this portion is limited to a maximum of R120 000. For those who have had a retirement annuity for longer than 26 years, an amount of R4 500 may be added to the tax-free amount for each additional year.

Note that no tax is payable on the growth or income earned on the assets in the living annuity.

Let us now consider a person who receives R100 000 of taxable income. He/she pays tax of R40 000 on it and invests the remaining R60 000 in a unit trust fund. A year later, with 10% growth net of fees, this investment is worth R66 000.

Instead of paying tax on it, he/she can use the R100 000 to contribute to a retirement annuity that is already worth R900 000. Assume the contribution grows to R110 000 (also 10% growth net of fees) over the following year (total retirement annuity value of R1.1m). At the end of that year, the person retires and opts to transfer the full R1.1m into a living annuity (no tax payable on transfer).

Let us assume that on the next day the person withdraws R110 000 from the living annuity (this R110 000 represents R100 000 contributed and the growth on it). The R110 000 withdrawal from the living annuity is taxable income and, as such, is taxed at the person's marginal tax rate in that year. Note that in the table below, the after-tax value of the withdrawal is calculated for a range of marginal tax rates.

From the last row of the table, it follows that a reduction of up to 45% in tax paid can be realized on both the contributions to your retirement annuity plus the growth on it **if your marginal tax rate post-retirement is much lower than your marginal tax rate pre-retirement.** This tax saving is not subject to erosion by inflation as the growth on the retirement annuity is likely to exceed inflation.

Investment in retirement annuity	R 100 000			
Growth over 1 year	10%			
Market value of new contribution	R 110 000			
Amount withdrawn from living annuity	R 110 000			
Marginal tax rate after retirement[1]	40%	30%	25%	18%
After-tax value of withdrawal	R 66 000	R 77 000	R 82 500	R 90 200
Tax paid on withdrawal	R 44 000	R 33 000	R 27 500	R 19 800
Reduction in R40 000 tax paid prior to unit trust investment	**0**	**25%**	**38%**	**45%**

Note 1: Marginal tax rate is the tax rate applicable to each additional Rand of taxable income earned.

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