Plexus Wealth Watch March 2016

Capital Gains Tax (CGT) is really becoming a problem for our clients. While that at least means that our investments have increased in value, the recent increase in the inclusion rate relating to CGT has made matters worse.

To re-cap, for individuals, 40% of any capital gain is included in taxable income. A R1million gain thus results in R400, 000 being added to taxable income.

If you are fortunate enough to be in the 41% tax bracket, this means tax of R164, 000.

This is sharply up from a 33% inclusion rate pre 29 February this year, and 25% when Capital Gains Tax (CGT) was introduced in 2001.

This tax is thus effectively 16.4% of the gain.

For companies and trusts it is even worse - an 80% inclusion rate - up from 67% last tax year and 50% when originally promulgated.

In a Trust this thus means an effective rate of 32.8% and for a company, 22.4% (assuming not distributed as a dividend in which case DWT would apply on top of this.)

There are still options for Trusts – capital gains can be distributed to beneficiaries with low tax rates. This is subject to legislative review at present and we will advise clients of any effects of any changes once there is clarity.

CGT is in many cases a very unfair tax. Consider for example an investor who invested in a somewhat mediocre unit trust 10 years ago in the amount of R1m. If that investor sold the unit trust today for R2m he would pay the R164, 000 noted above in CGT (less the small annual exclusion).

However it is fair to say that R2m today is worth less than R1m 10 years ago due to inflation, so the investor has actually not made a capital gain in real terms and has been taxed on inflationary movements in the value of currency.

In many other countries such as the UK, capital gains are first indexed for inflation and then taxed.

One of the best ways to avoid CGT also now allows for enhanced tax deductions.

The Retirement Annuity has sometimes not had a good name. Peddlers have tended to over-estimate future returns, and under-play the corrosive effect of high costs associated with these products.

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These days our Retirement Annuity platform costs are only 0.25% per annum.

Let's compare this to the tax savings.

Assumptions:

- R350, 000 for a 41% rate taxpayer and then no additions made for 20 years to retirement other than the tax refunds received as a result of contributions.
- Returns of inflation plus 5% or an estimated 11% return per annum after costs.
- Dividend yields average 4% and Dividends with-holding tax is 15%
- Income tax rates and CGT inclusion rates stay the same.

Note that within the RA there are no Dividends With-holding Tax - saving 15% on say an average 4% dividend yield saves 0.6% a year.

And then at the end, the gain is not subject to CGT.

	RA	Outside RA
Initial Investment	**R 350 000**	**R 350 000**
Year 1 Tax Refund Invested	R 143 500	
Further Years Tax Refund Invested	R 99 641	
Total invested at Inception	**R 593 141**	**R 350 000**
20 year growth	R 4 782 085	R 2 821 809
Dividends Withholding Tax		R -151 310
Extra costs including VAT	R -119 664	
Investment value before CGT	R 5 255 562	R 3 020 499
CGT		R -437 962
Investment at the end of 20 years	**R 5 255 562**	**R 2 582 537**

Please remember that that R5.2m in 20 years' time will not be enough on which to retire – the 2016 equivalent is about a quarter of this.

One of the main arguments against an RA is that at the end you have to annuitize the proceeds into a Living Annuity.

Annuity income is taxable to the extent that the income is withdrawn from the Living Annuity.

However in most cases, we invest the REIT portion of our clients wealth in the Living Annuity and REIT income is taxable whether through a Living annuity or otherwise.

At retirement, up to a third of the RA value can be taken in cash, subject to lump sum tax for lump sums exceeding R500, 000, so some diversification can be dealt with.

It is also useful to note that in most cases, a retirement annuity or living annuity does not fall into your estate for the purposes of estate duty and executors fees – there is thus an additional 23.99% saving for estates over the threshold on death.

An important note is that there are restrictions in taking the money you put into a Retirement Annuity – you can only convert it to a Living Annuity from age 55, and at that point there is a limit of drawing 17.5% of the capital value per annum.   Whether these are really such adverse factors should be the subject of individual discussions.

It is also useful to note that previously the RA deduction was only on retirement funding income.

It is now on taxable income, which thus now includes investment income that is taxable.

An investor does not need to be able to afford the RA contributions from their salary: why not use an existing investment outside an RA as a once off contribution?

By moving R350, 000 from an investment outside an RA into an RA, you would trigger a tax refund of R143, 500 Cash.

This is one of the potential solutions we could offer you to reduce your Capital Gains Tax liability

We look forward to discussing this and more with you at our next meeting.

Kind Regards

Eric, Connie, James, Don, Amanda and the Plexus Wealth team