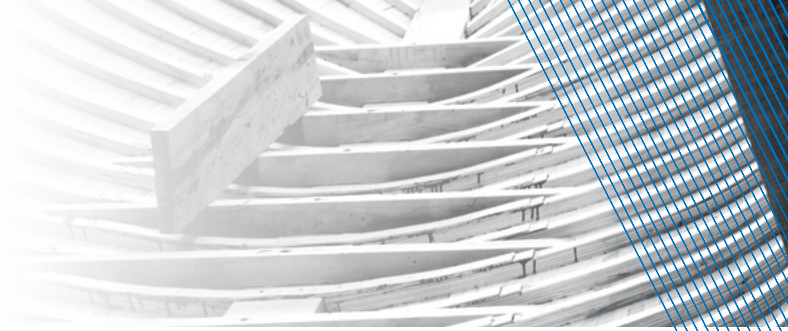
STANLIB Multi-Manager

The Educator

January 2019



In The Educator, we address a number of topics with the ultimate goal of providing a better understanding of investing clients' money.

Part 2: Contributing towards your retirement fund(s) – the impact of CGT on your retirement savings deduction

In part two of a three-part series we discuss the impact of Capital Gains Tax (CGT) when calculating the amount you can deduct for tax purposes. The series of articles focuses on section 11F of the Income Tax Act, which relates to the deduction of contributions to retirement funds.

Review – three limitations to be considered

The amount of the deduction in a particular year of assessment is limited by Section 11F to the lesser (smaller) of A, B and C below:

A: R350 000

B: 27.5% of the greater of:

Remuneration, excluding retirement lump sum benefits and severance benefits; or

Taxable income including a taxable capital gain but before allowing this deduction and the section 18A donations deduction. It also excludes any retirement lump sum benefits and severance benefits

C: Taxable income before the section 11F deduction and before the inclusion of the taxable capital gains

'Taxable income' vs. taxable income – be mindful of the context in which the words are used

Taxable income is used to determine the maximum amount you can deduct for tax purposes for retirement contributions. However, you need to be cautious when applying Section 11F as SARS uses the words taxable income in two instances, which can create confusion. **(1)** For determining the maximum amount you can deduct for tax purposes for retirement contributions, and **(2)** to determine your final tax liability.

The following examples illustrate the above application

The calculation is a three-step process:

- Calculate your **retirement fund deduction** by applying Section 11F
- Add your taxable capital gain to calculate your **taxable income**
- Apply the tax tables to determine your **tax liability**.

Example 1: R50 000 contribution

- Mrs Selinda earns an annual salary of R250 000
- Her employer contributed 20% (i.e. R50 000) to a pension fund on her behalf
- She also earned rental income of R20 000 (no expenses incurred)
- She incurred a taxable capital gain of R2 500 000 after selling shares from the portfolio she inherited from her late father.

Step 1:

The maximum deduction that she can make is limited to the lesser of:

A: **R350 000**

B: The greater of:

27.5% x R300 000 (remuneration) = R82 500 or

27.5% x R2 820 000 = **R775 500**
[R2 820 000 = R320 000 + R2 500 000]

C: R2 820 000 (taxable income) – R2 500 000 (taxable capital gain) = R320 000

The deduction will be limited to the lesser of the three amounts in bold, which is R320 000. Mrs Selinda only contributed R50 000 and therefore can deduct the full amount of **R50 000** for tax purposes.

To the extent that a taxable capital gain is included in taxable income, it will increase the potential deduction and 'saving more tax' for that year of tax assessment.

Step 2:

The following applies under the tax table:

Gross income	**R320 000**
Salary	*R250 000*
Employer contribution	*R50 000*
Rental income	*R20 000*
Plus: taxable capital gain	**R2 500 000**
Minus: retirement fund contributions	**R50 000**
Taxable income	**R2 770 000**

Step 3:

Tax payable	*R1 103 541*
Income/'take home pay' after tax (assume no rebates)	*R 1 666 459*

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Example 2: Retirement fund contribution of R350 000

- Mrs Selinda decided to increase her pension contribution to R350 000 for this year of tax assessment in order to 'get the full tax benefit' now that she has incurred a taxable capital gain of R2 500 000. She used R300 000 from the sale of shares from her equity portfolio to make a voluntary contribution towards a retirement annuity (RA). The total contribution is therefore R350 000 (R50 000 contribution from her employer and R300 000 voluntary contribution).

Step 1:
The maximum deduction that she can make is limited to the lesser of:
A: **R350 000**
B: The greater of:
27.5% x R300 000 (remuneration) = R82 500 or
27.5% x R2 820 000 = R775 500
[R2 820 000 = R320 000 + R2 500 000]
C: R2 820 000 (taxable income) – R2 500 000 (taxable capital gain) = **R320 000**

The deduction will be limited to the lesser of the three amounts in bold, which is R320 000. Mrs. Selinda contributed R350 000 BUT is now limited to deducting only R320 000 for tax purposes.

> **Taxable capital gain included BUT your deduction is limited to 'taxable income' only**

Step 2:
The following applies under the tax table:

Gross income	**R320 000**
Salary	*R250 000*
Employer contribution	*R50 000*
Rental income	*R20 000*
Plus: taxable capital gain	**R2 500 000**
Minus: retirement fund contributions	**R320 000**
Taxable income	**R2 500 000**

Step 3:

Tax payable	*R982 041*
Income/'take home pay' after tax (assume no rebates)	*R1 517 959*

> **The result is almost a 50%* tax saving with the additional R300 000 voluntary contribution**

(*R1 666 459 - R 1 517 959)

Dispelling the myth that your retirement contributions can reduce your tax on capital gains

Confusion exists among investors because taxable income, as defined in Section 11F, includes taxable capital gains. However, if you look at the limitations i.e. part C, the retirement savings deduction is reduced to taxable income before the taxable capital gain is added. In other words, your taxable capital gain is therefore still fully taxable – as illustrated per the above examples – and does not reduce the tax on capital gains.

> **Your taxable capital gain (and the eventual tax arising from it) cannot be eliminated or reduced by the deduction under Section 11F for retirement contributions**

Summary

- SARS uses the words 'taxable income' in two instances. This can create misunderstanding and ultimately, the miscalculation of deductible contributions – 'taxable income' for retirement contribution deductions and taxable income to calculate your final tax payable
- The inclusion of the taxable capital gain in Section 11F of the Income Tax Act, presents the opportunity to allocate a larger contribution to retirement funds for that year of assessment. The additional tax saving is clearly illustrated in the two examples
- The taxable capital gain is included in Section 11F, BUT your deduction limited to 'taxable income' only. Therefore, if you wish to make a larger retirement contribution in a year where you also have a large taxable capital gain, first apply Section 11F to assess the maximum amount you can deduct, before deciding on what your voluntary contribution should be in order to achieve the maximum tax saving
- Your taxable capital gain cannot be eliminated or reduced by the deduction under Section 11F for retirement contributions

STANLIB Multi-Manager is not a tax professional. Please seek the appropriate assistance/advice from a qualified financial or tax adviser.

In the next issue: Deductible contributions – Part 3: The advantages and disadvantages of your retirement contributions being more than the amount allowed for under Section 11F of the Income Tax Act, carried forward to future years of assessment.

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