nmg PERSONAL WEALTH

Maximize the Benefits of your Tax Free Savings Account over the Long-Term

By now, you are probably all too familiar with the Tax Free Savings Accounts (TFSA) which were introduced two years ago as a way to encourage a strong savings culture in South Africa. From 1 March 2015, we are allowed to contribute R 30 000 per annum into this savings vehicle without having to incur capital gains tax, income tax, and dividends withholding tax. There is a lifetime contribution limit of R 500 000 (there is no limit in terms of growth over time), which means that it will take us approximately 17 years to reach our maximum contribution, assuming that these parameters do not change.

There is no restriction in terms of the underlying assets that you hold, nor is there a restriction in terms of how much is invested offshore, which is quite useful as retirement funds restrict our asset allocation exposure to no more than 75% of equities, no more than 25% in property, and no more than 75% offshore amongst other prudential guidelines as set out in Regulation 28 of the Pension Funds Act.

Given the market volatility over the last two years, investors now prefer playing it safe and so request that the underlying asset in the TFSA is a fixed interest instrument such as Money Market. This makes no sense to me as those under the age of 65 are allowed an annual exemption of R 23 800 on any interest earned which means that you will need to have an investment amount of R 297 500 assuming an interest rate of 8% before you even reach that threshold of having to pay tax on income.

Furthermore, 17 years is a fairly reasonable time to be invested in high quality growth assets such as equity and property whereby you will be able to ride out the peaks and troughs of the local and global market in order to realise healthy capital gains on share prices and income in the form of rental income as well as profits from these shares (dividends), all of which is earned and compounded free of tax which becomes very significant over time.

All that's mentioned above is just one part of the story. What we need to understand next is how to further maximize the use of the TFSA to our advantage over the longer term leading up to retirement and beyond.

Now, let's assume that you have reached the maximum lifetime contribution limit of R 500 000 and you still have quite a way to go for retirement. With all else being equal, if I were in this position, I would just keep the funds invested until my retirement age to enjoy the compounding tax-free growth. And at retirement, I would opt to draw an income from my TFSA first and preserve my retirement funds (i.e. corporate pension and provident funds, retirement annuities, preservation funds, etc.) to a later date. Why? Well, there's a couple of reasons and it is all related to optimizing your tax efficiency.

Remember, whilst the growth in retirement funds and living annuities are exempt from tax, the income that you draw from them at retirement is taxed according to Pay-As-You-Earn (PAYE) scales, whereas the income that you draw down from a TFSA is exempt of any tax. In addition, there is one tax that applies on the TFSA – it forms part of your dutiable estate whereas capital left over in your pre-and post-retirement vehicles are excluded from your dutiable estate.

So the approach that I would take at retirement would be to draw an income from my TFSA first over a period of time as I am will not be paying PAYE, and if I manage to deplete it whilst I am still living, it cannot be added to my dutiable estate. After depleting my TFSA, and after I have managed to get further tax-free growth from my retirement funds, I will then exercise my retirement options on those vehicles whereby I will be drawing an income that is taxed based on PAYE scales, but hopefully I would be a lot older and qualify for the further income tax rebates that are granted to those over the age of 65 and more especially those over the age of 75. This will also enable me to sustain the buying power of my retirement capital over a longer period of time leading to my demise, after which there will not be estate duty problem due to the fact that they do not form part of my dutiable estate and can be pass on to my heirs free of any estate duty.

The take-up of the TFSA has been quite reasonable so far, but not great. Based on all of its advantages mentioned above, I am not sure what you are waiting for, but if you are keen to start or make additional investments to the TFSA, I would suggest that you get a hold of your NMG Personal Wealth Financial Adviser before mid-February 2017 to ensure that you meet the cut-off before the financial year ends on 28 February 2017.

Happy Tax-Free Investing!

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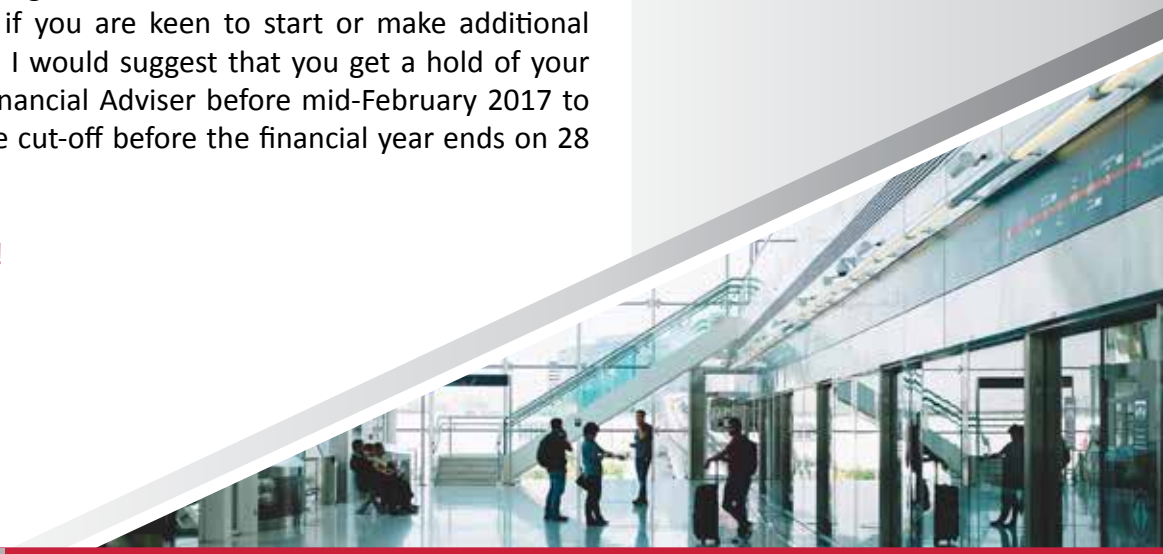

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