June 2021

The pursuit of the seven-day weekend

Part One (of Two)

Search the word 'retirement' on Google Images and you will face an overwhelming number of pictures featuring smiling pensioners, often sitting on a beach with a cocktail in hand. However, the process of saving for retirement has significant challenges not least because increasing life expectancy means that savers are faced with the prospect of spending nearly as many years in retirement as they did in employment. For most South Africans, just ensuring they have enough to get by is their primary concern, long before they think about jumping on a plane for that luxurious beachside holiday.

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01

Masterclass Insights

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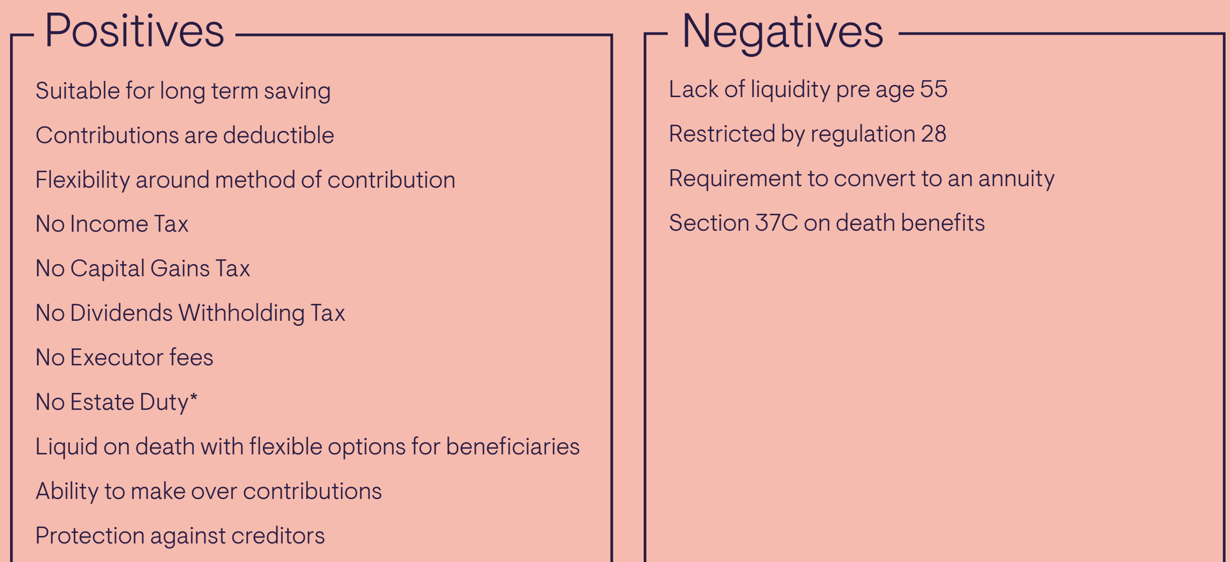
How much is enough

In a recent article 'How much is enough', which I encourage you to read, Paul Hutchinson broke down the formula for a successful retirement by outlining how much you need to save and for how long if you want to maintain your quality of life in retirement. Additional to the challenges posed by increased longevity, savers' progress towards the goals outlined in the article have been hampered by poor local equity returns over the past 10 years. This double whammy has caused many to question whether the retirement fund structure is still able to deliver on its promise. Whilst not an exhaustive list, this article serves to provide a reminder of some of the significant financial planning benefits that retirement funds can provide.

Figure 1: A reminder of retirement fund characteristics



* Provided no disallowed contributions remain on death

Providing a protective habitat

One of the key benefits of a retirement fund is that it provides a protective habitat, shielding investors from several undesirable outcomes. First, a pension fund provides protection against creditors. Second, the growth experienced is maximised by the exemptions from dividends withholding tax, income tax and capital gains tax. Third, and perhaps most importantly, the assets held in a retirement fund are excluded from a person's estate for estate duty purposes. By contrast, if an investor decides to provide for their retirement via a discretionary vehicle instead, those assets form part of their estate and they will be dutiable on death with a consequent reduction in value.

Figure 2 below demonstrates the history of estate duty in South Africa from the time that the estate duty abatement came into effect. The value of the abatement has not changed frequently or significantly, especially when compared to long-term inflation. In a nutshell, the current abatement R3.5m has remained unchanged in more than 13 years.

Figure 2: Estate duty act of 1955 changes rarely ... and provides little relief to discretionary savers

1988 — Estate duty **15%**
Single abatement of
R1 million introduced

1996 — Estate duty increased to **25%**
Single abatement unchanged
at R1 million

2001 — Estate duty reduced to **20%**
Single abatement increased
to R1.5 million

2006 — Estate duty maintained at **20%**
Single abatement increased
to R2.5 million

2007 — Estate duty maintained at **20%**
Single abatement increased
to R3.5 million

2018 — Estate duty increased to **25%**
on balance above R 30 million
Single abatement maintained
at R3.5 million

> It is important to consider that, for most South Africans, investments that are earmarked for retirement represent their only savings.

This is important because a person who earns R1m today and who is retiring in 20 years time will need to have saved approximately R20m in today's terms by the time they retire if they want to maintain their standard of living. If we take the historical changes in relief from estate duty as a guide for future increases, the majority of these savings within a discretionary product will be estate dutiable when they pass away. The estate duty challenge becomes proportionately larger and larger for wealthier individuals, because the relief available represents a smaller percentage of their total accumulated discretionary savings.

However, whilst significant, estate duty is not the only tax that can meaningfully reduce the value available to a person's dependents on death, if using a discretionary product. There are other fees and taxes that need to be factored into the equation. For example, beneficiary nominations on both pre-and post-retirement products ensure that the distribution of those assets fall outside of the control of an executor, meaning that executors fees are not applicable. By redirecting those same savings to a discretionary investment, the involvement of the executor becomes unavoidable and the value available on death will be reduced by the associated fees which can be as much as 4.03% of the capital value.

Capital gains tax is also payable on death for discretionary savings if the benefit passes to anyone other than a spouse. Over the long term, it is highly likely that the growth provides a greater contribution to the overall value than the capital and as much as 18% of that growth could be lost to capital gains tax.

It is important to consider that, for most South Africans, investments that are earmarked for retirement represent their only savings. It is important therefore that they also consider efficiency of succession as part of the planning process to ensure that loved ones, and particularly a surviving spouse, can be provided for quickly on death. A discretionary savings vehicle can be incredibly illiquid on death which could leave dependents without access to funds for a considerable period of time. This can place them under significant financial stress at a time where they are already experiencing substantial emotional turmoil. Beneficiary nominations on living annuities ensure that the investment can pass seamlessly on death to the nominated beneficiaries to ensure they can receive an income that enables them to meet their liabilities.

Beneficiaries need to be aware that if they take the retirement fund benefit in the form of cash that the retirement tax tables will apply which could mean that up to 36% of the value could be lost to tax. However if they choose to take as an annuity they ensure that the full value can be preserved to provide for their future income needs which is after all the purpose for which the savings were made in the first place.

Retirement is a significant lifetime event and the process requires careful planning which begins many years before the event itself. Taking all factors into consideration, not just the investment return, is the right approach and hence capitalising on the benefits of structures such as retirement funds is key to success. In part two, we will discuss the relative tax implications.

As always, we recommend that investors seek guidance from financial advisors to ensure they give themselves the best chance of achieving the retirement they deserve.

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